Introduction to Anti-Hybrid Rules in Sections 245A(e) and 267A

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Overview of US Anti-Hybrid Rules

- § 245A(e): Disallows participation exemption in the case of "hybrid dividends" for which the payor is allowed a deduction or other tax benefit
- § 267A: Disallows a deduction for certain payments where a deduction is otherwise available for the payor with no corresponding income inclusion for the recipient (deduction/no-inclusion or "D/NI")
- § 894(c): Denies income tax treaty benefits for payments made to certain hybrid and domestic reverse hybrid entities
- § 1503(d): Prevents a single economic loss to offset US income of a US corporation and foreign income of a foreign corporation (double-dipping)
- Income Tax Treaties: May include anti-hybrid provisions (see, e.g., 2016 US Model Treaty, Article 1(6) or US-Canada Treaty, Article IV(7))

Section 245A(e)

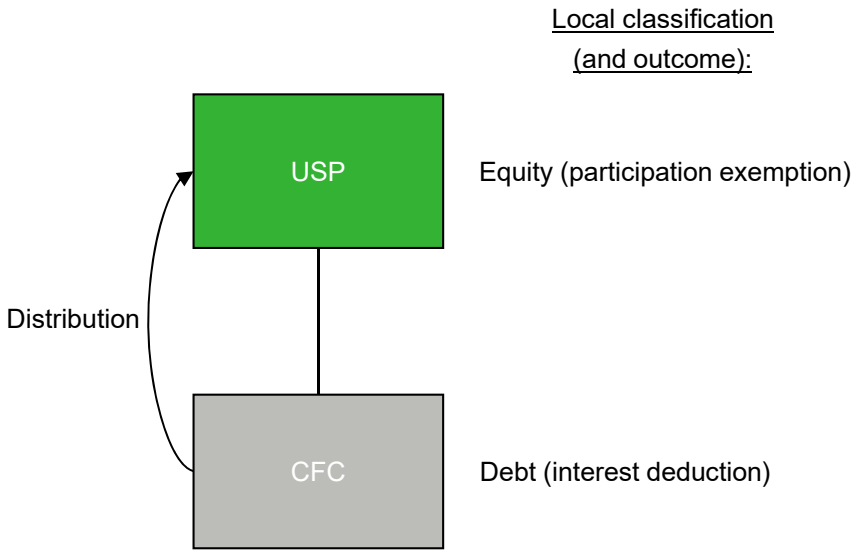
Section 245A(e)

General Rules

- § 245A(a): A U.S. corporation is permitted a deduction equal to the **foreign source portion** of any **dividend** received from a **specified 10-percent owned foreign corporation** if the U.S. corporation is a USSH with respect to such foreign corporation (participation exemption)
- § 245A(d): Disallows FTCs for and deductions of any taxes paid or accrued with respect to any dividend for which participation exemption is allowed
- § 245A(e): Section 245A(a) participation exemption does not apply to any dividend from a CFC if the dividend is a **hybrid dividend**
- Hybrid dividend = amount received from a CFC for which (i) a deduction would be allowed under § 245A(a) but for this subsection, and (ii) the CFC received a deduction (or other tax benefit) with respect to any income, war profits, or excess profits taxes imposed by any foreign country or possession of the US

Section 245A(e)

Hybrid Dividend (Abstract Example)



Facts

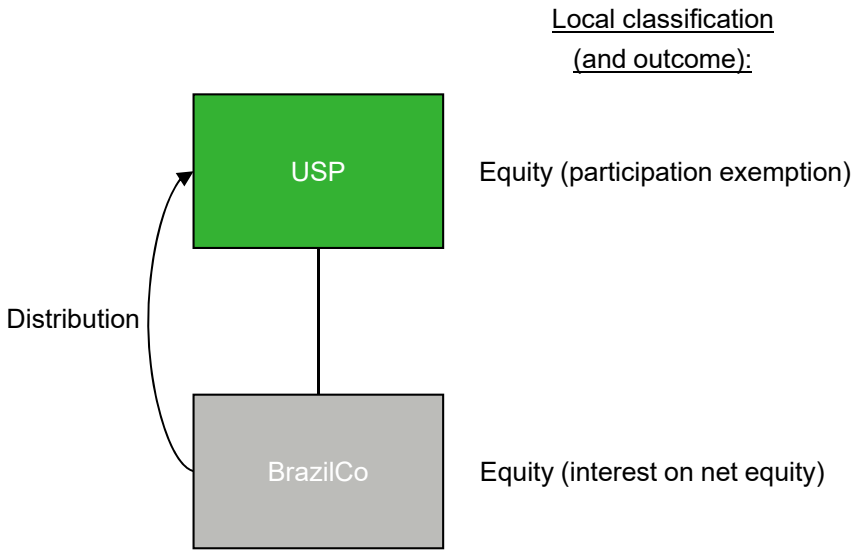
- USP directly owns 100% of CFC.
- CFC makes a distribution to USP on an instrument treated as (i) debt in CFC's jurisdiction and (ii) equity for US tax purposes.

Consequences

- § 245A(e) applies and the distribution qualifies as a hybrid dividend because (i) USP would be allowed a § 245A(a) deduction but for § 245A(e), and (ii) CFC is allowed a tax benefit (i.e., the deduction) in its jurisdiction.
- USP must include in income the full dividend, including the deducted amount that is deemed distributed or actually distributed.
- USP is also unable to take § 901 credits for any withholding or other taxes imposed by CFC in its jurisdiction on the dividend distribution.

Section 245A(e)

Hybrid Dividend (Practical Example)



Facts

- USP directly owns 100% of BrazilCo, a CFC.
- Brazilian tax law allows an "interest on net equity" ("INE") in an amount equal to (i) the Brazilian company's equity multiplied by (ii) the Brazilian central bank's long-term interest rate, and limited to the greater of (a) 50% of the Brazilian company's net accounting income and (b) 50% of the Brazilian company's retained earnings and profits reserves.
- BrazilCo's total net equity is $1,000,000 and Brazilian central bank's long-term interest rate is 5%.

Consequences

- Brazil:
  - BrazilCo may create up to $50,000 INE, deduct against $50,000 of income, and save $17,000 in Brazilian CIT.
  - Brazilian 15% INE withholding tax applies to the $50,000 INE, resulting in $7,500 of withholding tax.
- US:
  - § 245A(e) applies and the distribution is a hybrid dividend because (i) USP would be allowed a § 245A(a) deduction but for § 245A(e), and (ii) BrazilCo is allowed a tax benefit (i.e., INE) in Brazil.
  - USP must include in income the full dividend, resulting in tax of $10,500.
  - USP is unable to take § 901 credits for or deduct the $7,500 Brazilian withholding tax.
- Total tax of $18,000 worse than a $17,000 with no INE.

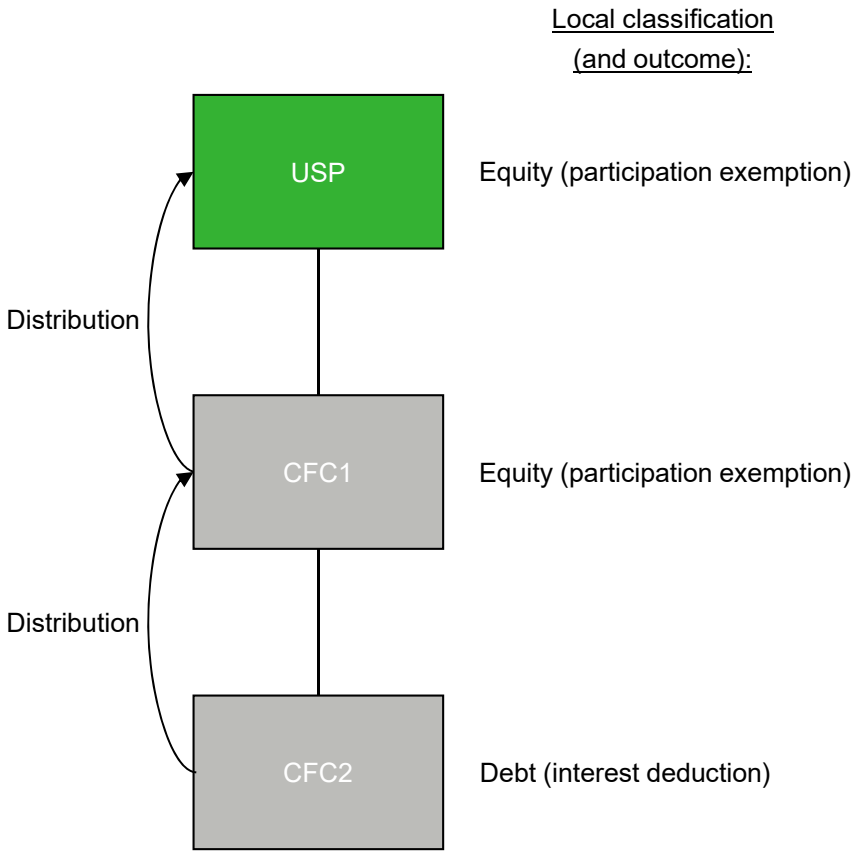
Section 245A(e)

Tiered Hybrid Dividends

- Prop. Reg. § 1.245A(e)-1(c)(1): If a CFC with respect to which a domestic corporation is a 10% US shareholder receives a **tiered hybrid dividend** from any other CFC with respect to which such domestic corporation is also a 10% US shareholder, then, notwithstanding any other provision of this title:
  - A. the hybrid dividend shall be treated as subpart F income of the receiving CFC for the taxable year of the receiving CFC in which the dividend was received,
  - B. the 10% US shareholder shall include in gross income an amount equal to the shareholder's pro rata share of the subpart F income described in A., and
  - C. foreign tax credits are disallowed
- Tiered hybrid dividend = amount received by a CFC from another CFC to the extent that the amount would be a hybrid dividend if the receiving CFC were a domestic corporation (Prop. Reg. § 1.245A(e)-1(c)(2))

Section 245A(e)

Tiered Hybrid Dividends (Example)



Facts

- USP directly owns 100% of CFC1 and CFC1 directly owns 100% of CFC2.
- CFC2 makes a distribution to CFC1 on an instrument treated as (i) debt in CFC2's jurisdiction and (ii) equity in CFC1's jurisdiction.
- CFC1 makes a distribution to USP on the instrument treated as equity in CFC1's jurisdiction and also for US tax purposes.

Consequences

- Prop. Reg. § 1.245A(e)-1(c) applies and the distribution qualifies as a tiered hybrid dividend because if CFC1 was a US corporation, the distribution would qualify as a hybrid dividend as (i) CFC1 would be allowed a § 245A(a) deduction but for § 245A(e), and (ii) CFC2 would be allowed a tax benefit (i.e., the deduction) in its jurisdiction.
- USP must include in income its pro rata share of the subpart F income.
- USP is also unable to take § 901 credits for any withholding or other taxes imposed on the dividend distribution.

Section 245A(e)

Hybrid Deduction Accounts

- Prop. Reg. § 1.245A(e)-1(d): A dividend can be a hybrid dividend only to the extent of the sum of the US shareholder's (or, in the case of tiered hybrid dividends, the CFC's) **hybrid deduction accounts**, which must be maintained on a share-by-share basis with respect to each CFC by 10% US corporate shareholders
  - It is generally increased by hybrid deductions of the CFC and decreased by hybrid deductions giving rise to hybrid dividends or tiered hybrid dividends
  - Basically, this tracking requirement allows the rules to capture D/NI outcomes in cases where the dividend and the hybrid deduction do not arise pursuant to the same payment or in the same taxable year for US and for foreign tax purposes, and it does so by matching hybrid deductions to dividends paid in subsequent taxable years
  - Sale of a CFC to a 10% US corporate buyer may cause the buyer to inherit untriggered hybrid deduction accounts

Section 245A(e)

Miscellaneous

- Foreign tax credits and deductions are disallowed for foreign taxes paid or accrued with respect to hybrid dividends and amounts included in gross income as tiered hybrid dividends (§ 245A(e)(3))
- Anti-avoidance rule (Prop. Reg. § 1.245A(e)-1(e))
  - Transactions with a principal purpose to avoid the purposes of § 245A are properly adjusted or disregarded
  - Examples: Transactions to eliminate hybrid deduction accounts or transactions to fail to satisfy § 245A(a) holding period requirements to avoid the tiered hybrid dividend rules

Section 245A(e)

Significant Exceptions

▪ Deduction or other tax benefit relates to or results from an amount "paid, accrued, or distributed" on the CFC instrument that is stock for US tax purposes	NOT if unconnected to the instrument that is stock for US tax purposes (e.g., territorial exemption, zero taxed CFC)
▪ Deduction or other tax benefit under foreign law must be "allowed" to CFC or a related person	NOT if deduction is denied for D/NI outcome under the CFC jurisdiction's mismatch rule
▪ Must be a dividend	NOT distributions of previously taxed earnings
▪ If the deduction results from a distribution, the effect must be to exempt the earnings under the CFC's tax law at both the CFC and SH levels	NOT if the CFC jurisdiction imposes a tax on the SH

Section 267A

Section 267A

General Rules

- Targets hybridity-based D/NI outcomes where a deduction is available for the payor with no corresponding income inclusion under foreign tax law for the payee
- § 267A(a) & Prop. Reg. § 1.267A-1(b): No deduction is generally allowed for any interest or royalty (or a **structured payment**) paid or accrued by a **specified party** (a specified payment) to the extent that the specified payment:
  a. is made pursuant to a hybrid or branch arrangement (a disqualified hybrid amount; Prop. Reg. § 1.267A-2),
  b. is directly or indirectly offset by certain hybrid deductions (a disqualified imported mismatch; Prop. Reg. § 1.267A-4), or
  c. falls within the anti-avoidance rule (Prop. Reg. § 1.267A-5(b)(6))

Section 267A

General Rules (cont'd)

- Specified party = a US tax resident, a CFC in which a US shareholder owns at least a 10% direct or indirect interest, and a US trade or business giving rise to effectively connected income or a US permanent establishment (US taxable branch or US PE) (Prop. Reg. § 1.267A-5(a)(17))
- Structured payments = certain interest- or royalty-like payments that are otherwise not treated as interest or royalties, such as substitute interest payments, commitment fees, or debt issuance costs (Prop. Reg. § 1.267A-5(a)(20))
- *De minimis* exception: § 267A does not apply for a taxable year if the specified party's (or related specified parties') aggregate interest and royalty deductions are less than USD 50,000 (Prop. Reg. § 1.267A-1(c))

Section 267A

Disqualified Hybrid Amounts

- A specified payment is a disqualified hybrid amount if it falls within any of the 5 below categories:

a. Payments pursuant to hybrid transactions (Prop. Reg. § 1.267A-2(a))

- It is made pursuant to a **hybrid transaction** (i.e., a transaction payments with respect to which are treated as interest or royalties for US tax purposes but are not so treated for the specified recipient's tax law purposes), and to the extent that,
- a **specified recipient** (i.e., any party that may be subject to tax on the specified payment under its tax law; may be multiple) of the payment does not include the payment in income (no-inclusion), and
- the specified recipient's no-inclusion is a result of the payment being made pursuant to a hybrid transaction

b. Disregarded payments (Prop. Reg. § 1.267A-2(b))

- The excess of a specified party's **disregarded payments** (i.e., payments not regarded under the recipient's tax law that, if regarded, would be included in income) for a tax year over its "dual inclusion income" for the tax year is treated as a disqualified hybrid amount
- Disregarded payments include payments that give rise to a benefit under consolidation, fiscal unity, or a similar regime of the recipient's tax law

Section 267A

Disqualified Hybrid Amounts (cont'd)

- A specified payment is a disqualified hybrid amount if it falls within any of the 5 below categories:

c. Deemed branch payments (Prop. Reg. § 1.267A-2(c))

- Any interest or royalty amount allowable as a deduction in computing the business profits of a US PE, to the extent the amount is deemed paid to the home office (or another branch of the home office) and not regarded (or otherwise taken under account) under the tax law of the home office or other branch

d. Payments to reverse hybrids (Prop. Reg. § 1.267A-2(d))

- To the extent an investor of the **reverse hybrid** (i.e., domestic or foreign entity transparent under its tax law but regarded under its investor's tax law) does not include the payment in income (no-inclusion) and the investor's no-inclusion is a result of the payment being made to the reverse hybrid

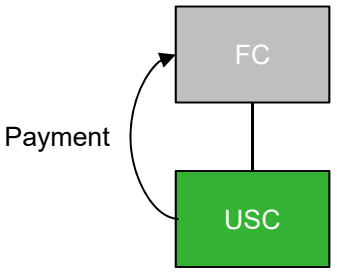
e. Branch mismatch payments (Prop. Reg. § 1.267A-2(e))

- To the extent that (i) the law of the home office treats the payment as income attributable to a branch (no-inclusion) and the home office's no-inclusion results from the payment being a branch mismatch payment, and (ii) the branch is not a taxable branch or under the branch's tax law, the payment is not treated as attributable to the branch

Section 267A

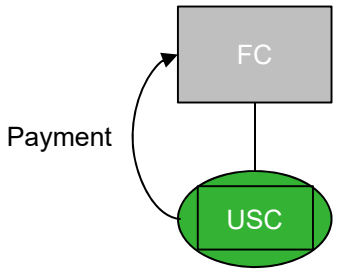
Disqualified Hybrid Amounts (Examples)

Prop. Reg. § 1.267A-2(a)
Payment pursuant to hybrid transaction



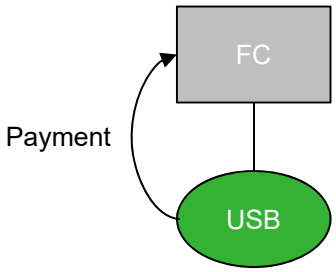
- US treats the payment as royalty or interest, for which it allows USC a deduction.
- FC jurisdiction treats the payment as dividend income for which it allows FC a participation exemption.
- The payment is a payment pursuant to a hybrid transaction.

Prop. Reg. § 1.267A-2(b)
Disregarded payments



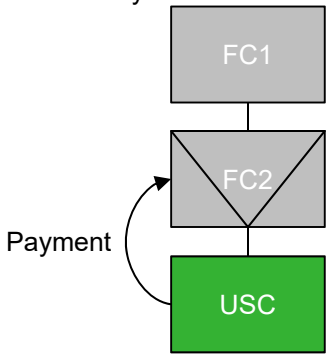
- USC, a corporation in US and DRE in FC's jurisdiction, pays 100 to FC pursuant to a debt instrument.
- USC has overall income of 150 and losses of 130. Because net 20 (150 – 130) is taxable in both jurisdictions (i.e., a dual inclusion income), 80 is a disqualified hybrid amount.

Prop. Reg. § 1.267A-2(c)
Deemed branch payments



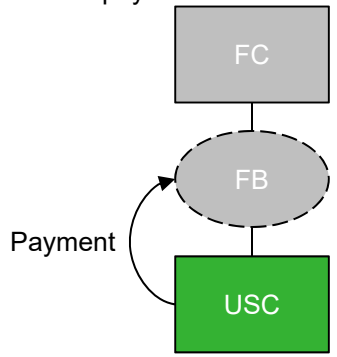
- USB, FC's branch (PE), pays royalty or interest to FC, which (i) reduces USB's income in the US and is deemed paid to FC, and (ii) USB's income is not included in FC's income (e.g., FC's jurisdiction does not tax extraterritorial income).
- The payment is a deemed branch payment.

Prop. Reg. § 1.267A-2(d)
Payments to reverse hybrids



- FC2 is treated as fiscally transparent or flow-through in its jurisdiction and as a taxable entity in FC1's jurisdiction.
- USC's interest or royalty payment is not included in income by neither FC2 or FC1.
- The payment is a payment to a reversed hybrid.

Prop. Reg. § 1.267A-2(e)
Branch mismatch payments



- FB is FC's branch (PE) in FC's jurisdiction but does not have sufficient taxable presence in FB's jurisdiction.
- USC's interest or royalty payment is treated as attributable to FB in FC's jurisdiction and is not taxed in FB's jurisdiction.
- The payment is a branch mismatch payment.

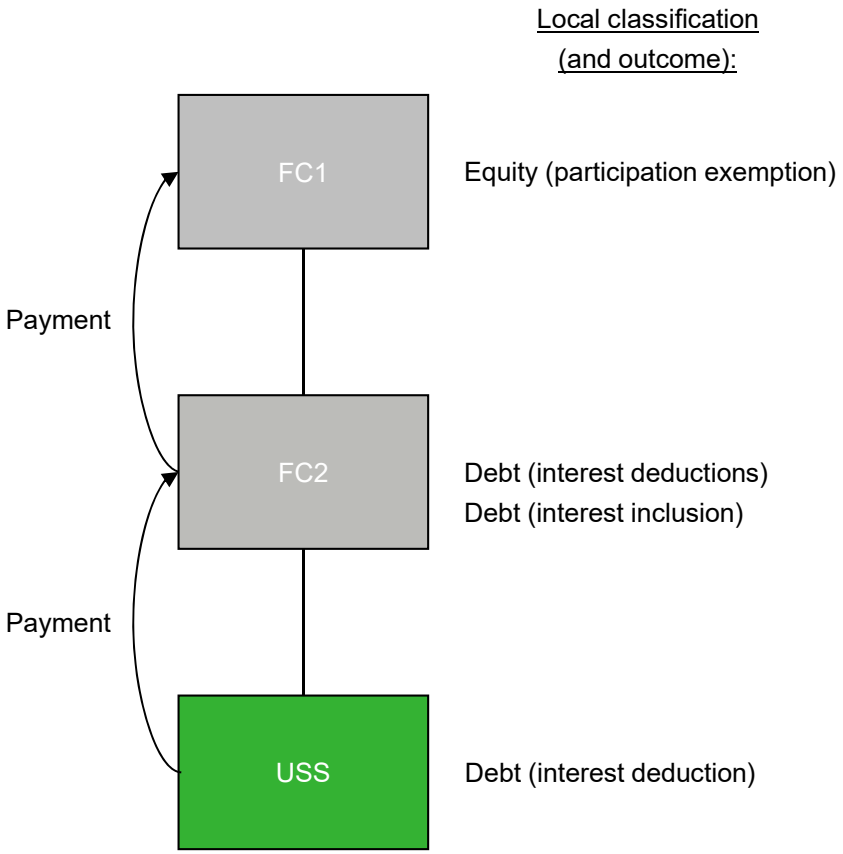
Section 267A

Disqualified Imported Mismatches

- Prop. Reg. § 1.267A-4(a) = a specified payment is a **disqualified imported mismatch** when (i) the recipient has a full inclusion of the interest or royalties, but (ii) income of that recipient (or a subsequent recipient of a payment connected through a chain of payments) attributable to the payment is directly or indirectly offset by a hybrid deduction under the recipient's tax law that would be denied if such tax law contained rules substantially similar to § 267A
- Mechanically, under the set-off and funding rules, a hybrid deduction directly or indirectly offsets the income attributable to an imported mismatch payment to the extent the payment directly or indirectly funds the hybrid deduction

Section 267A

Disqualified Imported Mismatches (Example)



Facts

- USS makes an interest payment to FC2.
- FC2 makes an interest payment to FC1.
- US and FC2's jurisdictions treat the underlying instrument as debt and FC1's jurisdiction treats the underlying instrument as equity.
- FC1's jurisdiction allows participation exemption.

Consequences

- USS's payment to FC2 is not a disqualified hybrid amount, but FC2's interest expense deduction is a **hybrid deduction** because it is paid with respect to a hybrid transaction.
- Under so-called **set-off rules**, FC2's hybrid deduction offsets income attributable to USS's imported mismatch payment because under so-called **funding rules**, USS's payment funds FC2's hybrid deduction.
- USS's payment is a **disqualified imported mismatch amount** and no deduction is allowed for that payment.

Section 267A

Anti-Avoidance Rule

- § 1.267A-5(b)(6) includes a broad purpose-based anti-avoidance rule in addition to various specific anti-avoidance provisions
- 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 § 267A
- Other specific anti-avoidance rules included, such as the structured arrangements rule or the multiple specified recipients rule

Section 267A

Miscellaneous

- No-inclusion standard: A specified recipient includes a specified payment in income to the extent that under its tax law –
  1. It includes (or will include during the 36-month safe harbor) the specified payment in its income or tax base at the full marginal rate imposed on ordinary income, and
  2. The specified payment is not reduced or offset by an exemption, exclusion, deduction, credit (or than withholding tax), or other similar relief particular to such type of payment
- *De minimis* inclusions; deemed full inclusions:
  - If at least 90% of the specified payment is reduced, then 100% of the specified payment is deemed reduced
  - If no more than 10% of the specified payment is reduced, no portion of the specified payment is deemed reduced

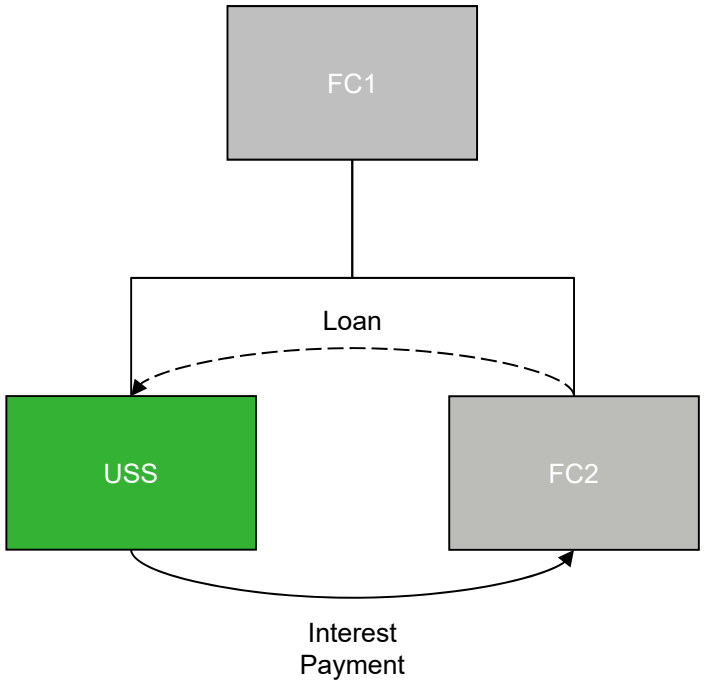
Section 267A

Miscellaneous (cont'd)

- Payments to US tax residents, taxable branches, and CFCs: A specified payment is not a disqualified hybrid amount to the extent the payment –
  - is included in gross income by a specified recipient that is a US tax resident or taxable branch,
  - is includible as subpart F income by a US shareholder that is a US tax resident or, if the a US shareholder is not a US tax resident, to the extent a US tax resident takes into account the subpart F income includible in gross income by the US shareholder, or
  - increases a US shareholder's pro rata share of a CFC's tested income, reduces the US shareholder's pro rata share of a CFC's tested loss, or both
- Whether a deduction for a specified payment is disallowed under § 267A is determined without regard to whether the payment is subject to withholding or is eligible for a reduced rate of withholding under a treaty, and whether any foreign secondary anti-hybrid rule applies

Section 267A

Structures Generally Not Impacted (Example 1)



Facts

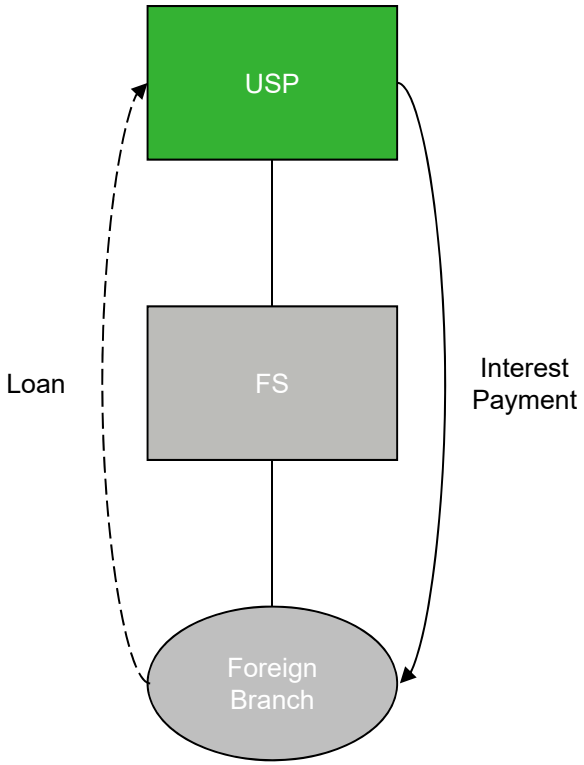
- Low-taxed FC2 lends to USS.
- USS gets an interest expense deduction.
- FC2 derives interest income taxed at its jurisdiction's tax rate.

Consequences

- § 267A does not apply. D/NI outcome is not achieved through a hybrid arrangement; the proposed regulations clarify that § 267A is limited to cases where "D/NI outcome occurs as a result of hybrid arrangements and not due to a generally applicable feature of the jurisdiction's tax system."
- Typical jurisdictions for similar arrangements are Switzerland, Ireland, Hungary, or jurisdictions with CFC's with substantial NOLs.

Section 267A

Structures Generally Not Impacted (Example 2)



Facts

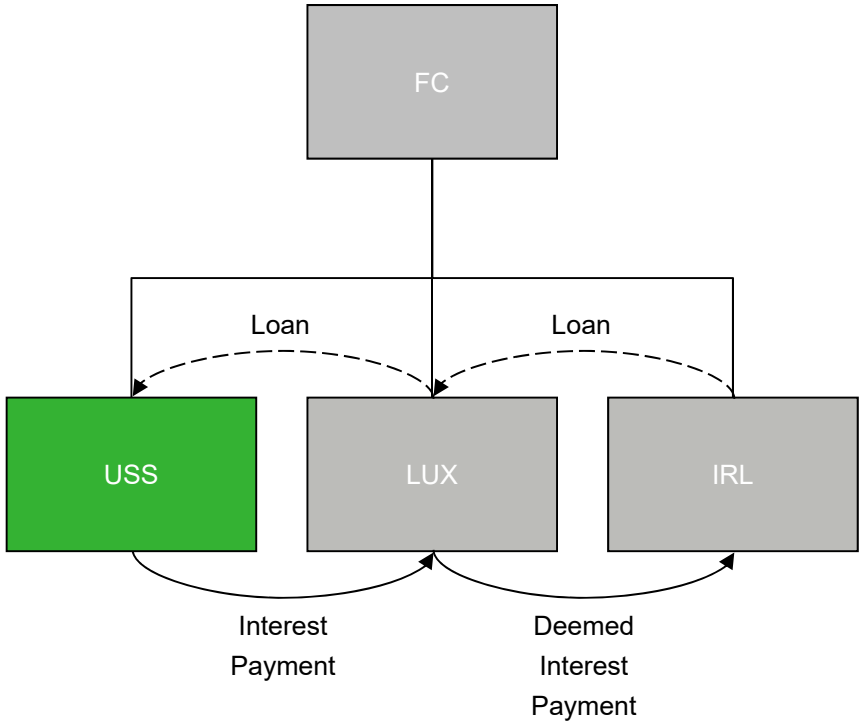
- FS lends to USP and contributes interests in the loan to Foreign Branch (PE) not treated as entity.
- US-FS jurisdiction tax treaty does not include a triangular branch rule.
- USP pays interest to Foreign Branch and gets an interest expense deduction.
- FS does not include interest payments from USP in income because they are attributable to Foreign Branch.
- Foreign Branch includes interest received in income but taxes it at a low rate.

Consequences

- § 267A does not apply. D/NI outcome is not achieved through a hybrid arrangement; the proposed regulations clarify that § 267A is limited to cases where "D/NI outcome occurs as a result of hybrid arrangements and not due to a generally applicable feature of the jurisdiction's tax system"—income is not taken into account by FS for reasons unrelated to hybridity.
- Caveat: If Foreign Branch not taxed because (i) it does not arise to a PE or (ii) the interest income not attributable to the PE in its jurisdiction, Prop. Reg. § 1.267A-2(e) branch mismatch rules would apply.

Section 267A

Unclear Application (Example 3)



Facts

- IRL lends to LUX under an interest-free loan.
- LUX on-lends to USS under an interest-bearing loan.
- USS gets and interest expense deduction.
- LUX derives interest income but offsets it with a deemed arm's length interest payment.
- IRL derives no actual or deemed interest income provided it does not carry on an active financing business.

Consequences

- Unclear whether § 267A applies.
- May be subject to Treas. Reg. § 1.267A-2 or -4.

Weil

Thank you

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