Preliminary highlights of the proposed anti-hybrid regulations

December 21, 2018

In brief

Treasury released proposed regulations (the Proposed Regulations) under the new dividends received deduction (DRD) and anti-hybrid rules as enacted under Sections 245A and 267A, respectively. Section 245A generally provides a 100% DRD for the foreign-source portion of dividends received by a US corporation from foreign corporations with respect to which it is a US corporate shareholder. Section 267A disallows deductions for certain related-party payments in connection with hybrid transactions or made by or to hybrid entities.

The Proposed Regulations, released December 20, are the first administrative guidance under both Section 245A and Section 267A, which were enacted by the 2017 tax reform act (the Act). (For prior coverage on the Act, see the 'See also' section at the end of this document). The regulations also propose to modify the dual-consolidated loss (DCL) rules under Section 1503(d) and the check-the-box rules under Section 7701.

The Proposed Regulations provide needed guidance related to the mechanics of the new anti-hybrid provisions under Sections 245A and 267A, but also provide several rules that expand the reach of those sections. In particular, the regulations under Section 245A propose to deny the DRD in cases where certain US shareholders receive a 'hybrid dividend' made by controlled foreign corporations (CFCs), clarify the application of Section 245A for hybrid dividends of tiered corporations, and address certain 'hybrid deduction accounts' that are relevant upon the transfer of CFC stock. In addition, the Proposed Regulations clarify the scope of Section 267A as applied to hybrid arrangements involving the payment of interest or royalties by certain branches, reverse hybrid entities, and other hybrid mismatch arrangements. This guidance also proposes to modify the DCL and check-the-box regulations in order to prevent the use of the same deduction in both the United States and in a foreign country. Finally, the Proposed Regulations amend a number of tax reporting requirements under Sections 6038, 6038A, and 6038C.

PwC is in the process of reviewing the Proposed Regulations in detail; some of the key highlights we have identified thus far are set forth below. Look for our forthcoming in-depth Insight on the Proposed Regulations. In addition, we will discuss the new anti-hybrid rules on an upcoming Tax Reform Readiness Series webcast.

In detail

Background

As addressed in previous PwC Insights (see the 'See also' section at the end of this document), the Act added new Section 245A to the Code, which allows a 100% DRD for the foreign-source portion of dividends received by a US corporation from foreign corporations with respect to which it is a US corporate shareholder. Section 245A(e), however, denies the DRD for any foreign-source dividends paid to a US shareholder where the foreign corporate payor receives a deduction or other tax benefit in relation to a hybrid dividend. Section 245A provides that a hybrid dividend is a dividend paid by a CFC to a domestic corporation that is a US shareholder when the CFC is a 10% owned foreign corporation and the CFC receives a deduction or similar benefit for foreign income tax purposes as a result of paying such dividend. Importantly, no foreign tax credit or deduction is allowed for any taxes paid or accrued with respect to any hybrid dividend received by a US shareholder or included in the US shareholder's income.

The Act also added new Section 267A, which denies a deduction for interest and royalties paid or accrued by a corporation to a related foreign party with respect to either (1) hybrid transactions or (2) hybrid entities. Specifically, the anti-hybrid rules apply to a payment made pursuant to a hybrid transaction or made by, or to, a hybrid entity, to the extent that there is no income inclusion by the foreign related party under the tax laws of its country of residence or the related party is allowed a deduction with respect to such amount under the tax laws of its country of residence. Under the statute, the anti-hybrid rules, however, do not apply to any payment to the extent such payment is included as subpart F income of a US shareholder.

Section 267A applies only if a payment is treated as a 'disqualified related party amount.' For defining a 'related party,' the anti-hybrid rules reference the definition of Section 954(d)(3), which provides that a person is generally related if (1) the person controls or is controlled by the payor or (2) for non-individuals (e.g., corporations), the person and the payor are under common control. For corporations, control includes direct or indirect ownership by more than 50% of the vote or value of the payor. For partnerships, trusts, or estates, control includes direct or indirect ownership by more than 50% of the value of the payor. For these purposes, constructive ownership rules of Section 958 apply.

Section 267A broadly defines a hybrid transaction as any transaction (or series of transactions), agreement, or instrument one or more payments with respect to which are treated as interest or royalties for US federal income tax purposes and which are not so treated for purposes of the tax law of the foreign country of which the recipient of such payment is resident for tax purposes or is subject to tax.

A hybrid entity is defined under Section 267A as any entity which is treated as fiscally transparent for US federal income tax purposes but not so treated for purposes of the tax law of the foreign country of which the entity is resident for tax purposes or is subject to tax, or vice-versa.

Congress provided broad regulatory authority to Treasury in Section 267A to address several other cases, including conduit arrangements that involve hybrid entities or transactions, branch structured transactions, certain tax preference items, participation regimes, and dual-resident entities.

Highlights of the Proposed Regulations

The Proposed Regulations--is the first guidance relating to the new DRD and anti-hybrid rules--include seven regulatory sections under new Section 267A and one regulatory section under new Section 245A, as well as certain modifications to existing regulations under Sections 1503(d), 6038, and 7701.

The following provides a high-level summary of key rules set forth in the Proposed Regulations and the impact such rules have on the revised interest expense limitation rules.

Special rules for hybrid dividends under Section 245A

The Proposed Regulations address the double non-taxation effect of a hybrid dividend otherwise eligible for a Section 245A DRD by denying the DRD with respect to the dividend (when received by a domestic corporation) or requiring an inclusion under Section 951(a) with respect to the dividend (when received by a CFC). In these circumstances, Section 245A(d) (denial of foreign tax credits and deductions) applies. In addition, the Section 951(a) inclusion required with respect to a hybrid dividend received by a CFC (a 'tiered hybrid dividend') generally applies without regard to any rule providing for an exception to or reduction in subpart F income (e.g., the Section 954(c) same-country exception and look-through rule do not apply).

The Proposed Regulations closely follow the Section 245A(e) statutory provisions, but expand the scope and potential reach of the particular aspects of the hybrid dividend rules, including with respect to tiered hybrid dividends.

First, the Proposed Regulations expand the definition of hybrid dividend by providing that a hybrid dividend is a dividend if (1) but for

Section 245A(e), a Section 245A deduction would be allowed and (2) the dividend is one for which the CFC (or a related person) is or was allowed a deduction or other tax benefit under a relevant foreign tax law. For these purposes, relevant foreign tax law means any foreign regime that imposes an income, war profits, or excess profits tax with respect to income of the CFC (other than a foreign anti-deferral regime under which an owner of the CFC is liable to tax).

Second, the types of deductions or other tax benefits that fall within the definition of 'hybrid deduction' go beyond what one might expect. Although the Proposed Regulations limit this to deductions or other tax benefits that are 'allowed' under foreign tax law (which effectively accounts for deductions disallowed under foreign hybrid mismatch rules), the regulations adopt a 'connection' approach to define the types of deductions or other tax benefits that relate to or result from an amount paid, accrued, or distributed with respect to an instrument of a CFC. Such an approach would include, e.g., deductions allowed under foreign tax law on equity such as dividends paid deductions and even notional interest deductions. Another example includes foreign currency gain or loss under a comparable Section 988 provision.

Third, the Proposed Regulations create a new 'hybrid deduction account' concept and require that such an account be maintained with respect to each share of stock of a CFC held by a person that, given its ownership of the CFC and the share, could be subject to Section 245A. The account tracks the amount of hybrid deductions of the CFC that have been allocated to the share. Pursuant to the Preamble, this rule is intended to ensure that dividends are subject to Section 245A(e) regardless of whether the dividend and the hybrid deduction arise pursuant to the same payment (or in the same tax year for US tax purposes and for purposes of the relevant foreign tax law). The Proposed Regulations set forth successor rules that apply if the stock of a CFC is transferred to a person (who otherwise is required to maintain a hybrid deduction amount) from the shareholder that held the stock when the hybrid deduction was incurred.

The Proposed Regulations also address tiered hybrid dividends between CFCs and the interaction with Section 959. In particular, the regulations provide that a tiered hybrid dividend does not include amounts described in Section 959(b) (i.e., Section 951(a) previously taxed earnings and profits).

The Proposed Regulations include a coordination rule for gain recognized by a CFC on the sale or exchange of stock in another foreign corporation that is treated as a dividend under Section 964(e). To the extent such a deemed dividend is a tiered hybrid dividend, the tiered hybrid dividend rules, rather than the rules of Section 964(e)(4), apply. As a result, a US shareholder that includes an amount in its gross income under the tiered hybrid dividend rule is not allowed the Section 245A(a) DRD, or foreign tax credits or deductions, for the amount.

The Proposed Regulations include an anti-avoidance rule. This rule provides that appropriate adjustments are made, including adjustments that would disregard a transaction or arrangement, if a transaction or arrangement is engaged in with a principal purpose of avoiding the purposes of Prop. Reg. sec. 1.245A(e)-1.

Scope of the Proposed Regulations under Section 267A

The Proposed Regulations apply to deny the deduction for interest or royalties paid or accrued (a 'specified payment') by a 'specified party' if the amount paid or accrued is described in one of the following three categories, each described in more detail below:

1. A 'disqualified hybrid amount' within the meaning of Prop. Reg. sec. 1.267A-2;
2. A 'disqualified imported mismatch amounts' within the meaning of Prop. Reg. sec. 1.267A-4; or
3. A specified payment satisfying the requirements of the anti-abuse rules in Prop. Reg. sec. 1.267A-5(b)(6).

Under the Proposed Regulations, Section 267A only applies to deductions of 'specified parties,' defined as a:

- tax resident of the United States;
- CFC with at least one US shareholder that directly or indirectly owns at least 10% of its stock; or
- US taxable branch.

While Section 267A generally applies to payments made to CFCs, the Proposed Regulations indicate, however, that Section 267A does not apply to payments made by a CFC to another CFC or to a US shareholder.

The Proposed Regulations define a 'tax resident' to mean an individual, corporation, or other entity liable to tax under the tax law of a country as a resident. Thus, a fiscally transparent entity is not a specified party (although its owners may be).

A US taxable branch is a trade or business carried on in the United States by a tax resident of another country (or, if an income tax treaty applies, a US permanent establishment).

The proposed Section 267A regulations address only 'deduction/no inclusion' (an item for which a deduction is available for the payer with no corresponding income inclusion for a recipient) (D/NI) outcomes; transactions that produce double deductions are addressed through other provisions or doctrines (e.g., the DCL rules under Section 1503(d)).

In addition, the proposed Section 267A regulations only address D/NI outcomes that are the result of hybridity and not a result of, for example, territorial exemption or the absence of corporate income tax of the specified recipient's tax law.

Amount of 'no-inclusion'

The amount of deduction subject to disallowance under Section 267A is generally the amount of 'no-inclusion' in a D/NI scenario. For this purpose, a tax resident or taxable branch is considered to include a specified payment in income to the extent that (under its tax law) (1) the payment in its income is included or tax base at the full marginal rate imposed on ordinary income, and (2) the payment is not reduced or offset by certain items (such as an exemption or credit) particular to such payment.

A specified payment may be considered included in income even though offset by a generally applicable deduction or other tax attribute (e.g., a depreciation deduction or net operating loss).

If a specified payment is taxed at a preferential rate, or if there is a partial reduction or offset particular to the type of payment, a portion of the payment is considered included in income (subject to rules regarding de minimis inclusions and deemed full inclusions).

Whether a tax resident or taxable branch includes in income a specified payment is determined without regard to any defensive or secondary hybrid mismatch rule under its tax law (i.e., a rule requiring income inclusion if a deduction for the amount is not disallowed under applicable tax law).

Furthermore, a long-term deferral--generally, an income inclusion deferred for more than three taxable year--is treated as a 'no-inclusion' outcome.

Hybrid transactions giving rise to disqualified hybrid amounts

The Proposed Regulations generally disallow the deduction with respect to interest or royalties if, by reason of the mismatch of the tax rules of the jurisdiction of the payee and the recipient, the payment is deductible to the payer under its tax law but is not included in the income of the recipient under the recipient's tax law (i.e., a 'D/NI' outcome). The amount disallowed is referred to as a 'disqualified hybrid amount.'

D/NI may arise as a result of a hybrid transaction, defined as a transaction, agreement, or instrument one or more payments with respect to which are treated as interest or royalties for US federal income tax purposes and which are not so treated for purposes of the tax law of the foreign country of which the 'specified recipient' of such payment is resident for tax purposes or is subject to tax. In addition, a payment is deemed to be made pursuant to a hybrid transaction if the taxable year in which the recipient recognizes the payment under its tax law ends more than 36 months after the end of the tax year in which the payor would be allowed a deduction for the payment under US tax law. Thus, even if the payment does not change its character under the recipient's tax law, it may be considered made pursuant to a hybrid transaction because of a long-term deferral of inclusion of the income by the recipient.

Examples of a payment made pursuant to a hybrid transaction include not only situations where the payer jurisdiction would treat the instrument as debt and the payee jurisdiction treats it as equity, but also situations where the payer jurisdiction treats the payment as interest and the payee jurisdiction treats it as return of principal.

A specified recipient is (i) any tax resident that derives the payment under its tax law or (ii) any taxable branch to which the payment is attributable under its tax law. In determining whether a tax resident 'derives' a specified payment, the principles of Treas. Reg. sec. 1.894-1(d)(1) apply.

A specified payment made pursuant to a hybrid transaction is generally a disqualified hybrid amount to the extent that the specified recipient does not include the payment in income.

Disregarded payments giving rise to disqualified hybrid amounts

The Proposed Regulations also provide rules that disallow deductions for 'disqualified hybrid amounts,' meaning payments that give rise to a D/NI outcome because they are regarded under the payer's tax law but are disregarded under the payee's tax law and therefore are not included in income. A disregarded payment may involve a payment by a domestic corporation to its foreign owner if, under the foreign tax law, the domestic corporation is a disregarded

entity, or a payment between members of a foreign consolidated group. This rule could apply even if the payment is subject to US withholding tax.

A disregarded payment is a disqualified hybrid amount only to the extent it exceeds 'dual inclusion income.' A specified party's dual inclusion income is the excess, if any, of (1) the sum of its items of income or gain for US tax purposes to the extent included in the income of the tax resident or taxable branch to which the disregarded payments are made, over (2) the sum of its items of deduction or loss for US tax purposes (other than deductions for disregarded payments) to the extent allowable as a deduction or loss under the tax law of the tax resident or taxable branch to which the disregarded payments are made.

Deemed branch payments giving rise to disqualified hybrid amounts

The Proposed Regulations deny deductions for 'deemed branch payments.' This rule applies where a foreign corporation that is eligible for benefits of an income tax treaty with the United States has a US permanent establishment. In such cases, the treaty may permit the permanent establishment to determine profits attributable to the PE using arm's length principles, including deemed payments of interest or royalties made to its home office, although such hypothetical payments may not be regarded as income attributable to the home office for purposes of the foreign corporation's tax laws and therefore not lead to an income inclusion to such foreign corporation. The Proposed Regulations deny a deduction for such a deemed payment to the extent the home office's tax law provides an exclusion or exemption for income attributable to the branch and does not attribute the deemed income to the home office. This rule may raise questions as to whether it attempts to override US treaty obligations.

Reverse hybrids giving rise to disqualified hybrid amounts

Under Section 267A, there has been a concern that a deduction for any payment or interest or royalties to a related foreign reverse hybrid would be disallowed because the payment was not taken into account in the income of that specific reverse hybrid entity. The Proposed Regulations address this issue by providing that the deduction would not be disallowed to the extent that either the reverse hybrid or an investor in the reverse hybrid takes the item of income into account. For this purpose, the Proposed Regulations leverage Treas. Reg. sec. 1.894-1(d), which contains rules addressing when a person 'derives' income that is paid to intermediate entities that are fiscally transparent.

A specified payment made to a reverse hybrid generally is treated as a disqualified hybrid amount to the extent that an investor does not include the payment in income. This appears to be the case even where the reverse hybrid includes the amount in income

Branch mismatch payments giving rise to disqualified hybrid amounts

A 'branch mismatch payment' is a specified payment that is treated as attributable to a branch under the home office's tax law, and under the tax law of the branch country, either (1) the home office does not have a taxable presence in the country or (2) the specified payment is treated as attributable to the home office and not the branch. Such a payment may 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.

A specified payment is a branch mismatch payment and generally is treated as a disqualified hybrid amount to the extent that the home office does not include the payment in income.

Relatedness or structured arrangement limitation

Each category of 'disqualified hybrid amount' incorporates a related-party requirement. For example, in determining whether a specified payment is made pursuant to a hybrid transaction, the tax law of a specified recipient will not be taken into account unless the specified recipient is either related to the specified party or is a party, or an investor of a party, to a structured arrangement.

Related-party status is determined under Section 954(d)(3) (requiring ownership of more than 50 percent) but without regard to downward attribution. For purposes of the relatedness test, a tax resident or taxable branch disregarded for US federal tax purposes is treated as a corporation.

A structured arrangement includes an arrangement with respect to which one or more specified payments would be a disqualified hybrid amount if analyzed without regard to the related-party requirement, and the hybrid mismatch is priced into the terms of the arrangement or is a principal purpose of the arrangement.

Inclusion in a third jurisdiction disregarded

The Proposed Regulations provide that a specified payment is a disqualified hybrid amount if a D/NI outcome occurs as a result of hybridity in any foreign jurisdiction, even if the payment is included in

income in another foreign jurisdiction (e.g., a low-taxed country).

Certain amounts includible in a US tax resident's or US taxable branch's income

A specified payment that otherwise would be a disqualified hybrid amount (i.e., a 'tentative disqualified hybrid amount') is reduced to the extent that it is included in gross income by a specified recipient that is a tax resident of the United States or a US taxable branch.

Under these rules, a specified payment is not subject to Section 267A to the extent the payment is included in the income of a US shareholder of a CFC under Section 951 or is included in tested income for purposes of Section 951A.

The Preamble clarifies that the Proposed Regulations, however, do not treat amounts subject to US withholding taxes as reducing disqualified hybrid amounts. Comments are requested on the interaction between the Proposed Regulations and with these issues.

Disqualified imported mismatch amounts

The Proposed Regulations also contain a rule designed to prevent the effects of an 'offshore' hybrid arrangement from being shifted into the US taxing jurisdiction through the use of a non-hybrid arrangement.

Under this rule, a deduction is disallowed for a specified payment that is non-hybrid in nature (referred to as an 'imported mismatch payment'), where the income attributable to the payment is directly or indirectly offset by a hybrid deduction of a foreign tax resident or taxable branch. The Proposed Regulations provide a series of rules for determining when a specified payment is treated as offsetting an imported mismatch payment.

Securities lending transactions

The Proposed Regulations clarify that certain securities lending transactions, sale-repurchase transactions, or similar types of transactions may be treated as a specified payment for purposes of applying Section 267A.

Definition of interest and royalty

The Proposed Regulations broadly define 'interest' to include certain amounts paid, received, or accrued as compensation for the use or forbearance of money. In addition, the Proposed Regulations provide that a 'structured payment' -- e.g., substitute interest payments, commitment fees, debt issuance costs, guaranteed payments, and certain amounts predominantly associated with the time value of money -- is treated as a specified payment. Thus, similarly to the proposed regulations under Section 163(j), these Proposed Regulations have a broad definition of interest.

A 'royalty' is defined to include amounts paid or accrued as consideration for the use of certain intellectual property, as well as information concerning industrial, commercial, or scientific experience. A royalty, however, does not include amounts paid or accrued for after-sales services, services rendered under a warranty, or pure technical assistance. The Preamble clarifies this definition is used in tax treaties (i.e., Article 12 of the 2006 US Model Income Tax Treaty).

Coordination with other provisions

Section 267A applies to a specified payment after the application of any other applicable provisions of the Code and regulations. Thus, if a deduction is deferred under a different provision, the determination of whether Section 267A applies is made with respect to the year in which the deduction otherwise would be allowed. The disallowance of a deduction to a corporation under Section 267A, however, does not impact the calculation of the corporation's earnings and profits.

Foreign currency gain or loss

While Section 988 gain or loss is generally not taken into account under Section 267A, such foreign currency gain or loss is taken into account if it relates to a specified payment of accrued interest or a royalty that is disallowed under Section 267A.

Anti-avoidance rule

The Proposed Regulations contain an anti-avoidance rule, which provides that a specified party's deduction for a specified payment is disallowed to the extent that 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 Section 267A regulations.

DCL rules

According to the Preamble to the Proposed Regulations, Treasury is concerned that taxpayers can avoid the DCL rules through the use of domestic reverse hybrid entities, i.e. US entities that are treated as transparent for foreign law tax purposes but that have elected to be treated as corporations for US tax purposes. By its terms, however, Section 1503(d) does not apply to such entities.

The Proposed Regulations accordingly would amend the check-the-box regulations under Section 7701 to provide that, as a condition to a domestic entity electing to be treated as a corporation, the domestic entity must consent to be treated as a

dual resident corporation (and thus subject to Section 1503(d)) for taxable years in which a foreign corporation under its tax laws derives items of income, gain, deduction, or loss of the domestic corporation. The Proposed Regulations provide that any domestic entity that would be subject to these rules that filed an election to be treated as a corporation before December 20, 2018, is deemed to consent to be treated as a dual resident corporation as of its first tax year beginning on or after the end of a 12-month transition period. The deemed consent can be avoided if the entity elects, effective before its first tax year beginning on or after the end of the transition period, to be treated as a partnership or disregarded entity.

Effective dates

The Proposed Regulations under Section 267A are generally effective for tax years beginning after December 31, 2017, while the rules under Prop. Reg. sec. 1.245A(e)-1 are proposed to apply to distributions made after December 31, 2017. However, the provisions in the Section 267A proposed regulations that address (1) disregarded payments, (2) deemed branch payments, (3) branch mismatches, (4) imported mismatches, and (5) structured payments apply to tax years beginning on or after December 20, 2018. Other effective dates also apply.

The regulations under the DCL and check-the-box rules are proposed to apply to tax years beginning on or after December 20, 2018.

Compliance considerations

The Proposed Regulations also include rules under Sections 6038 and 6038A that would require reporting deductions disallowed under Section 267A and hybrid dividends under Section 245A in accordance with the provisions of those reporting Section (i.e., on Form 5472). These rules apply to tax years beginning on or after December 20, 2018.

The takeaway

The Proposed Regulations, which are the first regulatory guidance under Sections 245A and 267A, clarify the application of guidance related to the mechanics of those provisions and expand the statutory rules in a number of respects.

Taxpayers should immediately assess the impact of the provisions in the Proposed Regulations, and consider commenting on issues that Treasury should address before publishing final Section 245A, Section 267A, and DCL guidance.

The above-mentioned highlights are not an exhaustive list of the provisions in the Proposed Regulations. We expect to publish an in-depth Insight in the coming weeks.

See also:

- PwC Tax Insight: US tax reform impact on non-US headquartered companies doing business in the United States
- PwC Tax Insight: Republican tax bill will significantly impact US international tax rules
- PwC Tax Insight: Proposed revisions to US tax code would significantly impact inbound companies

Let's talk

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

International Tax Services

Michael DiFronzo
(202) 312-7613
michael.a.difronzo@pwc.com

Oren Penn
(202) 414-4393
oren.penn@pwc.com

Steve Nauheim
(202) 414-1524
stephen.a.nauheim@pwc.com

Mergers & Acquisitions

Julie Allen
(202) 414-1393
julie.allen@pwc.com

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

Transfer Pricing

Marco Fiaccadori
(202) 346-5227
marco.fiaccadori@pwc.com

David Ernick
(202) 414-1491
david.ernick@pwc.com

Joe Murphy
(202) 414-1013
w.joe.murphy@pwc.com