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TAXQUARTERLY

DON'T TAX YOU. DON'T TAX ME. TAX THAT FELLOW BEHIND THE TREE.*

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Editor's Note

Not that working from home is getting old but CMTQ is really starting to miss the office. Everything is easier there. Logging on to the computer network, seeing your colleagues without having to arrange a Zoom call, keeping the good old paper files (remember those?) up-to-date, the list goes on and on. One thing we're not trying to let WFH affect is keeping our eye on the capital markets for new tax developments. While much of Q2 2020 was spent on figuring out the tax provisions of the Coronavirus Aid, Relief and Economic Security ("CARES") Act, there were also tax developments affecting financial instruments as we describe in this issue. As you can see from our coverage, one of the things we're focused on is how governments at all levels will repair the COVID-19 hit to their finances. In CMTQ Volume 02, Issue 04, we described a proposal by Sen Elizabeth Warren (D., Mass) to impose a super mark-to-market regime on wealthy US taxpayers. That was pre-COVID. Lo and behold, a similar proposal has surfaced in New York State whereby New York taxpayers with a net assets over $1 billion[1] would be treated as having sold their assets at fair market value on the effective date of the legislation and the last date of each taxable year.[2] This would apply not only to

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1 According to NY Governor Andrew Cuomo, there are 100 billionaires in New York. See "Cuomo Says Raising Taxes on Billionaires is Not Answer to State Budget Woes," NY1, July 29, 2020, available at https://www.ny1.com/nyc/all-boroughs/politics/2020/07/30/cuomo-balks-at-taxing-the-rich.

2 See "Billionaire Mark to Market Tax and the Worker Bailout Fund Act," NY State Senate Bill S8277A (introduced May 1, 2020). Revenue from the tax would be dedicated to a "worker bailout fund" which would provide emergency wage replacement for certain New York workers who

* As described in the Editor's Note, this quote is attributed to, among others, Sen. Russell Long (D., LA).

publicly traded stocks and bonds but also to privately held interests in entities and more. Also, in New York State our old friend the stock transfer tax (the "STT") has surfaced as a revenue raising proposal. The STT dates from the mid-1970s and has never been repealed although the tax has had a zero rate for decades. While NY Governor Andrew Cuomo has said he is opposed to both of these proposals (which means a lot), we have no doubt that other proposals will surface everywhere to raise taxes and some of these proposals, if adopted, will have an effect on capital markets transactions.

In this issue of CMTQ, we also cover the final anti-hybrid regulations under Code sections 267A and 245A(e), Rev. Proc. 2020-34, providing select relief for modifications of mortgages and leases held by certain entities, and more.

Update on US Tax Relief for COVID-19

As discussed in the last issue of CMTQ, both Congress and the Internal Revenue Service ("IRS") issued a host of new rules aimed at keeping the economy stabilized in the face of the COVID-19. The second quarter of 2020 focused on clarifying and refining those rules, as well as consideration of a new relief package as certain parts of the country experience an uptick in COVID-19 cases.

Perhaps the most hotly debated issue resulting from the first round of Congressional relief relates to the use of stimulus money to pay for deductible expenses. Under the CARES Act, the United States government launched a Paycheck Protection Program ("PPP"). Loans granted under the PPP can be forgiven if the proceeds are used to pay for certain types of expenses such as payroll, mortgage interest or rent. Ordinarily, the forgiveness of a loan results in "cancellation of indebtedness income" under Section 108 of the Internal Revenue Code of 1986 (the "Code").[3] However, the CARES Act explicitly overrides this general rule and provides that loan forgiveness under the PPP does not result in gross income to the borrower for tax purposes. A related question that has not been addressed explicitly by the CARES Act is whether expenses paid for with PPP proceeds that are forgiven are deductible. In Notice 2020-32, the IRS took the view that such expenses are non-deductible, on the basis that Code section 265 disallows a deduction for amounts allocable to tax-exempt income. The IRS reasoned that the purpose of section 265 is to prevent taxpayers from obtaining a double tax benefits, and that in the absence of such an interpretation, PPP recipients might be able to exclude forgiven loan proceeds from gross income and deduct expenses paid for with the forgiven amounts, resulting in such a double tax benefit. The stance from the IRS drew criticism from members of Congress as contrary to the goals of the PPP. It is possible that future legislation could provide a "fix" for the issue and explicitly state that any such expenses are deductible, however, the Senate Republican relief package does not include this provision.[4]

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do not qualify for unemployment insurance and financial assistance for certain New York households that suffer loss of income during a state of emergency declared by the governor. A video in support of the tax is available at https://www.youtube.com/watch?v=cIA1ex88faM&feature=youtu.be.

3 Unless otherwise stated, all section references herein refer to the Code and the regulations thereunder.

4 "Tax Issue Tangles Small Businesses' Pandemic Relief," The Wall Street Journal, July 30, 2020, page B6.

Another hotly debated topic is whether any future tax relief will include a cut to payroll taxes. President Trump has pushed the idea on social media; however the Senate Republican package does not include a payroll tax cut.

As Congress heads toward the August recess it remains to be seen whether there will be a relief package, what tax incentives might be included in the package, and how any such measures will impact tax planning for transactions occurring this year and beyond.

Proposal to Reactivate the New York Stock Transfer Tax

Enacted in 1905, the New York stock transfer tax ("STT") has been around for over 100 years, but has involved little more than shuffling paper and tax advisor hand-wringing for the last 40 years or so. New York State has allowed a rebate for the full amount of tax since 1981. Now, the economic distress caused by the pandemic, with its knock-on effects for state and local tax revenues, has New York taxpayers wondering where the State will look for money to fill the gap. A renewed proposal to eliminate the STT rebate, in Assembly Bill No. A07791B (July 1, 2020), may be one answer, and has attracted the attention of many anxious market participants. Elimination of the rebate could raise approximately $13 billion annually for New York.[5]

By way of background, the STT is currently imposed on any one of five (5) taxable events occurring in New York: sales, agreements to sell, memoranda of sales, deliveries, or transfers of shares or certificates of stock.[6] A taxable event may include any transfer on a securities exchange that facilitates the transaction, if the exchange is located, operates, or effectuates any aspect of the transaction in New York. Any person or persons making or effectuating a transfer or sale, including the person or persons to whom the transfer or sale is made, is responsible for payment of the STT.[7] The tax is only payable once—therefore, an option may be taxable, but the subsequent delivery of shares will not be taxable.[8]

For sales transactions, the STT is calculated on the value and number of shares sold. The tax rate varies between 1¼ cents to 5 cents per share. The maximum amount of STT is $350 for any single qualifying sale involving shares or certificates of the same class and issued by the same issuer, as long

5 In a similar vein, under Assembly Bill No. 4402 (July 16, 2020), New Jersey has proposed legislation in the form of a financial transactions tax on high-quantity processors of financial transactions to address its budget deficit. The Bill would impose a $0.0025-per-transaction tax on persons or entities that process 10,000 or more financial transactions through electronic infrastructure located in New Jersey during the calendar year.

6 NY Tax Law § 270; 20 NYCRR § 50.1. Also included are certificates of rights to stock; certificates of interest in property or accumulations; certificates of interest in business conducted by a trustee or trustees; and certificates of deposit.

7 NY Tax Law § 270.3; 20 NYCRR § 50.3. The parties to a transaction may agree which of them shall bear the liability and payment of the tax by either discharges the liability of both.

8 *See* 20 NYCRR § 50.2. "[I]f a sale, delivery of the certificates and record transfer to the name of the purchaser are all made within [New York], only one tax is payable."

as certain timing requirements are met.[9] For transfers other than a purchase and sale, the tax rate is 2½ cents per transaction. The current tax rates are as follows:[10]

Selling Price	**Rate (cents per share)**
Sale or agreement to sell at less than $5 per share	1 ¼ ¢
Sale at $5 or more but less than $10 per share	2 ½ ¢
Sale at $10 or more but less than $20 per share	3 ¾ ¢
Sale at $20 or more per share	5 ¢
Transfers of stock or certificates of interest other than by sale	2 ½ ¢

Though New York State effectively eliminated the STT many years ago, the rebate mechanism technically does not eliminate taxpayers' compliance obligations—they must still report and pay the tax and then request a rebate. The State therefore receives a fairly detailed picture of the revenue that could be gained from scaling back the rebate.

The Department of Taxation and Finance, pursuant to statutory authority, allows registered securities brokers and dealers to report the tax payable through a selected securities exchange and authorize the relevant clearing corporation to charge and remit the tax. As a result of the rebate, while brokers and dealers report the tax payable, the applicable clearing corporation merely charges and rebates the tax by book entry and then files a report with the Department.

Taxpayers other than registered brokers and dealers can pay the STT by purchasing tax stamps, affixing them to the bill of sale or stock certificate surrendered, and then canceling the tax stamps so they cannot be used again. The taxpayer can then file a rebate claim, provided the rebate claim is made within two years after the affixing and cancelling of stock transfer tax stamps or payment of the tax otherwise than by the use of stamps.[11]

Turning back to Assembly Bill No. A07791B, it would repeal the STT rebate in its entirety. It would also expand the tax, such that a transaction could be captured "if any activity in furtherance of the transaction occurs within [New York] or if a party involved in the transaction satisfies a nexus with New York state which shall be defined as broadly as is permitted under the United States Constitution." Rather than define nexus (and thus limit the STT) by taxable events that occur in New York, and capture transactions that are documented, executed, or delivered in New York, this

9 NY Tax Law § 270-e.1.

10 NY Tax Law § 270.2. Note that certain transactions are exempt from STT under NY Tax Law §§ 270.5 and 270-c and 20 NYCRR §§ 50.1(j) and 53.1.

11 *See* TSB-M-82(6)M *Stock Transfer Tax Rebate Program Stamp Users* (July 9, 1982); NY Tax Law § 280-a.3.

proposal would seemingly broaden nexus, and thus the STT, to include any transaction that, for example, had planning, analysis, or authorization occur in New York. It might also apply to transactions where execution and delivery occur outside New York, but the buyer, seller, or broker have nexus with New York. But could that really be constitutional? If every state enacted such a regime, double taxation would surely occur and the tax would have to be more narrowly administered.

On the subject of administration, it is likely that other significant amendments to the STT and regulations would be necessary because it has not been amended since 1977 to keep pace with changes in broker business models or the current stock trading environment. In particular, the STT was designed for open outcry trading instead of screens and would have to be updated for wholly electronic exchanges (most of which have their equipment located outside New York anyway). Overall, New York's desire to retain is dominance in financial markets and the ease with which trading could be shifted out of state, make the STT an unlikely candidate for solving New York's budget problems. The New York Legislature is currently out of session, but taxpayers should look for this proposal in the Governor's budget proposal for fiscal year 2022 to evaluate whether it has legs.

Rev. Proc. 2020-19 – IRS Cash Limitation Percentage for REITs and RICs

In the last issue of CMTQ, we covered a letter from the National Association of Real Estate Investment Trusts ("Nareit") requesting IRS relief for real estate investment trust ("REIT") distributions paid in cash and stock due to the global pandemic. On May 4, 2020, the IRS issued Rev. Proc. 2020-19.[12]

Although a REIT is generally subject to corporate-level tax, the Code provides a special deduction to REITs for dividends paid which can result in a complete elimination of US federal corporate income tax at the REIT level. Furthermore, a REIT is generally required to distribute at least 90% of its taxable income to shareholders in order to take advantage of the special rules applicable to REITs. In order for a distribution to be deductible by the REIT, and to count towards the 90% distribution requirement, the distribution must be a "dividend" for federal income tax purposes. REIT distributions paid in cash out of the REIT's current and accumulated earnings and profits are generally dividends that the REIT can deduct. On the other hand, distributions paid entirely in stock are generally not "dividends" and thus cannot be deducted by the REIT.

Rev. Proc. 2017-45 provided a safe harbor for publicly offered REITs[13] to satisfy the distribution requirement with a combination of cash and stock, provided in general that each shareholder can elect either cash or stock and the aggregate cash component of the distribution to all shareholders represents at least 20% of total distributions. Rev. Proc. 2020-19 temporarily reduces the cash

12 Rev. Proc. 2020-19 is available at https://www.irs.gov/pub/irs-drop/rp-20-19.pdf.

13 A publicly offered REIT is a REIT which is required to file annual and periodic reports with the Securities and Exchange Commission under the Securities Exchange Act of 1934.

limitation component to 10% with respect to distributions declared by a publicly offered REIT on or after April 1, 2020 and on or before December 31, 2020. This temporary relaxation also applies to publicly offered regulated investment companies ("RICs").

Rev. Proc. 2020-34 – Relief for Certain Modifications of Mortgages and Leases

On June 4, 2020, the IRS released Rev. Proc. 2020-34 to provide temporary safe harbors for rental property trusts with mortgages and lease holders who are experiencing financial hardship as a result of the COVID-19 pandemic.[14]

Rev. Proc. 2020-34 allows eligible trusts to make certain modifications to their mortgage loans in connection with a forbearance program, without jeopardizing their tax status as grantor trusts under Treas. Reg. section 301.7701-4(c) and Rev. Rul. 2004-86. Specifically, those modifications are not treated as replacing the unmodified obligation with a newly issued obligation, giving rise to prohibited transactions, or manifesting a power to vary when determining the federal income tax status of securitization vehicles that hold the loans.

In addition, Rev. Proc. 2020-34 provides that a cash contribution from one or more new trust interest holders to acquire a trust interest or a non-pro rata cash contribution from one or more current trust interest-holders must be treated as a purchase and sale under Code section 1001 of a portion of each non-contributing (or lesser contributing) trust interest-holder's proportionate interest in the trust's assets.

The modifications of mortgage loans must be related to the economic relief provided under the CARES Act or certain similar programs that are requested, or agreed to, from March 27, 2020 through December 31, 2020, and that are granted as a result of a borrower experiencing a financial hardship due to the COVID-19 pandemic.

Nareit Recommendations for IRS Priority Guidance Plan

In Notice 2020-47, the Department of the Treasury and the IRS invited the public to submit recommendations for items to be included on the 2020-2021 Priority Guidance Plan. The Treasury Department's Office of Tax Policy and the IRS use the Priority Guidance Plan each year to identify and prioritize the tax issues that should be addressed through regulations, revenue rulings, revenue procedures, notices, and other published administrative guidance. The 2020-2021 Priority Guidance Plan will identify guidance projects that the Treasury Department and the IRS intend to actively work on as priorities during the period from July 1, 2020 through June 30, 2021.

14 Rev. Proc. 2020-34 is available at https://www.irs.gov/pub/irs-drop/rp-20-34.pdf.

In response to Notice 2020-47, Nareit published a letter on July 20, 2020, making the following recommendations, listed in order of priority.[15] First, Nareit recommended the withdrawal of Notice 2007-55, which holds that REIT liquidating distributions and redemptions should be treated as capital gain liquidations that are subject to the Foreign Investment in Real Property Tax Act ("FIRPTA") if paid to foreign shareholders. Nareit argued that withdrawing Notice 2007-55 would encourage additional foreign investment in U.S. real estate and infrastructure and therefore be consistent with Executive Order 13924 (EO 13924). Issued in response to the COVID-19 public health and economic crisis, EO 13924 urges the heads of all agencies to rescind, waive, modify or otherwise take actions regarding regulatory standards that may inhibit economic recovery. Nareit further argued that withdrawal of Notice 2007-55 would be consistent with the Treasury Department's policy statement supporting the timely promulgation of regulations and the elimination of confusion and uncertainty. Nareit has repeatedly submitted letters requesting for the withdrawal of Notice 2007-55 since 2010.

Additionally, Nareit requested that the Treasury Department and the IRS exercise their regulatory authority to prevent otherwise qualifying rent payments from becoming nonqualifying income under the related party rent rules, solely due to the double downward attribution rules in section 318. Under the related party rent rules of section 856(d)(2)(B), payments that a REIT receives from an entity in which the REIT owns at least 10% of its equity are not considered qualified rents under the REIT income test. In determining the percentage interest of ownership, application of the attribution rules of section 318 not only complicates the determination but also leads to unintended results according to Nareit.

Lastly, Nareit requested that the IRS finalize regulations under Treas. Reg. section 1.337(d)-7, exempting transfers by a foreign corporation of appreciated assets to RICs and REITs if the foreign corporation is not otherwise subject to US tax.

IRS Delays Certain QI Certifications Due in 2020 and Issues FAQs to Confirm Postponement of QDDs Periodic Review

On April 30, 2020, the IRS amended the QI FAQs relating to the periodic review for Qualified Derivatives Dealers (QDDs).[16] *See* updated FAQ 1 and new FAQ 19 under the heading "Certifications and Periodic Reviews." In general, each Qualified Intermediary (QI) is required to make a certification (including a periodic review) to the IRS every three years. Under Notice 2020-2, 2020-3 I.R.B. 327, a QI that is a QDD is not required to perform a periodic review with respect to its QDD activities for a certification period ending in any calendar year prior to 2023. A QI that is a QDD (whether or not it acted as a QDD) may, however, still be required to conduct a periodic review of its QI activities that are not QDD activities for those years. Updated FAQ 1 provides that the IRS will permit a QI that is a QDD and that has a certification period ending in any calendar year before 2023 to apply for a waiver

15 The letter is available at https://www.reit.com/sites/default/files/Nareit_PGP_Recommendations_2020-21.pdf.

16 These FAQs can be found on the Qualified Intermediary (QI), Withholding Foreign Partnership (WP), and Withholding Foreign Trust (WT) FAQ webpage, which is available at https://www.irs.gov/businesses/corporations/qualified-intermediary-general-faqs.

of the periodic review when it otherwise meets the requirements of section 10.07 of the QI agreement with respect to its QI activities that are not QDD activities. New FAQ 19 provides that a QI that is a QDD must make any required periodic certifications, including the Certification of Internal Controls, taking into account both its QDD and non-QDD activities. However, for its QDD activities in calendar years ending before 2023, the QI may certify by taking into account whether the QDD made a good faith effort to comply with the section 871(m) regulations and the relevant provisions of the QI agreement. The QI must retain information to support the good faith effort certification.

Additionally, due to COVID-19, each QI with a periodic certification due date of July 1, 2020 will have until December 15, 2020 to submit its periodic certification or an application to waive the periodic review requirement. There is no need to file a request for extension with the IRS. Each QI should confirm that this revised date is reflected on its Account Management System profile (the QI System).

US v. Bittner: Favorable District Court Ruling on Non-Willful FBAR Penalty

In *U.S. v. Bittner*,[17] a district court found that the penalty for a non-willful Report of Foreign Bank and Financial Account ("FBAR") violation refers to each FBAR form rather than each foreign financial account maintained but not timely or properly reported, in a significant win for non-filers.

The IRS alleged that the taxpayer, a Romanian-born and naturalized U.S. citizen, had non-willfully failed to file FBARs from 2007 to 2011 against which the United States sought nearly $3 million in penalties and accruals, assessing $10,000 per account per FBAR violation. The taxpayer argued that the maximum penalty allowed was $10,000 per FBAR form. Multiple accounts are reported on a single FBAR form.

31 U.S.C. 5314 requires U.S. citizens to annually report certain transactions and relationships with foreign financial agencies. The implementing regulations, 31 C.F.R. 1010.306(c), further require U.S. citizens to report to the IRS foreign financial accounts exceeding $10,000 maintained during the previous calendar year on a Report of Foreign Bank and Financial Account ("FBAR").

If a U.S. citizen fails to file an FBAR, the IRS may impose a civil monetary penalty on such person. Under 31 U.S.C. 5321(a)(5)(A), the amount of the penalty depends on whether the conduct at issue is willful or non-willful. If the failure is non-willful, under 31 U.S.C. 5321(a)(5)(B)(i), the amount of any civil penalty imposed cannot exceed $10,000.

In the June 29, 2020 opinion, the court concluded that its interpretation of non-willful FBAR violations is consistent with the plain language and overall statutory and regulatory scheme of the Bank Secrecy

17 No. 4-19-cv-415 (E.D. Tex. 2020).

Act ("BSA"). Specifically, the court explained that Congress used the word "account" or "accounts" over 100 times throughout the BSA, but omitted any mention of "account" or "accounts" in 31 U.S.C. 5321(a)(5)(A) and (B)(i). The court also found additional support for its reasoning that penalties apply by year in the FBAR form instructions, which state that a form must be filed if the aggregate balance in accounts exceed $10,000. Therefore, the court held that the non-willful FBAR penalty should be assessed on a per reporting basis rather than a per account basis.

In addition, the court acknowledged but declined to follow the rationale in another similar case, *U.S. v. Boyd*,[18] which held that the non-willful FBAR penalty should be imposed on a per account basis. The court found that the *Boyd* court failed to provide adequate guidance as to how it reached the conclusion that it did. It remains to be seen whether this ruling will be upheld on appeal.

Final Section 199A Regulations Address RICs Holding REITs[19]

On June 24, 2020, the IRS issued final Treasury Regulations under Code section 199A (the "Regulations"), which largely follow the proposed Treasury Regulations proposed in February 2019.[20]

Code section 199A, enacted under the Tax Cuts and Jobs Act, allows a 20% "qualified business income" deduction for dividends received by a non-corporate taxpayer from a REIT. Previous Treasury Regulations issued under Code section 199A in February 2019 addressed certain items related to the section 199A deduction but did not address the treatment of REIT dividends received by regulated investment companies ("RICs"). Without clarification, by the terms of Code section 199A, RIC dividends might be ineligible for the section 199A deduction.

As noted in the preamble to the Regulations, Code section 199A directs the IRS to prescribe such regulations as are necessary to carry out the purposes of Code section 199A, including its application to tiered entities. The Regulations provide rules for "conduit treatment" for qualified REIT dividends (i.e., not capital gain dividends) received by a RIC. Under these rules, a "section 199A dividend" paid by a RIC to a non-corporate taxpayer is eligible for the 20% Section 199A deduction to the extent derived from qualified REIT dividends received by the RIC. The Regulations impose a holding period requirement, only permitting the section 199A deduction for shareholders who hold the applicable RIC stock for more than 45 days within the 91-day period beginning 45 days before the date on which the stock becomes ex-dividend with respect to the section 199A dividend.

18 No. CV 18-803-MWF, 2019 WL 1976472 (C.D. Cal. Apr. 23, 2019), *appeal docketed*, No. 19-55585 (9th Cir. May 22, 2019).

19 CMTQ would like to thank Mayer Brown summer associate Ping Hsu for his assistance with this article.

20 The Regulations are available at https://www.govinfo.gov/content/pkg/FR-2020-06-25/pdf/2020-11832.pdf. For Mayer Brown's previous reporting on the proposed Treasury Regulations, see "Mutual Funds That Hold REIT Shares – Are the Fund Dividends Eligible for the 20% Code Section 199A Deduction?", Capital Markets Tax Quarterly, Volume 01, Issue 02, January 23, 2019, available at https://www.mayerbrown.com/ /media/files/perspectives-events/publications/2019/01/capital-markets-tax-quarterly/files/capitalmarketstaxquarterlyupdatejanuary222019/fileattachment/capitalmarketstaxquarterlyupdatejanuary222019.pdf.

The Regulations do not provide for conduit treatment in the case of income earned by a RIC from a publicly traded partnership (a "PTP"). In the proposed Treasury Regulations, the IRS had noted several difficulties in applying the same conduit treatment to qualified PTP income received by a RIC, including with respect to the potential of PTPs to generate losses and the treatment of those losses. A PTP may not net losses from a "specified service trade or business" against other income, and net losses must be carried forward for section 199A attribute purposes. The IRS noted that it was unclear how those losses could be passed through on the payment of a dividend to RIC shareholders. Additionally, the section 199A deduction is available with respect to "specified service trade or business" income for taxpayers with income below a threshold, with a phase-out for taxpayers with income above that threshold. The IRS indicated that these complexities would make it difficult for a conduit regime to treat RIC shareholders in a manner consistent with the treatment of direct ownership of PTP interests. The preamble to the Regulations note comments received on these issues, including suggestions for addressing the "specified service trade or business" issues, and indicates that the Treasury Department and the IRS are continuing to evaluate options for applying conduit treatment for PTPs.

The Regulations also address several other issues, including the treatment of certain previously disallowed losses and deductions that are allowed in the current year and the treatment of section 199A deductions for owners or beneficiaries of trusts and estates.

IRS Releases Final and Proposed Anti-Hybrid Tax Regulations

In 2017, the Tax Cuts and Jobs Act ("TCJA")[21] added sections 245A(e) and 267A to the Code. 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. At the end of 2018, the Internal Revenue Service ("IRS") issued proposed regulations under both of these Code provisions (the "2018 Proposed Regulations").[22] In April, the IRS finalized these regulations (the "Final Regulations"). The Final Regulations are generally consistent with the 2018 Proposed Regulations,[23] but in some cases include some tailoring or explanation into the government's thinking. As it frequently does when finalizing a complex set of regulations, the Treasury released a new set of proposed regulations adding some new components to the originally proposed guidance (the "Proposed Regulations").[24]

The statute and Final Regulations implement several recommendations from the OECD's Base Erosion and Profit Shifting ("BEPS") reports. In particular, the BEPS Action 2 reports are designed to address

21 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."

22 The Proposed Regulations are available at https://s3.amazonaws.com/public-inspection.federalregister.gov/2018-27714.pdf. For a summary of the same, see our Legal Update "IRS Releases Proposed Anti-Hybrid Regulations."

23 The Final Regulations are available at https://www.govinfo.gov/content/pkg/FR-2020-04-08/pdf/2020-05924.pdf.

24 The Proposed Regulations are available at https://www.govinfo.gov/content/pkg/FR-2020-04-08/pdf/2020-05923.pdf.

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, including the particular 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 corresponding income under the laws of the recipient's country. This "Deduction/No Income" or "D/NI" outcome is what the Final Regulations are aimed at.

As discussed in more detail below, the Final Regulations generally supply technical mechanics for sections 245A(e) and 267A, but they also expand the scope of each provision in some ways. This article:

- analyzes the Final Regulations implementing the hybrid dividend rule in section 245A(e);
- analyzes the Final Regulations implementing section 267A;
- provides an overview of the reporting requirements imposed by the Final Regulations for both Code sections;
- discusses the content of the new Proposed Regulations; and
- summarized the effective dates for all of the above.

I. SECTION 245A(E) – HYBRID DIVIDENDS

A. 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 the then-new section 245A, a 100% dividends-received deduction for the foreign source portion of dividends received by US corporate shareholders owning at least 10% of the shares of a controlled foreign corporation ("CFC"). 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 a tiered hybrid dividend is received by a CFC, the dividend is treated as subpart F income to the US shareholder without regard to any other exclusions, including, for example, the earnings and profits limitation or the look-through provisions of section 954(c)(6).

B. Definition of a Hybrid Dividend

The Final 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) – termed a "hybrid deduction" by the regulations.[25] 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

25 *See* Treas. Reg. section 1.245A(e)-1.

equity for US 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 US tax purposes. This includes a dividends-paid deduction and notional interest deductions ("NID") available in some countries, such as Belgium.

One uncertainty under the 2018 Proposed Regulations was whether section 245A(e) applies even if the foreign jurisdiction has hybrid mismatch rules in place that deny deductions in the foreign jurisdiction. The preamble to the Final Regulations states that whether a deduction or other tax benefit is a hybrid deduction under section 245A(e) should be determined without regard to foreign hybrid mismatch rules. The Final Regulations provide that the determination of whether a foreign tax law allows a deduction or other tax benefit for an amount is made without regard to the application of foreign hybrid mismatch rules, provided that the amount gives rise to a dividend for US tax purposes or is reasonably expected for US tax purposes 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 would have otherwise been allowed.[26]

Comments to the 2018 Proposed Regulations requested flexibility for foreign deductions that were suspended by foreign law under a thin capitalization rule or where the foreign deduction was otherwise disallowed. The IRS declined to make either of these changes.

C. Lower-Tier CFCs

Section 245A(e) denies the participation exemption for hybrid dividends received by US 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 Final 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.[27] The Final Regulations go a step further to turn off the provisions of section 964(e) (gain on certain stock sales by CFCs treated as dividends) with respect to sales of shares of CFCs with a hybrid dividend account, disallowing any participation exemption deduction.

D. 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 Final Regulations require US shareholders of the CFC to maintain a "hybrid dividend account" for each share of stock for which section 245A may be available. The Final Regulations contain the plumbing for maintaining that account. A hybrid dividend account must be maintained for each share held by the US shareholder. Tax benefits are then allocated to each share based on the relative value of the CFC's shares. Tax

26 *See* Treas. Reg. section 1.245A(e)-1(d)(2)(ii)(B).

27 *See* Treas. Reg. section 1.245A(e)-1(g)(2), Example 2.

benefits with respect to a share of stock increase the hybrid dividend account. A US shareholder's hybrid dividend account is further adjusted by such holders subpart F or GILTI inclusions to extent those inclusions neutralize the double non-taxation effect of a hybrid dividend or tiered hybrid dividend.[28] 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 Final Regulations illustrates this point.[29] In the example, a US 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.

E. Specified Owners and Sales/Exchanges

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

The Final Regulations contain a number of rules with respect to transfers of shares subject to a hybrid dividend account.[30] 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. Where there is a section 338(g) election, the hybrid dividend account is reduced to zero, with no carryover to the purchaser.

The Final 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), with some special rules for spin-offs.

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28 These rules are in the Proposed Regulations, discussed in Part IV below.

29 *See* Treas. Reg. section 1.245A(e)-1(g)(1), Example 1.

30 *See* Treas. Reg. section 1.245A(e)-1(d)(4).

II. SECTION 267A – HYBRID TRANSACTIONS/ENTITIES

A. Background

Congress passed section 267A to limit those instances where a US taxpayer was claiming both a US tax benefit and a foreign country tax benefit from the same payment or transaction. For example, a US taxpayer might borrow money from a foreign person using an instrument that produced interest deductions for the US 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 US tax authorities.

The Final 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.

Code section 267A defines a DRPA as 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 a 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% test. If an interest or royalty payment is included in the gross income of a US shareholder under section 951(a) (i.e., the CFC rules) then the provision does not apply.

The Final 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 Final Regulations seek to accomplish this by denying a "specified party's"[31] deduction for any interest or royalty paid or accrued (a "specified payment").

The Final 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).[32] In response to comments to the proposed section 163(j) regulations (which have not yet been finalized), the Final Regulations (a) treat a swap with significant non-periodic payments as two separate transactions consisting of an on-market, level payment swap and a loan, with the time

31 The Final 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% (by vote or value) of the stock of the CFC), and a U.S. taxable branch." Accordingly, entities that are fiscally transparent for US 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.

32 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.

value component associated with the loan treated as interest expense to the payor, (b) exclude from the definition of "interest" swaps cleared by a derivatives clearing organization, and (c) exclude from the definition of "interest" non-cleared swaps that require the parties to meet the margin or collateral requirements of a federal regulator.[33]

The Final Regulations deny a specified party's deduction for a specified payment in three situations:[34]

a. 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 (addressed in Treas. Reg. sections 1.267A-2 and -3).

b. 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 US tax system (i.e., where payments of a specified amount are offset by a hybrid deduction) (addressed in Treas. Reg. section 1.267A-4).

c. A specified payment producing a D/NI outcome that the regulations classify as having a purpose of avoiding the section 267A regulations (addressed in Treas. Reg. section 1.267A-5(b)(6)).

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

B. Hybrid and Branch Arrangement Giving Rise to Disqualified Hybrid Amounts

A disqualified hybrid amount generally arises under the Final 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 below. Where a transaction gives rise to a disqualified hybrid amount, the US deduction for the payment is permanently denied.

The Final Regulations provide operating rules that apply to each of the four types of specified payments discussed below. Under the Final 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 allow a deduction with respect to a particular category of income. In these cases, the deduction is not disallowed since the hybridity does not cause the D/NI.[35]

33 *See* Treas. Reg. section 1.267A-5(a)(12).

34 The Final 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. Only payments that are from hybrid arrangements count towards the de minimis threshold.

35 *See* Treas. Reg. section 1.267A-3(a)(1).

In addition, a disqualified hybrid amount is reduced to the extent amounts are included or includible in a US tax resident's or US taxable branch's income.[36] 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 US tax resident or a US taxable branch, or taken into account by a US 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 Final Regulations indicates that the IRS considered comments recommending that certain types of withholding should reduce disqualified hybrid amounts on specified payments. However, the Final Regulations retain the approach of the 2018 Proposed Regulations in disregarding withholding.

Even if a specified payment is included in income in another foreign jurisdiction (other than the jurisdiction of the US 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 Final 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," generally 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.

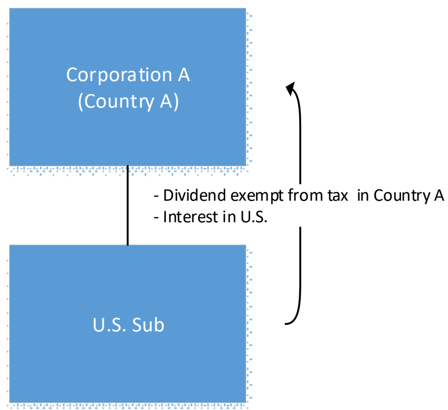
Hybrid transaction. The Final Regulations generally follow the statutory definition of "hybrid transaction," defining this term to include any transaction, series of transactions, agreement or instrument where one or more payments made are treated as interest or royalties for US federal tax purposes but treated differently for purposes of the tax law of the "specified recipient"[37] of the payment.[38] 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 Final Regulations. This situation is illustrated in Figure 1.

36 *See* Treas. Reg. section 1.267A-3(b).

37 "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. *See* Treas. Reg. section 1.267A-5(a)(19).

38 Treas. Reg. section 1.267A-2(a)(2).

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 US law, is a hybrid transaction (for example, a specified payment made pursuant to an instrument viewed as indebtedness under both the US and non-US tax law but, due to a mismatch in tax accounting treatment between the US and non-US tax law, results in long-term deferral). Here, the Final Regulations add a "reasonable expectation" rule to the approach in the 2018 Proposed Regulations, requiring that at the time of payment the payor assess whether it is reasonable to expect that the payee will include the payment in income within the 36-month period.

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 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). 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 US corporation (US Sub), and under the laws of Country A, items of income of US Sub are included on Corporation A's consolidated Country A tax return, and payments from US 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 Final 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-US law but another amount connected to the payment is regarded under such law (a "connected amount").[39] For example, consider a specified payment arising from a repo transaction involving stock, where a US person transfers the legal title to stock to a non-US person with an agreement to repurchase the stock back at a higher price, with the difference being treated as interest for US federal tax purposes. Suppose the tax laws of the non-US 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-US law is the connected amount under the Final 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 Final Regulations where the law of a non-US 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 US permanent establishment to its home office under an income tax treaty between the United States and the home office country.[40] This can occur, for example, where an amount is allowed as a deduction in computing the business profits of a US 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 Final 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.[41] 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 US and non-US 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.

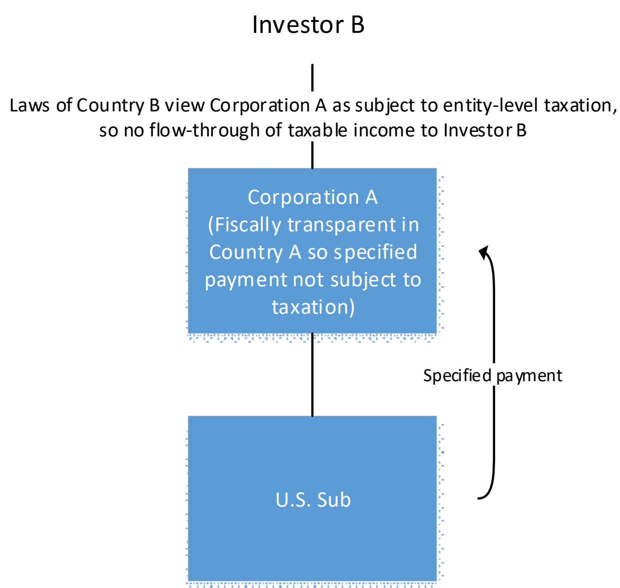
A specified payment made to a reverse hybrid is generally a disqualified hybrid amount to the extent that (a) an investor in the reverse hybrid does not include the payment in income and (b) the investor's no-inclusion would not occur if the investor's tax law treated the reverse hybrid as fiscally transparent.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

39 Treas. Reg. section 1.267A-2(a)(3).

40 Treas. Reg. section 1.267A-2(c).

41 *See* Treas. Reg. section 1.267A-2(d).

Figure 2



Branch mismatch payments. The Final 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 branch is not a taxable branch or (ii) the specified payment is treated as attributable to the home office and not the branch.[42] Generally, a branch mismatch payment is a disqualified hybrid amount to the extent the home office does not include the payment in income.

C. Disqualified Imported Mismatch Amount

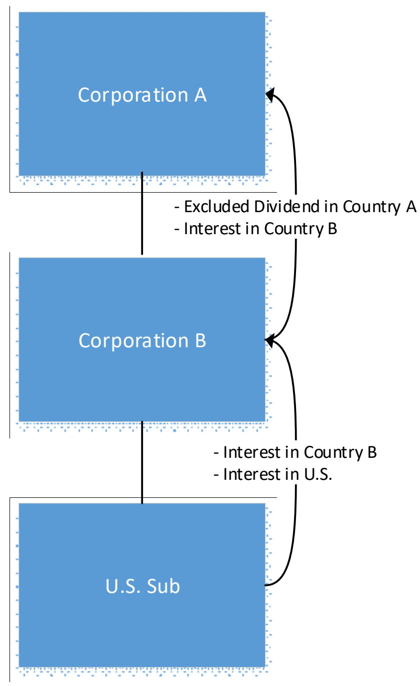
The rules in the Final Regulations disallowing the deduction for imported mismatch amounts are intended to prevent the effects of an "offshore" hybrid arrangement from being "imported" to the United States through the use of a non-hybrid arrangement. A payment is generally a disqualified imported mismatch amount where (a) the specified payment is non-hybrid in nature, such as interest paid on an instrument treated as debt for both 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.[43] 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 Final Regulations. The Final Regulations provide the mechanics for determining (a) whether a hybrid deduction offsets income attributable to a specified payment and (b) what payments are treated as hybrid deductions where the foreign tax law for a relevant party contains hybrid mismatch rules.

42 Treas. Reg. 1.267A-2(e).

43 *See* Treas. Reg. section 1.267A-4.

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 US corporation (US Sub). Suppose Corporation B holds an instrument issued by US Sub that is treated as indebtedness for both Country B and US 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 US 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 Final Regulations (since the Final 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 US Sub is disallowed under the imported mismatch amount rules.

D. Payments Within the Anti-Abuse Rule

Finally, the Final 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 terms or structure of the arrangement is to avoid the purposes of the regulations under section 267A.[44] This anti-abuse is an attempt to fill in any cracks that might be found in the Final Regulations down the road.

III. REPORTING FOR TRANSACTIONS UNDER THE FINAL REGULATIONS

The Final Regulations follow the reporting approach of the 2018 Proposed Regulations, with some additional color.[45] With respect to section 245A(e), the Final Regulations note that CFCs paying hybrid dividends must report such dividends on Form 5471. While previously unclear under the 2018 Proposed Regulations, the Final Regulations make clear that Form 5471 must contain any information relating to the rules of section 245A(e), including information related to a specified owner's hybrid deduction account.

With respect to specified payments and section 267A, the reporting imposed by the Final Regulations depends on the type of US entity making the specified payment. If the entity is a CFC, the Final 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 US corporation owned 25% by a foreign entity, or a foreign corporation engaged in a US 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% partner must provide information about the disallowance.

IV. NEW PROPOSED REGULATIONS

The Proposed Regulations generally (i) adjust hybrid deduction accounts under section 245A(e) for earnings and profits of a CFC that are included in income by a US shareholder, (ii) limit, for purposes of the conduit financing rules under section 881, equity interest arrangements that give rise to deductions or similar tax credits under the laws of foreign jurisdictions, and (iii) provide coordination rules relating to the treatment of certain payments under the GILTI provisions.

A. Reductions in Hybrid Dividend Accounts

The Proposed Regulations require hybrid deduction accounts to be reduced to the extent earnings and profits of the CFC which have not been subject to foreign tax as a result of certain hybrid arrangements, are included in income by a US shareholder. In particular, the proposed rules specify that hybrid deduction accounts should be reduced as part of the end-of-the-year adjustment by inclusions under (i) subpart F, (ii) GILTI, and (iii) sections 951(a)(1)(B) and 956.

Inclusions made under subpart F and GILTI are adjusted to the extent such inclusions are not offset by deductions or credits (e.g., a foreign tax credit). However, inclusions under sections 951(a)(1)(B) and 956 provide a dollar-for-dollar adjustment since deductions and credits are not generally available for such inclusions.

44 Treas. Reg. section 1.267A-5(b)(6).

45 *See* Treas. Reg. sections 1.6038-2(f)(13) and (14), 1.6038-3(g)(3), and 1.6038A-2.

In sum, these adjustments further ensure section 245A dividend received deductions are disallowed only for amounts sheltered from tax by virtue of hybrid financing arrangements. Specifically, the adjustments prevent potential (i) double taxation of earnings of a CFC that are already indirectly included in the income a US shareholder (e.g., US shareholders that have subpart F and GILTI inclusions) and (ii) double non-taxation by taking into account deductions and credits that offset subpart F and GILTI inclusions.

B. New Anti-Conduit Regulations

The Proposed Regulations expand the scope of financing transactions under the anti-conduit rules found in Treas. Reg. section 1.881-3(a)(2)(ii) to include equity interest arrangements that give rise to deductions under foreign law. Under current regulations, such equity interests are generally not considered financing transactions (unless the equity interest is redeemable under Treas. Reg. section 1.881-3(a)(2)(ii)(B)). In other words, currently, an instrument that is treated as equity (other than redeemable equity) for US tax purposes and indebtedness under the laws of a foreign jurisdiction is not considered a financing transaction.

To prevent taxpayers from structuring into such equity arrangements, bypassing the conduit financing rules, and exploiting foreign jurisdictions, the Proposed Regulations broaden the scope of financing transactions to include such equity arrangements by taking into account the tax treatment of such instruments in foreign jurisdictions.

Specifically, the Proposed Regulations consider an equity interest as a financing transaction if under the laws of the foreign jurisdiction of the issuer, the issuer is permitted a deduction or other tax benefit for amounts paid, accrued, or distributed with respect to the equity interest. A similar rule would apply if the issuer maintained a taxable presence in a separate jurisdiction (i.e., a permanent establishment) and that jurisdiction permitted a deduction or other tax benefit for amounts paid, accrued, or distributed with respect to the equity interest of the permanent establishment. The proposed rules also treat an equity interest as a financing transaction if a person related to the issuer is entitled to such tax benefits from taxes paid by the issuer to such foreign jurisdiction.

However, the proposed rules further provide that if the equity interest of an intermediate entity falls within the scope of the Proposed Regulations, it will not be subject to the conduit financing rules to the extent its participation in the financing arrangement is not pursuant to a tax avoidance plan.

C. Coordination with GILTI

The Proposed Regulations provide rules relating to the treatment of certain payments between related CFCs under the GILTI provisions. In particular, the preamble to the Proposed Regulations identifies transactions between related CFCs which generate payments, such as pre-payments of royalties, that create income during the disqualified period and a corresponding deduction or loss in tax years after the disqualified period.

Under the current rules, such deductions or losses could, for example, be used to reduce tested income or increase tested losses. The Proposed Regulations prevent the deductions attributable to such pre-payments from providing such tax benefits by allocating them solely to residual CFC gross income, similar to the treatment of deductions or losses attributable to disqualified basis as described under Treas. Reg. section 1.951A-2(c)(5)(i).

V. EFFECTIVE DATES

The 2018 Proposed Regulations were set to be generally effective for hybrid dividends and specified payments made in taxable years beginning after December 31, 2017 if they were finalized by June 22, 2019. Obviously, the summer of 2019 passed without the final regulations making an appearance. The various regulations therefore have the following applicability dates:

- Final section 245A(e) regulations. The Final Regulations under section 245A(e) generally apply to distributions made after December 31, 2017, provided such distributions occur during taxable years ending on or after December 20, 2018. Taxpayers can apply the Final Regulations before that date. Taxpayers can also elect to apply the 2018 Proposed Regulations in their entirety for all taxable years ending on or before April 8, 2020.

- Final section 267A regulations. Except in special cases, the Final Regulations under section 267A apply to taxable years ending on or after December 20, 2018, provided such taxable years begin on or after January 1, 2018.[46] Taxpayers can generally rely on the regulations under section 267A in their entirety for taxable years beginning after December 31, 2017 and ending before December 20, 2018. In addition, taxpayers may elect to apply the 2018 Proposed Regulations in their entirety for all taxable years ending on or before April 8, 2020. Certain rules, such as the imported mismatch rules discussed in Part II.C above, apply to taxable years beginning on or after December 20, 2018.

- Proposed 245A(e) regulations. The proposed rules relating to adjustments of hybrid deduction accounts will apply to tax years ending on or after the date that the final regulations are published in the Federal Register. However, a taxpayer may rely on Proposed Regulations before they are published as final regulations as long as the taxpayer does so consistently.

- Proposed anti-conduit regulations. The conduit financing Proposed Regulations will apply to payments made on or after the date the final regulations are published in the Federal Register.

- Proposed regulations coordinating with GILTI. These proposed rules apply to the tax years of foreign corporations ending on or after April 8, 2020 and to US shareholders in which or with which such tax years end. Thus, these rules are effectively limited to payments made during the disqualified period that give rise to deductions or loss in tax years of foreign corporations ending on or after April 8, 2020.

46 *See* Treas. Reg. section 1.267A-7.

In the News

RECENT RECOGNITION

On June 30, 2020, Mayer Brown launched Best Methods, a Transfer Pricing blog designed to provide in-house tax professionals, transfer pricing consultants, and tax administrations timely updates on the latest transfer pricing guidance, legislative and regulatory developments, and cases from the US, the OECD, and tax jurisdictions around the globe.

Mayer Brown was ranked in Tier 1 by *Legal 500* in all categories for Tax, including International Tax, Non-Contentious Tax, Contentious Tax and Tax-Financial Products in 2020. We are the only firm to receive the highest ranking in all four categories.

Mayer Brown is pleased to have been named the US Law Firm of the Year – Transactions for *GlobalCapital's* Americas Derivatives Awards 2020. We are also shortlisted for European Law Firm of the Year – Transactions, European Law Firm of the Year – Regulatory, and Global Law Firm of the Year (Overall) for *GlobalCapital's* upcoming Global Derivatives Awards 2020.

RECENT SPEAKING ENGAGEMENTS

TEI Virtual Midyear – Tax Controversy/Audit & Appeals

On July 30, William McGarrity joined Teri Wielenga, Gilead Sciences, and others on a panel discussing Transfer Pricing Controversy: Opinions, Appeals, Early Resolution. The discussion addressed the management of audits and tools for reaching early resolution, what is being learned from litigation and recently decided cases, and lastly forward looking trends, including the use of appeals, APA's and the survival of the Arm's Length Standard.

Convertible Bonds: Understanding the Key Benefits

On July 23, Anna Pinedo and Remmelt Reigersman, along with Claude DeSouza and Pete Pergola of Raymond James, hosted a webinar on convertible bonds and discussed topics such as: the state of the market, and provide a convertible bond overview; accounting and reporting implications for issuers; accompanying antidilutive strategies, including capped call and call/warrant structures; tax considerations for the issuer; addressing busted converts; and other securities and disclosure considerations.

PLI's Understanding the Securities Laws 2020

On July 16 and 17, Partner Anna Pinedo co-lead a discussion entitled Securities Act Exemptions, and covered topics such as: exempt securities versus exempt transactions; private placements, including offerings under Rules 504 and 506 of Regulation D; Regulation A+ offerings; "Intrastate" offerings; Crowdfunding; Employee equity awards; Rule 144A offerings; Regulation S offerings outside the U.S.; and resales of restricted and controlled securities: Rule 144, Section 4(a)(7) and "Section 4(a)(1½)."

TEI Virtual Midyear – Tax Controversy/Audit & Appeals
On July 16, Brian Kittle and Gary Wilcox joined Patricia Rexford, Johnson & Johnson and others for the Statutory Interpretation & Regulatory Deference webinar exploring issues around statutory interpretation and judicial deference to administrative interpretations.

TEI Virtual Midyear – Tax Controversy/Audit & Appeals
On July 16, Thomas Kittle-Kamp and Scott Stewart joined Anthony O'Donnell, EMD Serono for the Transfer Pricing: The Arm's Length Standard after the TCJA webinar discussing the significant impact of the changes introduced in the TCJA and the role of the arm's length standard going forward.

Continuous Offerings: Equity Line Financings and At the Market Offerings
Equity line transactions often are confused with continuous offerings that are structured as at the market offering programs. Each financing alternative has distinct characteristics, and differ in important respects. On July 9, Anna Pinedo along with Nikolai Utochkin of Nasdaq and Steven Martin of Aspire Capital, discussed topics such as: basic structure of an equity line; public versus private; SEC's historic analysis of private equity lines; registration of securities sold in private equity line transactions; overview of, and application of Nasdaq 20% limitation / shareholder vote rules to equity line financings; at the market offering basics; application of Nasdaq rules to ATMs; and differences between equity lines and ATMs; and SEC's S-3 baby shelf rules applied to continuous offerings.

TEI Virtual Midyear – Tax Controversy/Audit & Appeals
On July 9, Michael Lebovitz, Jason Osborn and Elena Khripounova joined Kristen Mikolaitis, Nestle USA and others for The Future of the Functional Analysis: Pillar One and Beyond webinar. The panel discussed: identifying transfer pricing issues and the place of digital transactions within global value chains, how to adapt approaches for functional and value chain analysis for the post-digital era, including comparability factors and value drivers such as marketing intangibles and user base, and explore how Pillar One may impact transfer pricing analyses and some ways that functional and value chain analysis can be leveraged and adapted to prepare for both the possible implementation of Pillar One and the challenges likely to arise if Pillar One is not implemented.

TEI Virtual Midyear – Tax Controversy/Audit & Appeals
On July 9, Lucas Giardelli joined Eli Dicker of TEI and others for the The Tax Cuts and Jobs Act – Nuts & Bolts From a Tax Controversy Perspective webinar. The panel introduced key pieces of the TCJA architecture to in-house tax professionals who have yet to encounter live TCJA-related issues in their own company examinations. Also discussed, was what are the central components of the TCJA, how do they fit together and what are some of the tax controversy issues that could arise.

Navigating the Storm: Initial Structuring, Exit Strategies and Tax Controversy Considerations in Asia, the EU and Brazil On June 30, Andy Baik, Celso Grisi and Benjamin Homo, Pieter de Ridder and Jason Osborn discussed technical and practical tax considerations in the initial acquisition structuring in these regions, exit strategies and post-exit tax controversy in these regions, as an alternative fund structure (to the traditional Cayman offshore fund), onshore fund structures in Singapore and Hong Kong and the benefits and other considerations related to these options, and the venues for foreign tax dispute resolution and double tax relief available in the US for US MNCs and PEFs with US investors.

Opportunity Zone Expo Virtual Program

On June 24, Mark Leeds moderated a panel discussing "Powerful Collaborations: Strategies for Public and Private Partnerships and the Benefits of Community Driven Investment".

Market Developments Covering Late Stage Private Placements

On June 23, 2020, Anna Pinedo and Thomas Vitale of Mayer Brown led a discussion along with Anat Alon-Beck of Case Western School of Law, Kevin Gsell of Nasdaq Private Markets, and Brooke Parker of Barclays Capital on market developments affecting the private markets, including late stage private placements; unicorn investors and the emergence of new market actors; participation by CVCs; terms of late-stage private placements and how these are changing as a result of the market downturn; principal concerns for cross-over funds participating in private rounds; legal considerations, including diligence, projections and information sharing; issuer and third-party tender offers; and structuring private placements with existing security holders.

Tax Executive Institute's Virtual Midyear Conference

On May 27, Brian Kittle discussed "Transfer Pricing Policy, Planning and Practice in a Changing World" during the Tax Executive Institute's Virtual Midyear Conference.

Tax Executive Institute's Virtual Midyear Conference

On May 20, Jason Osborn discussed "Unilateral Taxation of the Digital Economy" at the Tax Executive Institute's Virtual Midyear Conference.

The Current Tax Landscape and What's on the Horizon in Asia, the EU and Brazil

On June 9, Mayer Brown hosted Part I of its two-part webinar series on the exit-related taxation of inbound fund investments in Asia, the European Union and Brazil. Tax Transactions & Consulting partners Andy Baik, Celso Grisi and Benjamin Homo discussed the current tax landscape and what may lie ahead pertinent to foreign fund investment exits in the two regions and Brazil.

Financial Transactions: OECD Guidance and COVID-19 Considerations

On May 28, Astrid Pieron, Scott Stewart and Elena Khripounova reviewed guidance on specific issues, including loans, treasury function and guarantees, and also discussed whether and how the analysis is affected by the COVID-19 environment in a Transfer Pricing webinar.

Liability Management – the Tax Angle

On May 6, 2020, Thomas Humphreys, Remmelt Reigersman and Brennan Young hosted a webinar discussing the tax implications to issuers and investors resulting from various liability management transactions, including: debt repurchases; debt modifications or exchanges;

recapitalizations; bankruptcy restructurings; and payment of consent fees.

Supply Chain Disruptions: Key International Tax Issues
On April 30, Astrid Pieron, Mike Lebovitz, Matthew Mortimer and counsel Kitty Swanson discussed how the COVID-19 crisis has highlighted the challenges a multinational enterprise faces when global supply chains are disrupted. The panel discussed some of the key international tax challenges associated with this disruption, including: transfer pricing challenges, such as how the crisis is affecting limited risk distribution models, how catastrophic costs are allocated among the group and how to manage the tax impact of distributor terminations and renegotiations, tax challenges arising from functional dislocation, including permanent establishment and controlled foreign corporation, and indirect tax issues associated with changes in place of supply.

Intelligize Webinar: Mind the Non-GAAP: A Look at Recent SEC Guidance on Non-GAAP Financial Measures
On April 29, 2020, Ryan Castillo and Laura Richman presented on the use of non-GAAP financial measures by public companies. Topics that were discussed included: the nature and purpose of non-GAAP financial measures; the current regulatory framework, including Regulation G, item 10(e) of Regulation S-K and the C&DIs issued by the SEC's Division of Corporation Finance; recent SEC guidance on key performance indicators (KPIs) and metrics used in MD&A and other company disclosures; recent SEC guidance on non-GAAP financial measures in COVID-19 disclosures; recent SEC comment letters on non-GAAP financial measures and areas of concern of the SEC's Division of Corporation Finance; SEC enforcement actions related to non-compliance; audit committee and management roles in compliance and effective disclosure controls; practical suggestions for ongoing compliance with SEC rules and guidance on non-GAAP financial measures, KPIs and metrics; and proposed amendments to MD&A.

REVERSEinquiries Workshop: US Taxation of Structured Notes
On April 28, 2020, Thomas Humphreys, Remmelt Reigersman and Brennan Young presented a workshop on the current US tax rules and any new developments regarding structured products, including: the tax characterization of structured notes; the dividend equivalent provisions and current state of play; the IRS basket option notices; and PFIC and FIRPTA considerations.

Private Placements and Hybrid Securities Offerings 2020
This two day PLI seminar featured panel discussions covering the basics of private placements, resales of restricted securities, Section 4(a)(1-1/2) transactions and block trades. Partner Anna Pinedo served as chairperson of the program and partner Marlon Paz spoke on a panel entitled, "Practical Considerations for Broker-Dealers Acting as Placement Agents in Exempt Offerings."

COVID-19: Forward-Looking Disclosure
On April 17, 2020, Partner Jennifer Carlson joined a panel organized by the Society for Corporate Governance where the speakers covered SEC Joint Statement: brief overview & key takeaways; Principles applicable to COVID-19 disclosures for earnings releases, Exchange Act reports, and analyst

calls and presentations, including forward-looking statement safe harbors, risk factors and recent disclosure guidance; practical challenges/considerations including Form 8-K item triggers and rapidly changing information; and additional resources including sample disclosures, best practices guidance and memos.

PIPE Transactions: Basics and Current Developments
On April 8, 2020, Jen Carlson and Anna Pinedo held a webinar on PIPE Transactions, in which they discussed topics such as: recent market trends; PIPE documentation and the principal negotiating issues; the securities exchange shareholder approval rules, recent changes to such rules, and the financial viability rule; using warrants and structuring approaches for at-market deals; venture capital and private equity PIPE transactions; and change of control PIPE transactions.

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