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Nuts And Bolts Of The IRS' Proposed Anti-Hybrid Regulations

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The Tax Cuts and Jobs Act of 2017[1] added new Sections 245A(e) and 267A to the Internal Revenue Code of 1986.[2] Section 245A(e) denies the Section 245A dividends-received deduction for “hybrid” dividends. Section 267A concerns payments on hybrid instruments and payments by, or to, a hybrid entity, providing that no deduction is allowed for any amount (i) paid or accrued pursuant to a “hybrid” transaction or (ii) paid by, or to, a “hybrid” entity. On Dec. 20, 2018, the Internal Revenue Service issued proposed regulations under both of these IRC provisions.[3] The proposed regulations note that if the regulations are finalized by June 22, 2019, then they will generally be effective Jan. 1, 2018. However, if the proposed regulations are not finalized by June 22, 2019, then they would be effective Dec. 20, 2018. Treasury has requested comments on the proposed regulations by Feb. 26, 2019.

As discussed in more detail below, the proposed regulations generally supply technical mechanics for Sections 245A(e) and 267A, but they also expand the scope of each provision in some ways. In this article:

- Part I analyzes the proposed regulations implementing the hybrid dividend rule in Section 245A(e);
- Part II analyzes the proposed regulations implementing Section 267A;
- Part III provides an overview of the reporting requirements imposed by the proposed regulations for both code sections; and
- Part IV discusses the current impact of the proposed regulations.

Section 245A(e) – Hybrid Dividends

Background

One of the major provisions of the TCJA was the enactment of a participation exemption regime. For the first time in the history of the code, Congress provided, through new Section 245A, a 100 percent dividends-received deduction for the foreign source portion of dividends received by U.S. corporate shareholders owning at least 10 percent of the shares of a controlled foreign corporation. This change brought the code in line with the tax regimes in most other developed countries.

At the same time, Congress added Section 245A(e) to exclude "hybrid" dividends as dividends eligible for the participation exemption and also require a Subpart F inclusion for hybrid dividends received by a CFC. Moreover, if the dividend is a hybrid dividend, no foreign tax credits or foreign tax deductions are available with respect to the dividend. In addition, if the hybrid dividend is received by a CFC, the dividend is treated as Subpart F income without regard to any other exclusions, including, for example, the earnings and profits limitation or the look-through provisions of Section 954(c)(6).

Treasury notes in the preamble to the proposed regulations that the statute and regulations for Section 245A(e), along with its companion provision Section 267A, implement several recommendations from the Organisation for Economic Co-operation and Development's base erosion and profit shifting reports. In particular, the BEPS action 2 reports are designed to address hybrid transactions, namely transactions that exploit differences in the tax treatment of a transaction or entity under the laws of two or more countries. The BEPS action 2 reports addressed a number of hybrid scenarios, in particular a scenario where, as part of one transaction, a taxpayer is allowed a deduction in one country while the recipient is not subject to tax on the receipt of the income under the laws of the recipient's country. This "deduction/no income," or D/NI, outcome is exactly what Section 245A(e) is aimed at. The proposed regulations implement Section 245A(e).

Hybrid Dividend

The proposed regulations define a hybrid dividend as a dividend otherwise eligible for the participation exemption but for which the paying CFC is or was allowed a tax deduction or other tax benefit under the laws of the CFC's country or the laws of a third country where the CFC is liable to tax — for example, on branch profits. A basic example of a prohibited tax benefit is where the investment in the CFC is treated as debt in the CFC's country and equity for U.S. purposes. Because the CFC would be entitled to an interest deduction for some or all of the putative dividend payment, the distribution is treated as a hybrid dividend.

The tax deduction or benefit must relate to the amount distributed with respect to the instrument treated as equity for U.S. tax purposes. This includes a dividends-paid deduction and notional interest deductions, or NID, available in Belgium, Cyprus and other countries.

The proposed regulations confirm that amounts distributed as previously taxed earnings and profits, or PTEP, will not be considered hybrid dividends. This applies to dividends received by the U.S. shareholder directly as well as dividends received by lower-tier CFC's. This is an especially important clarification given the significant amounts of PTEP arising as a result of Section 965 inclusions as well as on-going global intangible low-taxed income, or GILTI, inclusions under Section 951A.[4] Further, the regulations provide that in at least some circumstances, if the foreign jurisdiction has hybrid mismatch rules in place that deny deductions in the foreign jurisdiction, then Section 245A(e) may not apply.

Lower-Tier CFCs

Section 245A(e) denies the participation exemption for hybrid dividends received by U.S. shareholders and also provides similar tax consequences when the hybrid dividend is received by a CFC from a lower-tier CFC. In this case, the hybrid dividend is treated as Subpart F income, notwithstanding any other provision in the code. The legislative history and the proposed regulations make clear that the earning and profits limitation in Section 952(c), deductions available under Section 954(b)(5) and the look-through rules of Section 954(c)(6) do not apply to a hybrid dividend. The proposed regulations go a step further to turn off the provisions of Section 964(e)(4) with respect to sales of shares of CFC's with a hybrid dividend account. The Joint Committee on Taxation, General Explanation of Public law 115-97, or "Bluebook,"[5] notes that a technical correction may be necessary to reflect this legislative intent.

Hybrid Dividend Accounts

Because there will often be timing differences between the prohibited tax benefit and the dividend for which the benefits of Section 245A would be claimed, the proposed regulations require U.S. shareholders of the CFC to maintain a "hybrid dividend account" for each share of stock for which Section 245A may be available. A hybrid dividend account must be maintained for each share held by the U.S. shareholder. Tax benefits are then allocated to each share based on the relative value of the CFC's shares. Tax benefits with respect to a share of stock increase the hybrid dividend account. Distributions reduce the hybrid dividend account to the extent the distribution is allocable to a share of stock with a positive hybrid dividend account.

To the extent a distribution is received from a CFC and there is a hybrid dividend account relating to the shares on which the distribution is paid, the distribution is treated as a hybrid dividend and no participation exemption, foreign tax credits or foreign tax deductions are available with respect to the distribution. Importantly, even though hybrid dividend accounts are maintained for each share of CFC stock, to the extent any dividend is paid for which a hybrid dividend account exists, the distribution is considered a hybrid dividend even if a portion of the dividend relates to a share with no hybrid dividend account. An example in the proposed regulations illustrates this point. In the example, a U.S. shareholder holds two shares — share A and share B. Only share A has a hybrid dividend account. The CFC pays a dividend with respect to both share A and share B. The example makes clear that even though share B has no positive hybrid dividend account, since the dividend is paid with respect to both shares, share A's hybrid dividend account is exhausted first before the participation exemption will apply.

Specified Owners and Sales/Exchanges

Section 245A(e) applies to a "specified owner" of a CFC. The proposed regulations define a specified owner as a domestic corporation that is a U.S. shareholder of a CFC — as defined in Section 951(b) — or an upper-tier CFC that would be a U.S. shareholder if it were a domestic corporation. Thus, in general, a specified owner is any corporate U.S. shareholder of a CFC as well as any upper tier CFC.

The proposed regulations contain a number of rules with respect to transfers of shares subject to a hybrid dividend account. For example, where one specified owner sells a share of stock with a positive hybrid dividend account to a shareholder that is a specified owner immediately after the transaction, that hybrid dividend account transfers with the share to the new specified owner. As a result, hybrid dividend accounts will become a relevant tax due diligence item in M&A transactions involving CFCs.

The proposed regulations also provide that on a Section 332 liquidation by a CFC with a hybrid dividend account to an upper-tier CFC, the upper-tier CFC increases its hybrid dividend account accordingly. Similar rules are provided in connection with other reorganization transactions covered by Section 381(a)(1).

Section 267A – Hybrid Transactions/Entities

Background

Congress passed Section 267A to limit those instances where a U.S. taxpayer was claiming both a U.S. tax benefit and a benefit in a foreign country from the same payment or transaction. For example, a U.S. taxpayer might borrow money from a foreign person using an instrument that produced interest deductions for the U.S. taxpayer but was treated as equity in a foreign jurisdiction where such distributions were eligible for a "participation" or other exemption. Such transactions have been around for many years although their popularity has waned for a number of reasons, including increased sophistication on the part of foreign tax authorities and increased scrutiny by U.S. tax authorities.

The proposed regulations take a complicated and expansive approach in interpreting the statute, which denies a deduction for any “disqualified related party amount,” or DRPA, paid or accrued pursuant to a hybrid transaction or by, or to, a hybrid entity.

A DRPA is any interest or royalty paid or accrued to a related party to the extent that (A) such amount is not included in the related party's income under the foreign country tax law where the related party is resident or is subject to tax, or (B) the related party is allowed a deduction with respect to such amount under the foreign country tax law. Related party status is determined under Section 954(d)(3) which provides for a more than 50 percent test. If an interest or royalty payment is included in the gross income of a U.S. shareholder under Section 951(a) — i.e., the CFC rules — then the provision does not apply.

The proposed regulations under Section 267A generally implement the provision and try to neutralize the double non-taxation effects of certain hybrid transactions and transactions involving hybrid entities with interest or royalty components where, as part of one transaction, a taxpayer is allowed a deduction in one country while the recipient is not subject to tax on the receipt of the income under the laws of the recipient’s country — as discussed above, also called a D/NI. The proposed regulations seek to accomplish this by denying a “specified party’s”[6] deduction for any interest or royalty paid or accrued — a “specified payment”. The proposed regulations also provide specific definitions for both interest and royalties, with interest being defined broadly along the lines of the definition of interest in the proposed regulations under Section 163(j).[7]

The proposed regulations deny a specified party’s deduction for a specified payment in three situations:[8]

- The payment is a “disqualified hybrid amount,” generally defined as a specified payment that produced a D/NI outcome as a result of a hybrid or branch arrangement;

- The payment is a ‘disqualified imported mismatch amount,” generally defined as a payment that produces an indirect D/NI outcome as a result of the effects of an offshore hybrid or branch arrangement being imported into the U.S. tax system — i.e., where payments of a specified amount are offset by a hybrid deduction; or

- A specified payment producing a D/NI outcome that the regulations classify as having a purpose of avoiding the Section 267A regulations.

The next section provides an overview of each of these situations.

Hybrid and Branch Arrangement Giving Rise to Disqualified Hybrid Amounts

A disqualified hybrid amount generally arises under the proposed regulations where a specified payment is made pursuant to a hybrid transaction, a deemed branch payment, a payment to a reverse hybrid or a branch mismatch payment, each discussed separately below. Where a transaction gives rise to a disqualified hybrid amount, the U.S. deduction for the payment is permanently denied.

The proposed regulations also provide operating rules that apply to each of the four types of specified payments discussed below. Under the proposed regulations, a D/NI outcome gives rise to a disqualified hybrid amount only to the extent that the D/NI outcome is a result of hybridity. This is not always the case — for example, a hybrid transaction could have a D/NI outcome as a result of the specified recipient's tax law containing a pure territorial system (thus exempting all foreign source income from taxation), or the specified recipient's tax law may not have a corporate income tax. In these cases, the deduction is not disallowed, since the hybridity does not cause the D/NI. The proposed regulations generally require a counter factual analysis to determine whether such hybridity exists.

In addition, a disqualified hybrid amount is reduced to the extent amounts are included or includible in a U.S. tax resident's or U.S. taxable branch's income. This exception is meant to ensure that a specified payment is not a disqualified hybrid amount to the extent included in the income of a U.S. tax resident or a U.S. taxable branch, or taken into account by a U.S. shareholder under the Subpart F or GILTI rules. Source-based withholding by the United States or another country, however, does not reduce a disqualified hybrid amount, under the theory that source based withholding does not neutralize a D/NI outcome. The preamble to the proposed regulations requests comments on whether certain types of withholding should reduce disqualified hybrid amounts on specified payments.

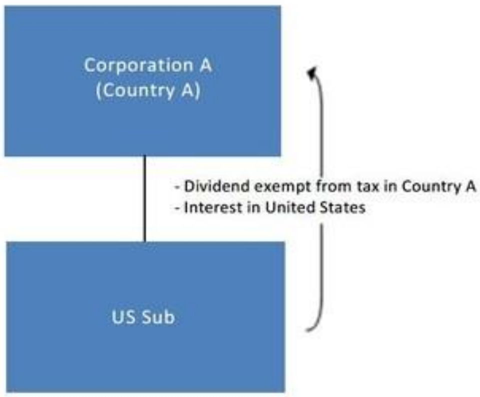
Even if a specified payment is included in income in another foreign jurisdiction — other than the jurisdiction of the U.S. payee and specified recipient, a specified payment is a disqualified hybrid amount if a D/NI outcome occurs as a result of hybridity. This rule is intended to prevent circumvention of Section 267A by structuring a transaction so that the specified payment is included in income in a third, low-tax jurisdiction.

Finally, in determining whether a specified payment is made pursuant to a hybrid or branch mismatch arrangement, the proposed regulations generally only consider the tax laws of the tax residents or taxable branches that are related to the specified party. However, the tax laws of an unrelated tax resident or taxable branch are taken into account if the tax resident or taxable branch is a party to a "structured arrangement," defined as an arrangement where the hybrid mismatch is priced into the terms of the arrangement or, based on all the facts and circumstances, where the hybrid mismatch is a principal purpose of the arrangement.

Hybrid Transaction

The proposed regulations generally follow the statutory definition of "hybrid transaction," defining this term to include any transaction, series of transactions, agreement or instrument where one or more payments made are treated as interest or royalties for U.S. federal tax purposes but treated differently for purposes of the tax law of the "specified recipient"[9] of the payment. For example, a payment that is treated as interest in the United States but as a distribution on equity or return of principal under the tax law of the specified recipient could be a hybrid transaction within the meaning of the proposed regulations. This situation is illustrated in Figure 1.

Figure 1



In addition, a transaction resulting in long-term deferral, generally defined as 36 months after the end of the taxable year in which the specified party would be allowed a deduction for the payment under U.S. law, is a hybrid transaction — for example, a specified payment made pursuant to an instrument viewed as indebtedness under both the U.S. and non-U.S. tax law but, due to a mismatch in tax accounting treatment between the U.S. and non-U.S. tax law, results in long-term deferral. However, a specified payment is not considered made pursuant to a hybrid transaction if the payment is a "disregarded payment," defined as a situation where a specified payment is deductible in the United States but not included in income under foreign tax law. A deduction for a disregarded payment is only disallowed to the extent it exceeds "dual inclusion income" — a specified party's income or gain for U.S. tax purposes to the extent included in income of the tax resident or taxable branch to which the disregarded payments were made over the specified party's items of deduction or loss for U.S. tax purposes (other than deductions for disregarded payment) to the extent the items of deduction or loss are allowable under the tax law of the tax resident or taxable branch to which the disregarded payments are made. This calculation is intended to prevent the excess of the disregarded payment over dual inclusion income from offsetting non-dual inclusion income. For example, assume Corporation A, organized in Country A, owns a U.S. corporation — U.S. Sub — and under the laws of Country A, items of income of U.S. Sub are included on Corporation A's consolidated Country A tax return, and payments from U.S. Sub are disregarded. As discussed above, to the extent income items attributable to the specified payment are included in income on Corporation A's Country A consolidated tax return, such amounts are not disqualified hybrid amounts.

The proposed regulations provide specific mechanics for payments made pursuant to securities lending transactions, repos, and similar transactions where a payment on such an instrument is not regarded under non-U.S. law but another amount connected to the payment is regarded under such law (a "connected amount"). For example, consider a specified payment arising from a repo transaction involving stock, where a U.S. person transfers the legal title to stock to a non-U.S. person with an agreement to repurchase the stock back at a higher price, with the difference being treated as interest for U.S. federal tax purposes. Suppose the tax laws of the non-U.S. counterparty do not regard the payments from the United States as interest, but instead treat such payments as dividends. In this situation, the dividend under the non-U.S. law is the connected amount under the proposed regulations, and the determination of the identity of the specified recipient of the specified payment is made with respect to the connected amount. These rules function as a glue for the application of the proposed regulations where the law of a non-U.S. counterparty does not recognize payments on a repo or other similar transaction.

Deemed Branch Payment

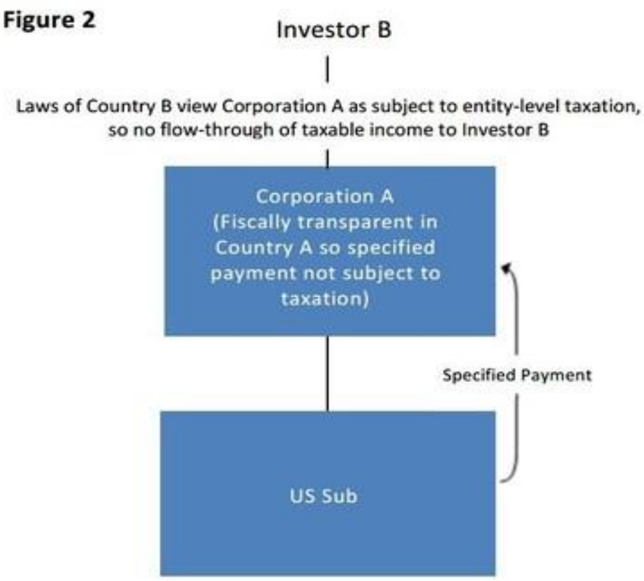
A deemed branch payment is one where a specified payment is considered paid by a U.S. permanent establishment to its home office under an income tax treaty between the United States and the home office country. This can occur, for example, where an amount is allowed as a deduction in computing the business profits of a U.S. permanent establishment with respect to the use of intellectual property developed by the home office. 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 for income attributable to a branch.

Payments to Reverse Hybrids

Generally, the proposed regulations define a reverse hybrid as an entity that is fiscally transparent for purposes of the tax law of the country in which it is established but not for purposes of the tax law of its owner. Payments to a reverse hybrid 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 owner does not derive the payment under its tax law. Both U.S. and non-U.S. entities can be reverse hybrids, since this D/NI outcome may occur regardless of whether the establishment country is a foreign country or the United States.

A specified payment made to a reverse hybrid is generally a disqualified hybrid amount to the extent that (a) an investor in the reverse hybrid does not include the payment in income, and (b) the investor's no-inclusion would not occur if the investor's tax law treated the reverse hybrid as fiscally transparent. This situation is illustrated in Figure 2.

Figure 2



Branch Mismatch Payments

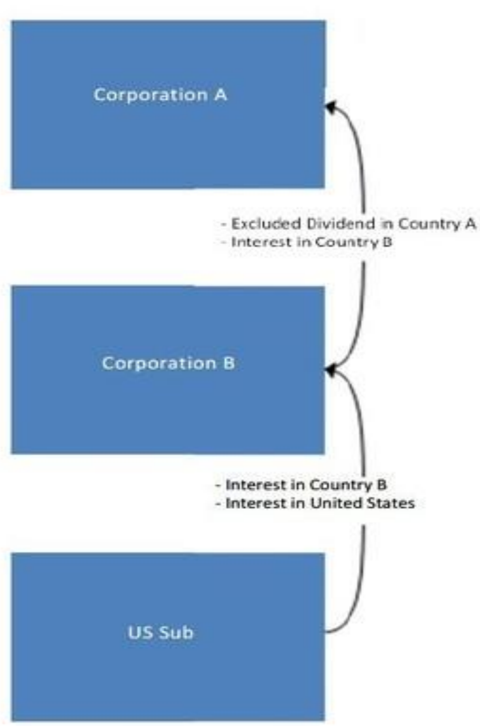
The proposed regulations treat a specified payment as a branch mismatch payment if (a) under a home office's tax law, the specified payment is treated as attributable to a branch of the home office and (b) either (i) the home office does not have a taxable presence in the country or (ii) the specified payment is treated as attributable to the home office and not the branch. Generally, a branch mismatch payment is a disqualified hybrid amount to the extent the home office does not include the payment in income.

Disqualified Imported Mismatch Amount

The rules in the proposed regulations disallowing the deduction for imported mismatch amounts are intended to prevent the effects of an "offshore" hybrid arrangement from being "imported" to the United States through the use of a non-hybrid arrangement. A payment is generally a disqualified imported mismatch amount where (a) the specified payment is non-hybrid in nature, such as interest paid on an instrument treated as debt for both U.S. and foreign tax purposes and (b) the income attributable to the specified payment is directly or indirectly offset by a hybrid deduction of a foreign tax resident or taxable branch. A hybrid deduction for purposes of the imported mismatch rule is generally an amount for which a foreign tax resident or taxable branch is allowed an interest or royalty deduction under its tax law to the extent the deduction would be disallowed if such tax law were to contain rules substantially similar to the proposed regulations. The proposed regulations provide mechanics for determining whether a hybrid deduction offsets income attributable to a specified payment.

For example, consider a situation where Corporation A is organized in Country A, and holds all the interests of Corporation B, organized in Country B, which holds all the interests of a U.S. corporation — U.S. Sub. Suppose Corporation B holds an instrument issued by U.S. Sub that is treated as indebtedness for both Country B and U.S. tax purposes, and Corporation A holds a corresponding instrument issued by Corporation B that is still treated as indebtedness under the laws of Country B but is treated as equity under the laws of Country A, where Country A has a participation exemption for dividends from foreign subsidiaries. This fact pattern is illustrated in Figure 3.

Figure 3



In this situation, the interest payment by U.S. Sub is not a disqualified hybrid amount. However, the interest payment is a disqualified imported mismatch amount, because (a) the interest payment is non-hybrid in nature, and (b) the interest income to Corporation B is offset by the payment to Corporation A which would be disallowed as a deduction if Country B had rules similar to the proposed regulations (since the proposed regulations would treat the payment from Corporation B to Corporation A as a disqualified hybrid amount pursuant to a hybrid transaction). As a result, the deduction by U.S. Sub is disallowed under the imported mismatch amount rules.

Payments Within the Anti-Abuse Rule

Finally, the proposed regulations contain an anti-abuse rule, which provides that a specified party's deduction for a specified payment is disallowed to the extent that (a) the payment (or income attributable to the payment) is not included in the income of a tax resident or taxable branch, and (b) a principal purpose of the plan or arrangement is to avoid the purposes of the regulations under Section 267A. This anti-abuse is intended to fill in any cracks that might be found in the proposed regulations down the road.

Reporting for Transactions Under the proposed regulations

With respect to Section 245A(e), the proposed regulations note that CFCs paying hybrid dividends must report such dividends on Form 5471. The proposed regulations seem to indicate that reporting is only required when a hybrid dividend is paid rather than when there is a hybrid dividend account. This issue may be clarified when the IRS revises Form 5471.

With respect to specified payments and Section 267A, the reporting imposed by the proposed regulations depends on the type of U.S. entity making the specified payment. If the entity is a CFC, the proposed regulations state that if in an annual accounting period a corporation pays or accrues interest or royalties that carry a disallowed deduction, then Form 5471 must contain information about the disallowance. If the entity is a U.S. corporation owned 25 percent by a foreign entity, or a foreign corporation engaged in a U.S. trade or business, such entity's Form 5472 must provide information about the disallowance. Finally, if the entity is a controlled foreign partnership, the Form 8865 of a controlling 50 percent partner must provide information about the disallowance. As in the case of reporting under Section 245A(e), the proposed regulations defer to later guidance on the manner in which such information is reported.

Looking Ahead

As discussed, the proposed regulations are generally effective for hybrid dividends and specified payments made in taxable years beginning after Dec. 31, 2017 if they are finalized by June 22, 2019.[10] However, if the proposed regulations are not finalized by June 22, 2019, they would be effective Dec. 20, 2018. Treasury has requested comments on the proposed regulations, which are due by Feb. 26, 2019.

The proposed regulations are complicated to say the least and, assuming the final regulations are issued as intended, these effective dates mean that taxpayers will have to apply the rules in 2018. For example, the new system of "hybrid dividend accounts" will have to be implemented beginning Jan. 1, 2018, affecting already completed transactions. In addition, hybridity with respect to a share of stock may already exist raising a question as to whether tax benefits arising prior to 2018 are relevant in determining a hybrid dividend account. The proposed regulations make clear that only tax deductions and benefits arising in taxable years beginning after Dec. 31, 2017, are taken into account for purposes of determining the hybrid dividend account. This is a welcome clarification.

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Jason S. Bazar, a partner at the firm, also contributed to the drafting of this article.

[1] 115 P.L. 97; for an overview of the TCJA's main provisions, please see our legal update, The Good, the Bad and the Ugly — Fundamental Tax Reform Is Enacted Into Law at https://www.mayerbrown.com/the-good-the-bad-and-the-uglyfundamental-tax-reform-is-enacted--into-law-12-27-2017/.

[2] IRC Sections 245A(e) and 267A.

[3] The proposed regulations are available at https://s3.amazonaws.com/public-inspection.federalregister.gov/2018-27714.pdf.

[4] For a more detailed description of the GILTI rules and the proposed regulations issued thereunder, please see our legal update, GILTI Pleasures: The IRS Releases proposed regulations on Global Intangible Low-Taxed Income at https://www.mayerbrown.com/files/Publication/d9950498-dda3-4a1b-98c0-cb4dfefdbb04/Presentation/PublicationAttachment/09b4dc8c-c8ca-4cb9-87f0-7be3df70ae48/UPDATE_GILTI_Pleasures_IRS_Releases_Proposed_Regulations_0918_V4_.pdf.

[5] Joint Committee on Taxation, General Explanation of Public law 115-97 (December 2018), available at https://www.jct.gov/publications.html?func=startdown&id=5152.

[6] The proposed regulations define a "specified party" as a "tax resident of the United States, a CFC (other than CFC with respect to which there is not a United States shareholder that owns (within the meaning of Section 958(a)) at least 10 percent (by vote or value) of the stock of the CFC), and a U.S. taxable branch." Accordingly, entities that are fiscally transparent for U.S. federal income tax purposes are not specified parties (although the owners of these entities might be). For example, in the case of a payment by a partnership, a domestic corporation or a CFC that is a partner of the partnership is a specified party subject to Section 267A's deduction denial.

[7] For a more detailed description of the proposed regulations under Section 163(j) and the definition of interest therein, please see our legal update High-Level Overview of the proposed regulations on Interest Deduction Limitation Rules at https://m.mayerbrown.com/files/Publication/86d01210-815f-421a-b1c4-4e7c8637d401/Presentation/PublicationAttachment/4d2b47c1-7515-49b6-b63e-6a153dc4bca7/High_Level_Overview_of_the_Proposed_Regulations_on_Interest_Deduction_Limitation_Ru.pdf.

[8] The proposed regulations provide a de minimis exception under Section 267A, stating that a specified party is excepted from the application of Section 267A for any taxable year for which the sum of its interest and royalty deductions (plus the interest and royalty deductions of any related specified parties) is below $50,000.

[9] "Specified recipient" is broadly defined to mean any tax resident that under its tax law derives the specified payment and any taxable branch to which under its tax law the specified payment is attributable.

[10] Section 7805 permits the Treasury Department to issue retroactive regulations under a statute if such regulations are issued within 18 months of the date a statutory provision is enacted to which the regulation relates.