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The Dual Inclusion Exception of the §267A Regulations

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As noted in my last installment in this journal,[1] the final regulations under **§267A** (and **§245A(e)**) present a host of complex questions under foreign tax law that will probably be beyond most taxpayers' — and the IRS's — ability to fathom or apply. My last installment discussed the counterintuitive rules applicable to royalties, which do not even seem to present genuine hybrid issues in the first place. This installment deals with the dual inclusion exception to the disregarded payment rule. Like most of the terminology in the regulations, neither of these terms is intuitive, so let's start at the beginning.

[1] **49 Tax Management Int'l J. 324** (June 2020).

The disregarded payment rule is found in Reg. **§1.267A-2(b)**. It provides that the excess, if any, of a specified party's[2] disregarded payments for a taxable year over its dual inclusion income for the same taxable year is a disqualified hybrid amount. Where there is a disqualified hybrid amount, there is a disallowance of the U.S. deduction for a specified payment.[3] For example, assuming no dual inclusion income, a payment of interest by a U.S. corporation to its foreign parent is not deductible if the U.S. corporation is regarded for U.S. tax purposes but is disregarded under the law of the foreign parent's country (e.g. because the U.S. corporation is treated as a disregarded entity under that country's tax rules).

[2] A "specified party" includes a U.S. taxable person, a controlled foreign corporation ("CFC") having one or more U.S. inclusion shareholders, and a taxable U.S. branch. Reg. **§1.267A-5(a)(17)**. All section references herein are to the **Internal Revenue Code**, as amended, or the Treasury regulations thereunder.

[3] Reg. **§1.267A-1(b)(1)**.

It is worth noting that, putting aside branch operations, the disregarded payment rule is not likely to arise frequently in practice in the "inbound" context, because few countries have rules that would treat a U.S. corporation as a disregarded entity. The reverse or "outbound" scenario, however, is extremely common and was one of the principal reasons

that the OECD BEPS project adopted Action Item #2 on hybrids. U.S. corporations have long used debt of disregarded hybrid foreign subsidiaries to strip the foreign tax base by paying interest that is deductible under foreign tax law but is disregarded under U.S. tax law.

The application of the disregarded payment rule in the foregoing "outbound" case has generated controversy. U.S. tax practitioners, including government officials, have pointed out that any blanket disallowance of a deduction for disregarded payments results in a double inclusion in income where the U.S. parent is taking the income of the disregarded foreign subsidiary into account currently in computing its U.S. taxable income. For example, assume that a U.S. corporation owns a Country B foreign subsidiary that is disregarded for U.S. tax purposes but treated as a corporation in Country B and that earns $100 of net income for both U.S. and Country B tax purposes, before taking into account a $100 payment of disregarded interest. Because the U.S. parent reports the $100 of underlying income of the subsidiary (but not the $100 interest payment), any disallowance of the deduction for the interest paid would result in a tax in both the United States and Country B.

The purpose of the regulations' dual inclusion exception is to reflect the fact that the income of the disregarded U.S. subsidiary in the "inbound" context may similarly be taxable at the level of its foreign owner. The dual inclusion exception is set out at Reg. **§1.267A-2(b)(3)**. Part (i) of the rule covers the relatively simple case in which the parent takes into account, in calculating its foreign tax base, items of gross income and deduction of the disregarded subsidiary. The operation of the exception is illustrated in Reg. **§1.267A-6(c)(3)(ii)**. There, a disregarded U.S. subsidiary of a foreign parent makes a $100 payment of interest to the parent that would ordinarily be disallowed under the disregarded payment rule. However, the example goes on to state that if the U.S. subsidiary earns $125 of gross income and incurs $60 of deductible expenses, all of which are reported by the foreign parent, the amount disallowed is only $35, that is, the excess of "bad" the $100 interest payment over the "good" income inclusion of $65.

It will be clear at this point that in order to determine the amount that is disallowed, the U.S. subsidiary will need to understand how much of its income is reflected on its foreign parent's foreign tax return. This should be feasible given that the U.S. subsidiary is wholly owned by the parent. But this does not end the inquiry into foreign tax law. What if there is no inclusion of the disregarded subsidiary's income at the foreign parent level, but the non-inclusion is tied to a rule that operates to avoid double taxation?

In response to comments, the final regulations address one aspect of this scenario, involving dividends. Part (ii) of the definition of dual inclusion income includes dividend income that is exempt from tax in the foreign parent's hands under a participation exemption or similar regime, but only if no deduction is allowed to the payor of the dividend. Similarly, if the dividend is not taxed to the U.S. subsidiary under a participation exemption or similar regime (including **§245A**), but is taxable to the foreign parent, the dividend will qualify as dual inclusion income. The preamble to the final regulations stated:

> The Treasury Department and the IRS have concluded that an item of income of a specified party should be dual inclusion income even though, by reason of a participation exemption or other relief particular to a dividend, it is not included in the income of the tax resident or taxable branch to which the disregarded payment is made, provided that the application of the participation exemption or other relief relieves double-taxation (rather than results in double non-taxation). The final regulations are thus modified to this effect. See **§1.267A-2(b)(3)(ii)**; see also **§1.267A-6(c)(3)(iv)**. The final regulations provide a similar rule in cases in which an item of income of a specified party is included in the income of the tax resident or taxable branch to which the disregarded payment is made but not included in the income of the specified party by reason of a dividends received deduction (such as the **section 245A(a)** deduction).

An example illustrating this rule is set out at Reg. **§1.267A-6(c)(3)(iv)**. There, FX is a foreign corporation resident in Country X. Its disregarded subsidiary, US1, holds all the interests of FZ, a CFC resident in Country Z. Ignoring US1's payment of $100 in disregarded interest to FX, US1's only item of income, gain, deduction, or loss during the taxable year is $80 paid to US1 by FZ pursuant to an instrument that is treated as debt for U.S. tax purposes and as equity for Country Z and Country X tax purposes. The $80x paid to US1 by FZ is accordingly treated as interest for U.S. tax purposes and included in US1's income, but is treated as a non-deductible dividend for Country Z tax purposes and as an excludible dividend for Country X tax purposes by reason of the Country X participation exemption. Because the $80 payment is not deductible by FZ, the participation exemption accorded to FX is

excused, such that the entire $80 is treated as dual inclusion income. Accordingly, only $20 of US1's payment to FX is disallowed as a disqualified hybrid amount.

The inclusion of this additional category in the dual inclusion exception is commendable. However, it means that one now needs to know the law of two different foreign countries in order to determine whether and to what extent a disregarded payment will be deductible for U.S. tax purposes.

Moreover, the exception is limited to dividends that are exempt under a participation exemption or similar regime. One might ask whether there are other factual situations in which the income of a disregarded U.S. subsidiary is not included in the foreign owner's income, but that non-inclusion is intended to prevent double taxation rather than to result in no inclusion anywhere.

For example, I don't know whether other countries have a rule similar to **§338(h)(10)**. Non-U.S. tax lawyers typically misunderstand this rule and believe it to be a give-away, but it is not. It allows a member of a U.S. consolidated group that sells stock of a lower-tier group member to treat the sale of stock as if the target sold its assets, with a basis step-up to the buyer but without the duplicative tax that would result if the stock seller sold target stock followed by a sale by the target of its assets. (The same rule allows shareholders of an S corporation to sell stock but treat the sale as a sale of assets by the S corporation, resulting in a single level of tax at the shareholder level.) The effect is that the sale of the target's stock is ignored, and the distribution of the sales proceeds is treated as a nontaxable complete liquidation of the target.[4]

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[4] Similar rules are provided under **§336(e)**.

The reason for the rule of **§338(h)(10)**, of course, is to avoid the second level of corporate tax that would otherwise arise within a single U.S. consolidated tax group (or the corporate-level tax that would arise in the S corporation context). The selling consolidated group (or S corporation shareholder) will still pay tax on the sale, but the tax will be based on a sale of assets rather than a sale of stock. Essentially, the rule treats the selling group as a single taxpayer, mimicking a participation exemption.

It is not hard to imagine that some other country might have a consolidation-type regime in which an amount is not taxable to a foreign owner of a disregarded entity because it is taxable to a lower-tier member of the group. Imagine that, in the above example from the regulations, FX and FZ were formed under the law of the same country, and that instead of FZ paying a dividend that was excluded from FX's income, US1 were to sell the stock of FZ and distribute the proceeds of such sale to FX. It is possible that Country X law does not require FX to include the distribution in income if FZ is treated as selling assets in a taxable transaction. This scenario would seem eligible for the dual inclusion exception on the same ground that the regulations' example involving a participation exemption would be.

Some may find this example far-fetched. But there are hundreds of countries in the world, each with its own unique set of tax rules, not all of which can be dealt with in a single regulation package. If the U.S. government is determined to act as the world's tax police, the regulations should be based on general principles rather than on specifically identified foreign regimes. Taxpayers ought to be able to demonstrate that a non-inclusion of income is attributable to a foreign tax rule that operates to eliminate the dual inclusion of income, however that rule is crafted. Of course, this involves an inquiry into the details of foreign tax law, potentially in more than one country. But this is already the case under the regulations generally. If U.S. taxpayers are required to delve into the details of foreign law in order to determine the amount of their payments that are deductible, they should be permitted to delve into details of foreign law in order to show that the payments are in fact deductible.