MAYER·BROWN

Canadian Banks Operating in the US—New IRS Guidance

Tax Cuts and Jobs Act of 2017

Thomas A. Humphreys
Partner
212.506.2450
thumphreys@mayerbrown.com

February 20, 2019
Toronto

Agenda

- TCJA Overview
- New US Base Erosion Anti-Abuse Tax
- New US Anti-Hybrid Rules

TCJA Overview

- New 21% US federal corporate income tax rate
- Deemed repatriation of pre-2018 earnings
- New Global Intangible Low Taxed Income ("GILTI") regime
- New Foreign Derived Intangible Income ("FDII") regime
- Immediate expensing of equipment
- Section 163(j) limit on "business interest expense"

BEAT

Base Erosion Anti-Abuse Tax ("BEAT")

- New IRC §59A – base erosion minimum tax
  - Impose on each taxpayer the "base erosion minimum tax" for the taxable year
    - Large taxpayers only (at least $500 mm average annual gross receipts)
    - Minimum base erosion percentage is 3% (2% for financial institutions)
  - Means:
    - 10% (5% for 2018, 12.5% after 2025) of modified taxable income, over
    - Regular tax liability
  - Financial institution minimum tax rate increased by 1%
    - Definition: affiliated group that includes a bank or securities dealer

BEAT, cont'd.

- Modified taxable income adds back to taxable income any deduction for "base erosion" payments, unless full U.S. withholding tax collected on the payment
- Base erosion payment: any deductible amount paid or accrued to a related foreign party and amounts paid for depreciable property purchased from a related foreign party
- Payment for services excluded if payment meets certain transfer pricing limits
- Broad definition of related foreign party: 25% or more owner of taxpayer, any related party (50% test) to such owner, any other "related" party under IRC §482 principles
- Add back does not include cost of inventory
- Also excludes certain derivative payments

BEAT, cont'd.

- Example:

- $100 of gross income, $90 of related party interest expense deduction = $10 taxable income

  - 21% tax rate, so $2.1 of tax without BEAT (($100-$90)*21%)

- BEAT: add back the $90 interest expense deduction so "modified taxable income" is $100 and section 59A tax is $7.9 ($100*10% = $10 - $2.1).
  - Total tax is $10

Proposed BEAT Regulations

- Proposed Regulations Issued December, 2018

Outline of Proposed Regulations

1.59A-1	Tax and Definitions
1.59A-2	Applicable Taxpayer
1.59A-3	Base erosion payments and base erosion tax benefits
1.59A-4	Modified taxable income
1.59A-5	Base erosion minimum tax amount
1.59A-6	Qualified derivative payment
1.59A-7	Partnerships
1.59A-8	Reserved [Expatriated entities]
1.59A-9	Anti-abuse/recharacterization rules
1.59A-10	Effective date

Applicable Taxpayer: Prop. Reg. section 1.59A-2

- A corporation other than a RIC, REIT or S corporation
- Satisfies $500 mm gross receipts test (1.59A-2(d))
- Satisfies base erosion percentage test (1.59A-2(e))
- Gross receipts test and base erosion percentage done on basis of aggregate group

Aggregate Group

- Group of corporations
- Controlled group (more than 50% vote or value)
- Exclude foreign corporations
  - Except with regard to U.S. effectively connected income (or net taxable income if treaty-based)

Base erosion payments: Prop. Reg. section 1.59A-3

- Any amount paid or accrued to a related foreign party where a deduction allowed under IRC
- Any amount paid or accrued by taxpayer to related foreign party in connection with acquisition of depreciable property
- Premiums for reinsurance
- Amount paid or accrued that results in reduction of gross receipts of "surrogate foreign corporation" [a product of US anti-inversion rules]

Exclusions from Base Erosion Payments: Prop. Reg. section 1.59A-2(b)(3)

- Services cost method amounts
- Qualified derivative payments
- Effectively connected income
- Exchange loss on section 988 transaction
- TLAC payments
- Amounts paid or accrued in TY beginning before January 1, 2018
- Business interest carry forward from TY beginning before January 1, 2018

Qualified Derivative Payment: Prop. Reg. section 1.59A-6

- Any payment made by a taxpayer to a foreign related party pursuant to a derivative if
  - Taxpayer marks to market annually
  - Mark to market gain or loss treated as ordinary
  - Taxpayer treats all items with respect to the derivative as ordinary
- Derivative
  - Any contract (including option, forward, futures, short position, swap or similar contract) the value of which (or any payment) determined by reference to stock, debt, actively traded commodity, currency or rate, price, amount, index, formula or algorithm (but not a direct interest in foregoing)

Internal TLAC: Prop. Reg. section 1.59A-3(b)(3))(v)

- Total Loss Absorbing Capital
- US Federal Reserve May Require TLAC for US Subsidiary of Foreign Financial Institution
- Proposed Regulations: exclude interest payments on Federal Reserve required "internal TLAC" from base erosion payment calculation
- Exclusion limited to amount required

Payments to a US Branch: Prop. Reg. section 1.59A-3(b)(3)(iii)

- Issue: a payment from a Canadian bank's US subsidiary to the Canadian bank's US branch is technically a payment to a "related foreign person" that would be added back for BEAT purposes
- Proposed Regulations: payment is not treated as a base erosion payment to extent subject to US federal income tax as effectively connected with a US trade or business
- Rationale: US branch is subject to US tax on its net income that is "effectively connected"

Modified Taxable Income: Prop. Reg. section 1.59A-4

- Taxable income plus
- Base erosion tax benefits
- Certain NOL deductions
- REMIC residuals

Base Erosion Tax Benefit: Prop. Reg. section 1.59A-3(c)

- Amount of deductible payment
- Depreciation deductions
- Exclude amounts subject to U.S. 30% withholding tax
  - Treaty rate rule

Amount of Tax: Prop. Reg. section 1.59A-5

- Excess of
  - BEAT Tax Rate times Modified Taxable Income over
  - Regular tax liability reduced by certain credits
- BEAT Tax Rate
  - 2018: five percent
  - 2019-2025: 10 percent
  - After 2025: 12.5 percent
  - Rate increased by one percentage point for a taxpayer that is member of an affiliated group that includes a bank or securities dealer

ANTI-HYBRID RULES

Anti-Hybrid Rules

- Section 245A(e) and hybrid dividends
- Section 267A and hybrid transactions/entities

CODE SECTION 245A(E)—INBOUND (TO US) DIVIDENDS

Participation Exemption Under Section 245A

- 100% participation exempt for foreign source dividends received by U.S. shareholders owning at least 10% of the shares of a CFC

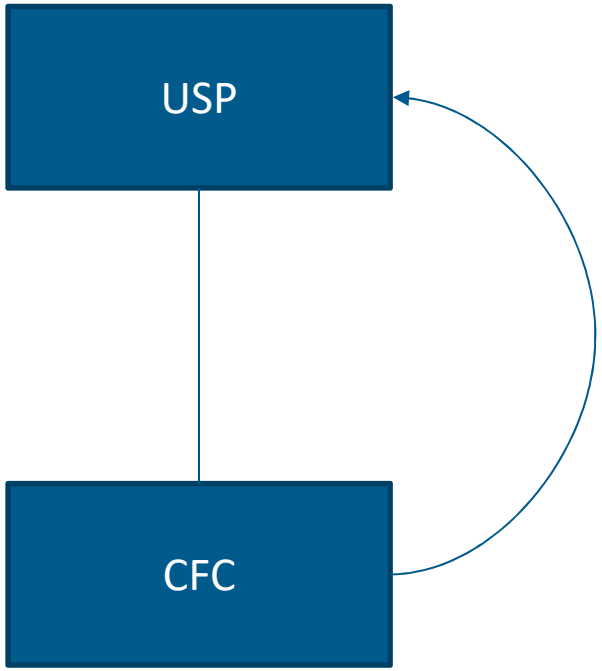
Section 245A(e)

- New Sections 245(e) and 267A represent US implementation of BEPS Action 2
- “Hybrid dividends” excluded from participation exemption
- Hybrid dividends require a subpart F inclusion if received by a CFC
- No foreign tax credits or foreign tax deductions available with respect to hybrid dividends

What is a Hybrid Dividend?

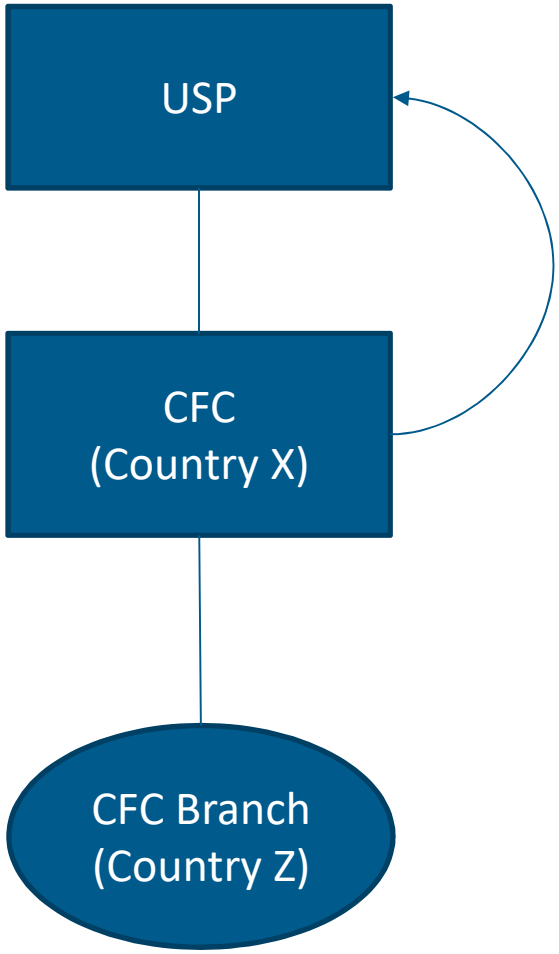
- The proposed regulations define a hybrid dividend as a dividend otherwise eligible for the participation exemption but for which the paying CFC is or was allowed a tax deduction or other tax benefit under the laws of the CFC country or the laws of a third country where the CFC is liable to tax (for example, on branch profits)
- Tax deduction or benefit must relate to the amount distributed with respect to the instrument treated as equity for US tax purposes
- Previously taxed earnings and profits are not hybrid dividends

What is a Hybrid Dividend? – Base Case



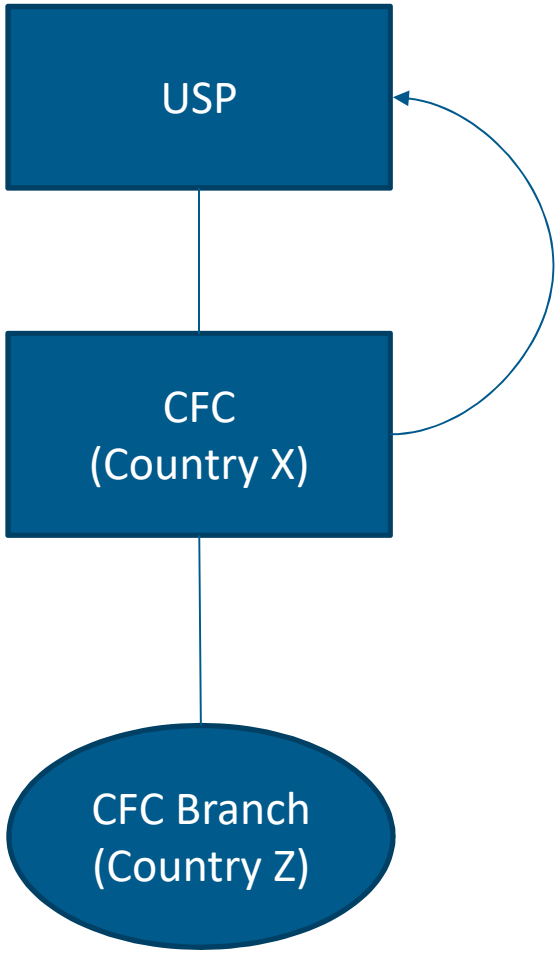
- Investment in CFC treated as equity for US tax purposes and debt for local purposes
- Distribution is a hybrid dividend if CFC gets local deduction for distribution

What is a Hybrid Dividend? – Taxable Branch



- CFC has taxable branch in Country Z
- Investment in CFC treated as equity for both US and Country X purposes but debt for Country Z purposes
- Distribution is still a hybrid dividend because CFC is still getting local deduction for distribution

What is a Hybrid Dividend? – Exempt Branch



- CFC has branch in Country Z but income from branch is exempt in Country X
- Distribution is not a hybrid dividend because there is no connection between the branch exemption and the characterization of the investment in CFC

What is a Hybrid Deduction?

- Any deduction or other tax benefit (such as an exemption, exclusion, or credit equivalent to a deduction) allowed to the CFC or a related person under a "relevant foreign tax law" if it relates to or results from an amount paid, accrued, or distributed with respect to an instrument issued by the CFC treated as stock for U.S. tax purposes
  - Notional Interest Deductions
  - Dividends Paid Deductions (consistent with BEPS Action 2?)
- Includes only deductions or other tax benefits allowed with respect to a taxable year under the relevant foreign tax law beginning after December 31, 2017

Lower-tier CFCs

- Participation exemption denied for hybrid dividends received by a CFC from a lower-tier CFC
- 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
- Proposed regulations deny benefits of section 964(e)(1) and (e)(4) for tiered hybrid dividends.

Hybrid Dividend Accounts

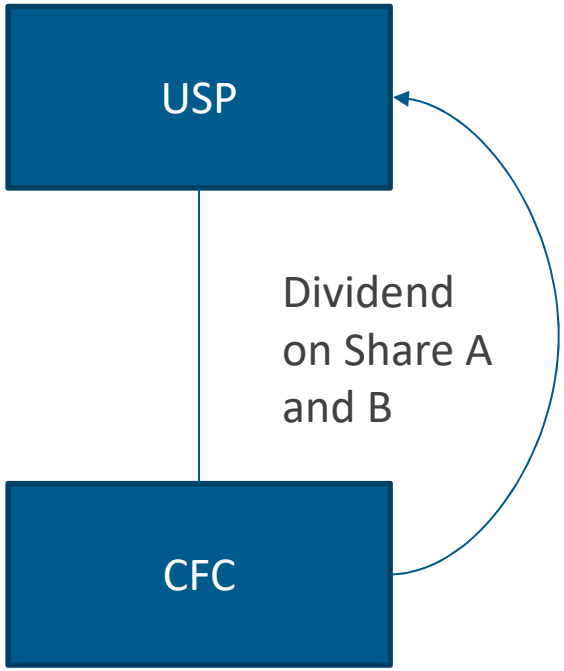
- Proposed regulations require U.S. shareholders of the CFC to maintain a "hybrid dividend account" for each share of stock for which section 245A may be available
- Designed to account for timing differences between deduction and distribution
- Tax benefits allocated to each share based on relative value
  - Tax benefits with respect to a share increase hybrid dividend account
  - Distributions reduce hybrid dividend account to the extent allocable to a shore of stock with a positive hybrid dividend account
- Updated Form 5471 reporting

Hybrid Dividend Accounts - Mechanics

- If 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 until hybrid dividend account is exhausted
- 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

Hybrid Dividend Accounts

- USP holds two shares of CFC
- Share A – debt for local purposes
- Share B – equity for local purposes



- Dividend on both shares treated as hybrid dividend until Share A's HDA is eliminated
- Result applies even if no HDA on Share B

Hybrid Dividend Account in Share Transfers

- Proposed regulations prescribe rules for transfers of shares
- 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.
- In 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)
- Hybrid dividend accounts will become a relevant tax due diligence item in M&A transactions involving CFCs

SECTION 267A—
OUTBOUND (FROM US)
INTEREST AND ROYALTIES

The Target

- Cross border instruments or transactions that give rise to an interest or royalty deduction in the US but no inclusion in the foreign jurisdiction (hereinafter “Home Jurisdiction”)
- Examples
  - Debt in the US treated as equity in Home Jurisdiction
  - Interest deduction in US treated as return of principal in Home Jurisdiction

Section 267A(a) (TCJA-2017)

- No deduction for "disqualified related party amount" paid or accrued pursuant to a hybrid transaction or by, or to, a hybrid entity
- Disqualified related party amount
  - Interest or royalty
  - Paid to related party
  - Amount not included in related party's income in Home Jurisdiction or
  - Related party allowed a deduction in Home Jurisdiction

Hybrid Transaction (267A(c))

- Transaction, series of transactions, agreement, or instrument
- One or more payments treated as interest or royalties under IRC but not so treated for purposes of Home Jurisdiction tax law

Hybrid Entity (267A(d))

- Either
  - Fiscally transparent under IRC but not in Home Jurisdiction
  - Fiscally transparent in Home Jurisdiction but not under IRC

PROPOSED REGULATIONS— DECEMBER 2018

MAYER·BROWN

Organization of the Proposed Section 267A Regulations

- 1.267A-1—Disallowance rule
- 1.267A-2– Hybrid and branch arrangements
- 1.267A-3– Income inclusions and amounts not treated as disqualified hybrid amounts
- 1.267A-4– Disqualified imported mismatch amounts
- 1.267A-5—Definitions
- 1.267A-6– Examples
- 1.267A-7– Effective dates

Key Defined Terms—Specified Party (Prop. Reg. section 1.267A-5(a)(17))

- A "specified party" is 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% (by vote or value) of the stock of the CFC), and a U.S. taxable branch."

Specified Payment (Prop. Reg. section 1.267A-5(a)(18)/1.267A-1(b))

- "…any interest or royalty paid or accrued with respect to the specified party…"
- "Interest" is broadly defined in Prop. Reg. section 1.267A-5(a)(12):
  - Compensation for use or forbearance of money
  - Embedded interest in non-cleared swaps with significant non-periodic payments
  - Amounts affecting the effective cost of borrowing
- "Royalty" is defined in Prop. Reg. section 1.267A-5(a)(16)

Specified Recipient (Prop. Reg. section 1.267A-5(a)(19)

- **Specified recipient** means "with respect to a specified payment, any tax resident that derives the payment under its tax law or any taxable branch to which the payment is attributable under its tax law"
- Prop. Reg. section 1.267A-2(f) requires relationship to specified party
  - Prop. Reg. 1.267A-5(a)(14)[Section 954(d)(3) with qualifiers]
  - Includes a "party to a structured arrangement" under Prop. Reg. section 1.267A-5(a)(20)

Deduction/No Inclusion ("D/NI")

- The situation 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

Rule (Prop. Reg. section 1.267A-1(b)): A Specified Party's Deduction for a Specified Payment is Only Disallowed if:

- The payment is a "**disqualified hybrid amount**;"
- The payment is a '**disqualified imported mismatch amount**;" or
- The payment is a specified payment producing a D/NI outcome that the regulations classify as having **a purpose of avoiding the section 267A regulations**.

Prop. Reg. section 1.267A-2--Disqualified Hybrid Amount

- Rule: If a **specified payment** is made pursuant to a **hybrid transaction** then, subject to -3, the payment is a "**disqualified hybrid amount**" to the extent that:
  - A specified recipient does not include the payment in income (i.e., a "**no inclusion**") and
  - The **specified recipient's no inclusion** is a result of the payment being made pursuant to the hybrid transaction

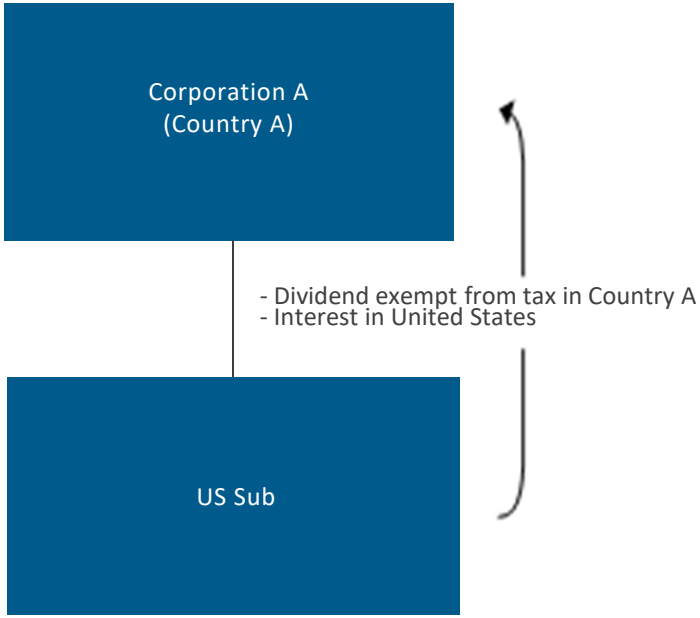
Prop. Reg. section 1.267A-2(a)(2): Hybrid Transaction

- "Hybrid transaction," includes any transaction, series of transactions, agreement or instrument where one or more payments made are treated as interest or royalties for US federal tax purposes but treated differently for purposes of the tax law of the "specified recipient" of the payment.
- Specified payment "deemed" to be made pursuant to hybrid transaction if more than 36 month deferral
  - Inclusion year ends more than 36 months after end of specified party's deduction year

Is the D/NI Result Caused by Hybridity?

- 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.

Example of Hybrid Transaction



Disregarded Payments Are a Disqualified Hybrid Amount But Only if They Exceed Dual Inclusion Income

- "Disregarded payment," defined as a situation where a specified payment is deductible in the United States but not regarded under foreign tax law.
- Disallowed to the extent it exceeds "dual inclusion income" (a specified party's income or gain for US 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 US 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).

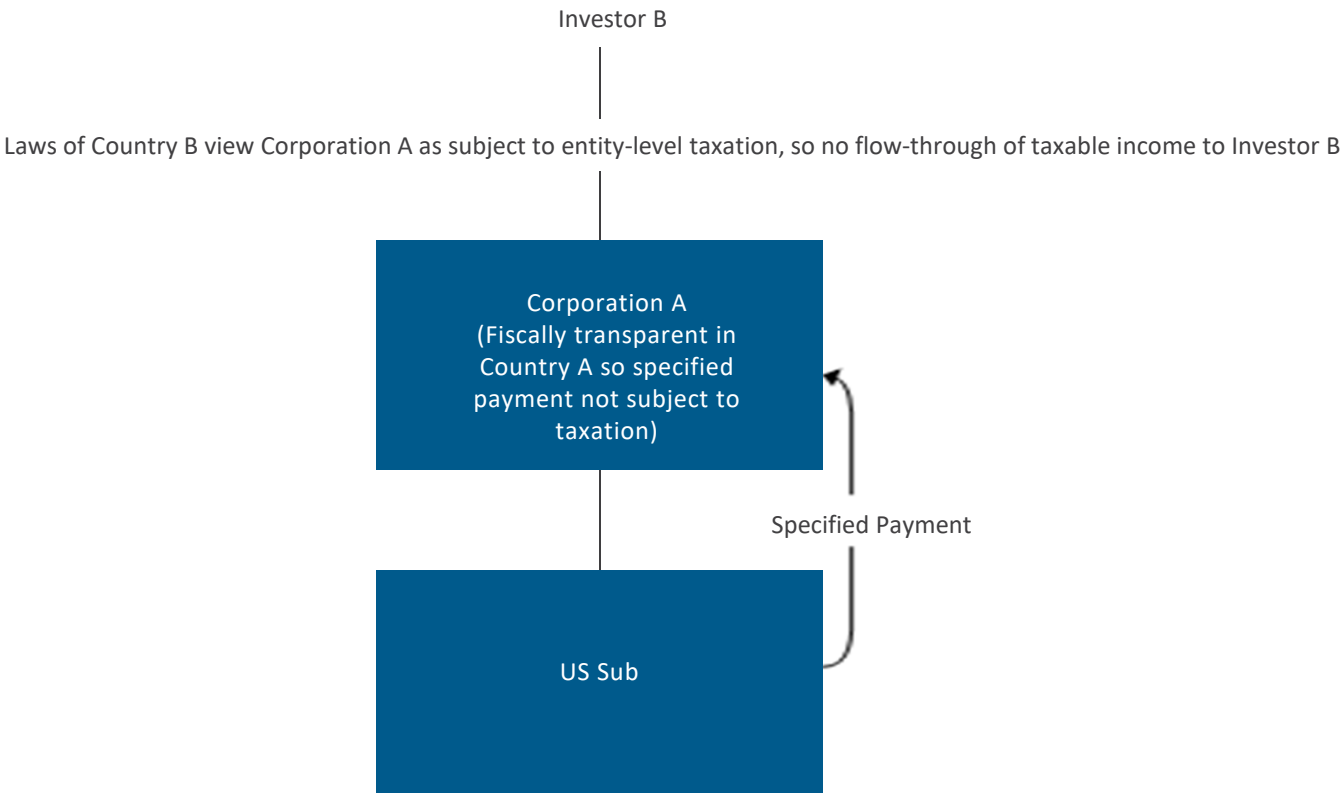
Prop. Reg. section 1.267A-2(c): Deemed Branch Payments

- A specified payment that is a "**deemed branch payment**" is a disqualified hybrid amount if Home Jurisdiction tax law exempts the US branch's income.
- A deemed branch payment is any amount of interest or royalties deductible in computing a US branch's income to the extent deemed paid to the home office where the Home Jurisdiction does not regard the payment (usually because of a tax treaty between the United States and the Home Jurisdiction).

Prop. Reg. section 1.267A-2(d): Payments to Reverse Hybrids

- 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 on the next slide.

Payment to Reverse Hybrid



Prop. Reg. section 1.267A-2(e): Branch Mismatch Payments

- A "**branch mismatch payment**" is a disqualified hybrid amount
  - To the extent a home office, which under the Home Jurisdiction tax law treats the payment as attributable to a branch of the home office, does not include the payment in income, and
  - The no-inclusion is a result of the payment being a branch mismatch payment.
- A specified payment is 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 branch is not a taxable branch, or (ii) under the branch's tax law, the payment is not treated as attributable to the branch.

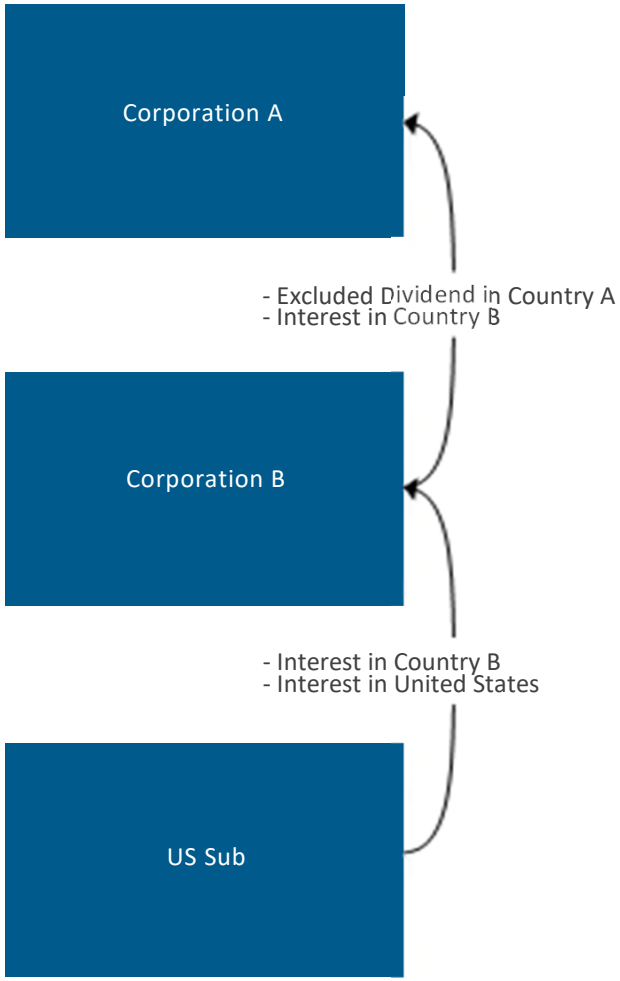
Prop. Reg. section 1.267A-4: Disqualified Imported Mismatch Amount

- This rule addresses the situation where, between the US and a foreign country there is no hybrid, but the D/NI result occurs in the foreign country through a hybrid
- Thus, 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 US 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.

Prop. Reg. section 1.267A-4: Disqualified Imported Mismatch Amount (cont.)

- 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.
- So ask: what if foreign country adopted section the Proposed Regulations.
- Connection required: imported mismatch payment must "fund" the hybrid deduction directly or indirectly

Example of Disqualified Imported Mismatch



Prop. Reg. section 1.267A-5(b)(6): Anti-Abuse Rule

- 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
  - 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 regulations under section 267A.
- This scope of the anti-abuse rule is unclear.

From a US Taxpayer's Perspective

- Identify all interest and royalties
- Determine whether paid, directly or indirectly, to a related foreign party
- Determine tax treatment of payment in Home Jurisdiction
- A first of a kind exercise from a US federal income tax standpoint

Effective Date

- The Proposed Regulations are generally effective for hybrid dividends and specified payments made in taxable years beginning after December 31, 2017 if they are finalized by June 22, 2019.
- However, if the Proposed Regulations are not finalized by June 22, 2019, they would be effective December 20, 2018.
- Treasury has requested comments on the Proposed Regulations, which are due by February 26, 2019.

Section 267A Key Takeaways

- Disallowance only for interest and royalties
  - But interest is broadly defined
- Disallowance only if D/NI results from "hybridity"
  - Principle is clear; words of the proposed regulations less so
- Burden of proof is on the taxpayer

Disclaimer

- These materials are provided by Mayer Brown and reflect information as of February 20, 2019.
- The contents are intended to provide a general guide to the subject matter only and should not be treated as a substitute for specific advice concerning individual situations.
- You may not copy or modify the materials or use them for any commercial purpose without our express prior written permission.

Thomas Humphreys - Biography

Thomas A. Humphreys
Partner
thumphreys@mayerbrown.com
NEW YORK
T: +1 212 506 2450
F: +1 212 849 5768

Thomas Humphreys is a partner in Mayer Brown's New York office and a member of the Tax Transactions & Consulting practice. He has extensive experience with the tax aspects of capital markets transactions; financial instruments; real estate investment trusts; mergers and acquisitions; bankruptcy and reorganization; tax controversy, including transfer pricing; and international transactions. Thomas also works with investment banks and issuers on developing new financial products.

He is the author of *Limited Liability Companies and Limited Liability Partnerships*, published by Law Journal Seminars Press. He is also a co-author of *Federal Taxation of Partnerships and Partners*, a CCH Expert Treatise Library publication. He frequently speaks on tax topics before various audiences, including the Practising Law Institute.

Thomas is an adjunct professor of law at New York University Law School, where he teaches Taxation of Financial Instruments in the LLM program. He is also a solicitor, admitted as a member of the Law Society of England and Wales.

MAYER·BROWN