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U.S. Tax Treatment of Hybrid Entities and Transactions: Sections 267A and 245A(e) Regulations

Navigating the Mismatches of U.S. and Foreign Tax Law, Key Planning Techniques for Tax Professionals

THURSDAY, MARCH 25, 2021

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

Today's faculty features:

Devon M. Bodoh, Partner, **Weil Gotshal & Manges LLP**, Washington, D.C.

Anthony V. Diosdi, Partner, **Diosdi Ching & Liu, LLP**, San Francisco

Amanda P. Varma, Partner, **Steptoe & Johnson LLP**, Washington, D.C.

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U.S. Tax Treatment of Hybrid Entities and Transactions: Sections 267A and 245A(e) Regulations

Devon M. Bodoh
Anthony Diosdi
Amanda Varma

Strafford Webinars

March 25, 2021

Agenda

1. §245A(e) Anti-Hybrid Rules
2. §267A Anti-Hybrid Rules
3. Expanded Conduit Financing Rules
4. Dual Consolidated Loss Rules

Overview of US Anti-Hybrid Rules

- § 245A(e): Disallows participation exemption in the case of "hybrid dividends" for which the payer is allowed a deduction or other tax benefit
- § 267A: Disallows a deduction for certain payments where a deduction is otherwise available for the payer 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)

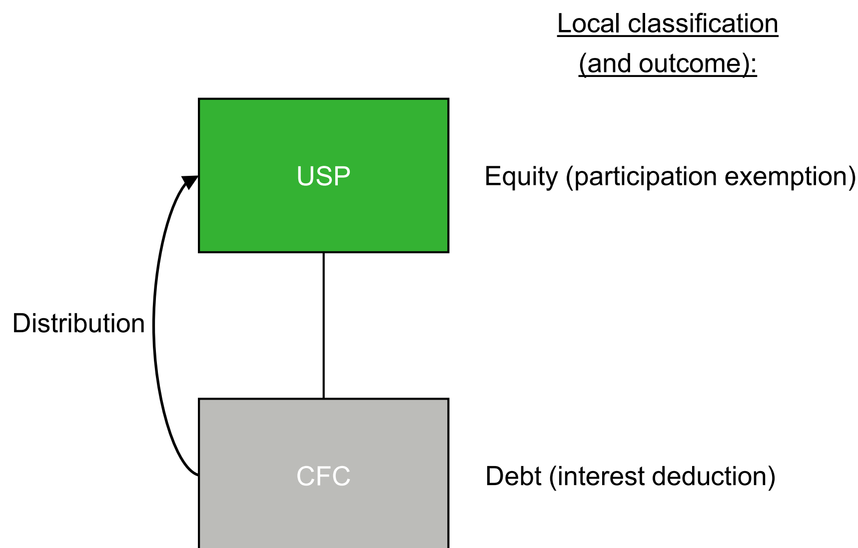
Section 245A(e)

General Rules

- § 245A(a): A US 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 US corporation is a US shareholder 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 United States

Section 245A(e)

Hybrid Dividend (Abstract Example)



Facts

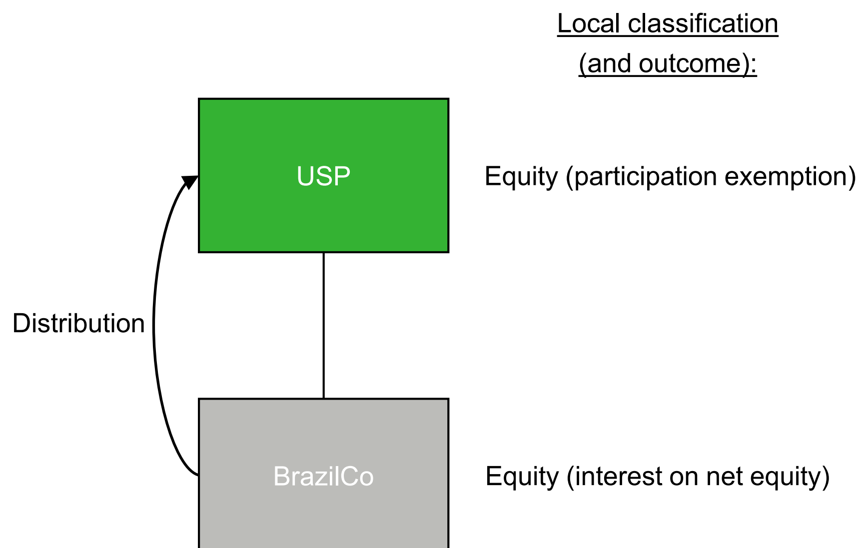
- USP directly owns 100% of CFC.
- CFC makes a distribution to USP on an instrument treated as (i) debt in CFC's jurisdiction and (ii) equity for US tax purposes.

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.

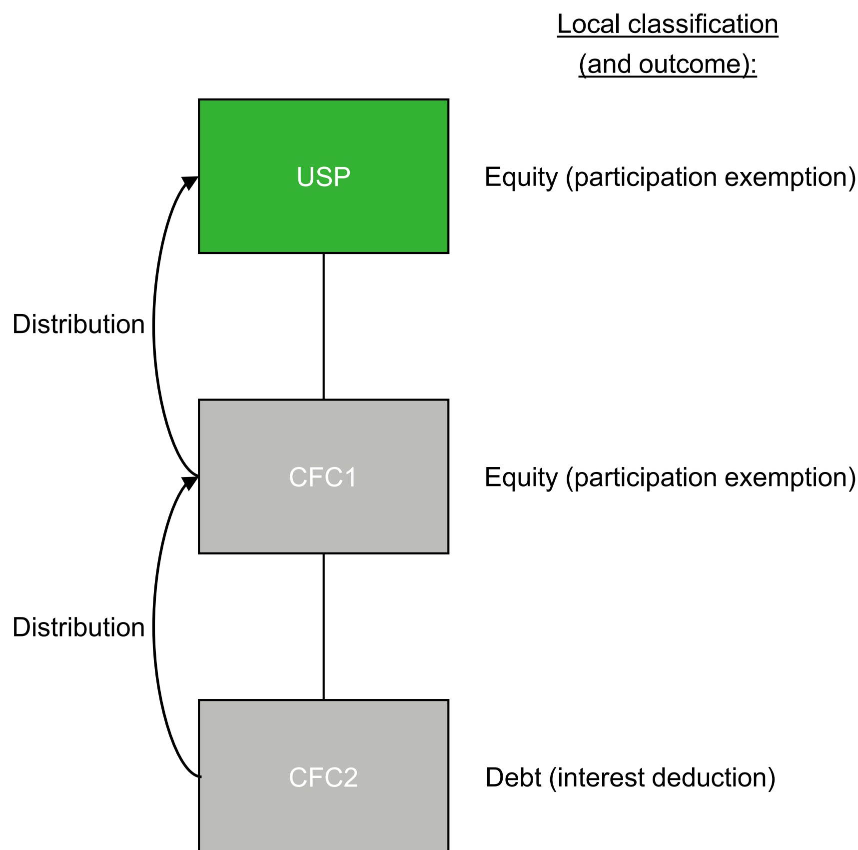
Section 245A(e)

Tiered Hybrid Dividends

- Reg. § 1.245A(e)-1(c)(1): If a CFC with respect to which a US corporation is a 10% US shareholder receives a **tiered hybrid dividend** from any other CFC with respect to which such US corporation is also a 10% US shareholder, then, notwithstanding any other provision of the code:
  A. the tiered hybrid dividend is 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 includes 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 (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

- 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

- 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 that gave 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 (Reg. § 1.245A(e)-1(e))
  - Transactions with a principal purpose to avoid the purposes of § 245A(e) 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
  - Exception: The anti-avoidance rule does not apply to disregard or adjust a restructuring of a hybrid arrangement into a non-hybrid arrangement

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, low-taxed CFC)
▪ Deduction or other tax benefit under foreign law must be "allowed" to CFC or a related person (but regardless of whether it is "used or otherwise reduces tax")	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 shareholder levels	NOT if the CFC jurisdiction imposes a tax on the shareholder

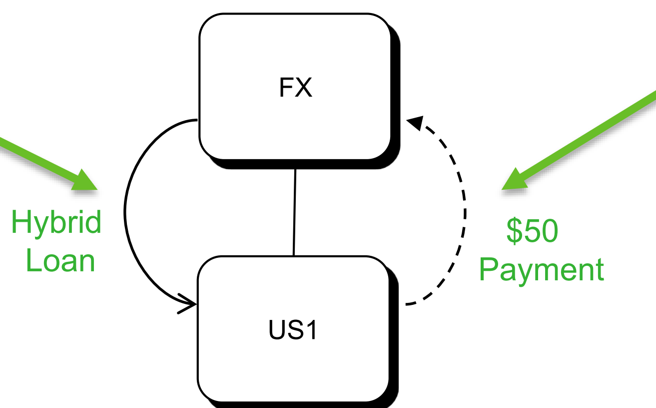
Section 267A

Section 267A Overview

- Section 267A disallows a deduction
  - for **interest and royalties**
    - paid to a **related party** in connection with c**ertain hybrid arrangements**
    - i.e., where there a different characterization of a transaction or entity under US tax law and foreign tax law

Treated as **debt** for U.S. tax purposes

Treated as **equity** for foreign tax law purposes



Treated as **deductible interest** for U.S. tax purposes

Treated as an **excludable dividend** for foreign tax law purposes

What might be covered?

- Hybrid transactions
  - Includes sale/repo transactions
  - Interest-free loans
  - Notional interest deductions
- Disregarded Payments in excess of dual inclusion income
- Deemed branch payments
- Payments to reverse hybrids
- Branch mismatch payments
- Imported mismatch amounts

Basic Rules – Deduction Disallowance

- Deduction disallowance only applies to “specified party”
  - US tax resident
  - CFC (with direct or indirect US shareholders)
  - US Taxable branch
- Deduction disallowed for any interest or royalty paid or accrued with respect to a specified party (“specified payment”) to the extent such payment is:
  - A disqualified hybrid amount (“DHA”);
  - A disqualified imported mismatch amount (“DIMA”); or
  - One to which the anti-avoidance rule of §1.267A-5(b)(6) applies.
- $50,000 de minimis exception (applied on a group wide basis

Basic Rules on DHAs

- If a specified payment is made pursuant to a hybrid transaction, the payment is a DHA to the extent that –
  - A "specified recipient" does not include the payment in income (a "no-inclusion") or has a "long-term deferral"
  - The specified recipient's no inclusion is a result of the payment being made pursuant to a "hybrid transaction"

Basic Rules on DHAs

- "Specified recipient" = any tax resident that derives the payment under its law or a taxable branch to which the payment is attributable under its tax law
  - Apply the "fiscally transparent" principles of §1.894-1(d)(1)
  - There can be more than one specified recipient with respect to a specified payment.
- Specified recipient (and certain others) only taken into account if
  - related to the specified party, or
  - party to a structured arrangement

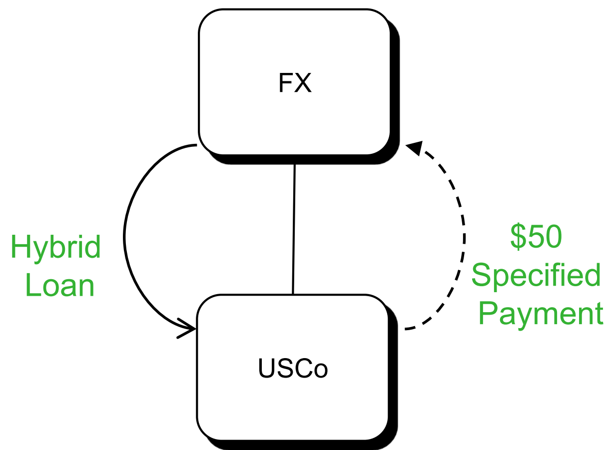
Basic Rules – What is a DHA

- Hybrid Transaction
  - Any transaction, series of transactions, agreement or instrument where one or more payments are treated as interest or royalties for US tax purposes but not for purposes of the tax law of a specified recipient of the payment.
    - *E.g.*, Instrument classified as debt for US tax purposes but as equity under tax laws of specified recipient
  - Includes a transaction where the specified recipient recognizes the payment under its tax laws in a taxable year that ends more than 36 months after the end of the taxable year in which the specified party is otherwise allowed a deduction under US tax law

Exception to DHA treatment

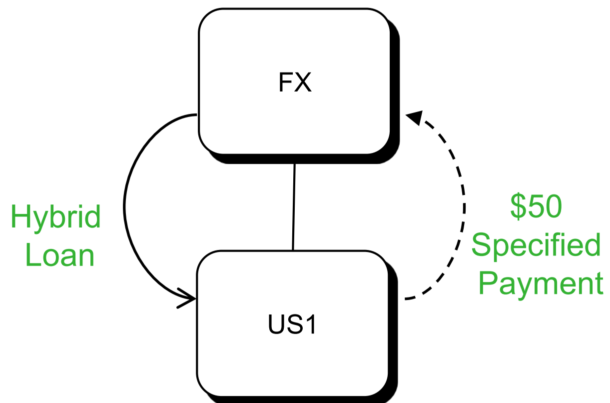
- Any amount that is otherwise a DHA (a "tentative DHA") is reduced to the extent such amount:
  - Is included in the income of a specified recipient that is a tax resident of the US or a US taxable branch.
  - Is received by a CFC, and taken into account in calculating subpart F income or tested income for GILTI purposes, but Final Regulations add:
    - "Taken into account" w/o regard to E&P limitation under §952.
    - Cannot use hybrid payments to convert subpart F income into GILTI income to achieve rate arbitrage with the 50% deduction.
    - Exception added for hybrid payments included in income of US person pursuant to a QEF election

Example 1(i) – Hybrid Instrument



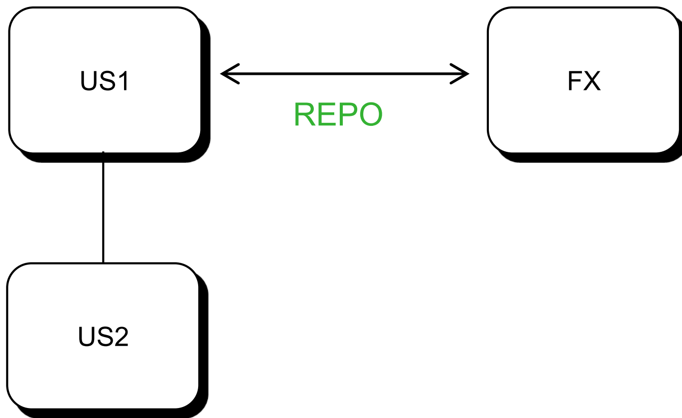
- $50 payment is interest for US tax purposes and an excludable dividend for Country X purposes.
- Results:
- Payment made pursuant to a hybrid transaction.
- A "no-inclusion" occurs because of the participation exemption in Country X.
- Payment is a non-deductible DHA.

Example 1(v) – Pure Territorial System, No-Inclusion <u>Not</u> the Result of Hybridity



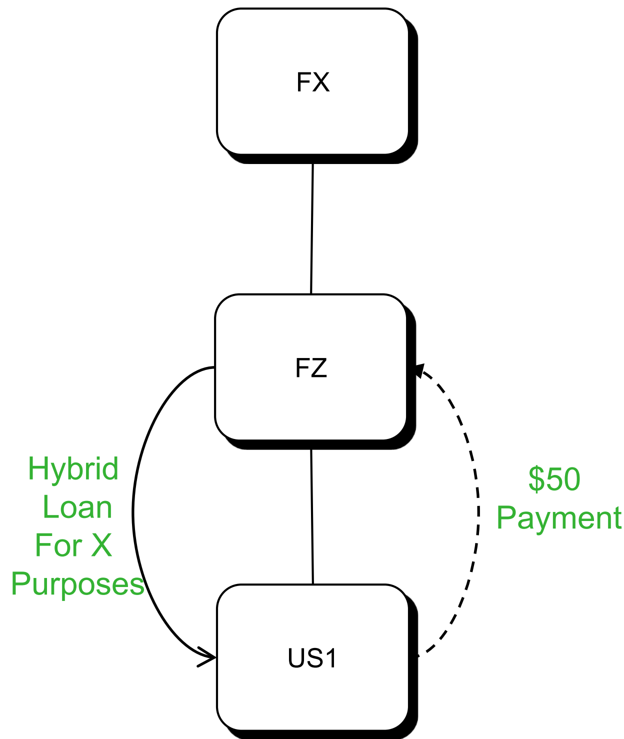
- Same facts as Ex. 1(i), except Country X has a pure territorial regime and taxes <u>neither</u> foreign source dividends nor foreign source interest.
- <u>Results</u>:
- Due to the Country X pure territorial regime, FX would exclude the $50 specified payment even if it were interest
- Since, the no-inclusion would exist even if the specified payment were interest, the no-inclusion is <u>not</u> a result of the payment being pursuant to a hybrid transaction
- Thus the payment is not a DHA.
- Same is true if Country X does not impose a corporate tax of any kind.
- *See* Reg. §1.267A-2(a)(1)(ii).

Example 2(iii): Structured Repo



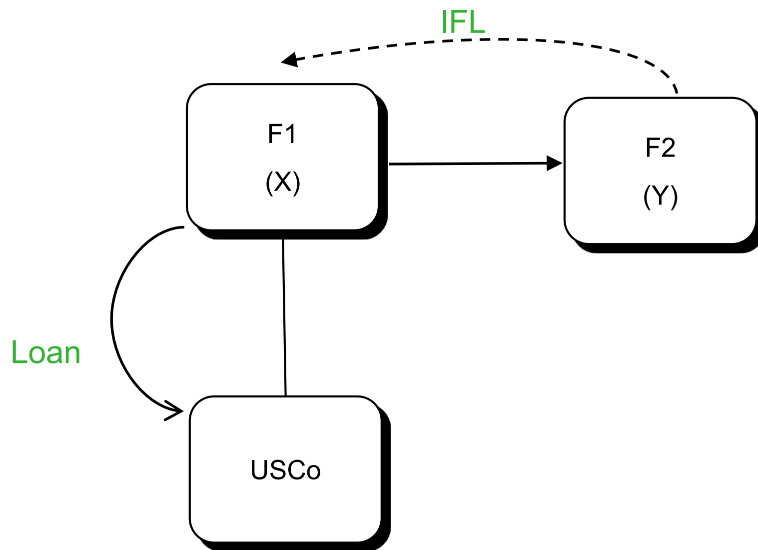
- Same facts as Ex. 2(i), but FX is a bank and unrelated to US1 and the REPO is a "structured arrangement"
- Even though FX is unrelated to US1, because it is party to the structured arrangement, FX is still a specified recipient
- Same result as in Ex. 2(i)

Example 1(iii) – Multiple Specified Recipients



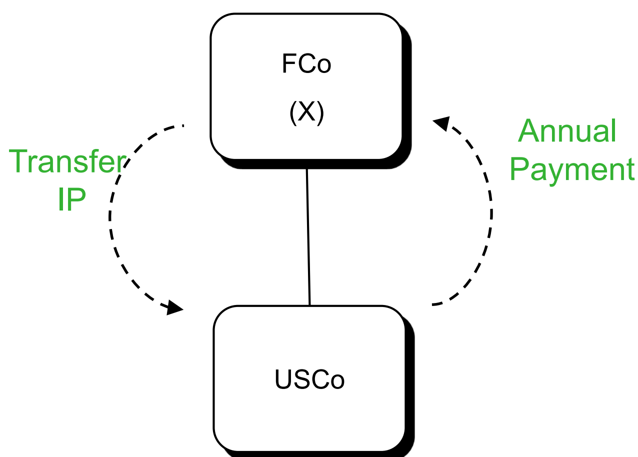
- Same facts as in Ex. 1(i) except:
  - FZ owns US1
  - FX owns FZ
  - The hybrid instrument is a hybrid in Country X, but not in Country Z and is held by FZ, not FX.
  - FZ is nontransparent for Country Z purposes
  - FZ is transparent for Country X purposes, and Country X excludes the payment from income.
  - Payment treated as interest for Country Z purposes.
- Results:
- Both FX and FZ are specified recipients.
- Since a no-inclusion occurs with respect to one specified recipient, FX, the payment is a DHA.
- Does not matter if FZ is taxed at a high rate in Country Z.
- Treasury considered and rejected exception from DHA status for payment included in income of at least one of the specified recipients, as inclusion may be at a low rate; however, if tax rate is high enough is there a policy concern?

Interest Free Loans



- USCo borrows from F1 (Country X) under a normal loan, treated as debt both in the US and in Country X.
- F1 borrows from F2 (Country Y). This loan is also debt in both Country X and Y, but the loan is interest-free.
- F1 is allowed an imputed interest deduction under Country X tax laws.
- BUT, F2 is not required to impute interest income under Country Y's tax laws.
- Result:
- Interest free loans now treated as hybrid transactions §1.267A-2(a)(4)
- Interest paid by USCo to F1 treated as a disqualified hybrid mismatch amount.

IP Sale/License



- FCo sells IP to USCo but does not transfer "all substantial rights."
- Country X treats the transfer as an installment sale and allows FCo to recover basis first.
- The US treats the payments as royalties, normally deductible.
- Result:
- Carved out of final anti-hybrid rules – happens frequently and generally not abusive.

Disregarded Payments

- The excess of a specified party's "disregarded payments" over its "dual-inclusion income" is a DHA.
- A "disregarded payment" is a specified payment to the extent that, under the tax law of a tax resident or taxable branch to which the payment is made, the payment is not regarded and were the payment regarded (e.g., treated as interest or a royalty) under such tax law, the tax resident or taxable branch would include the payment in income.

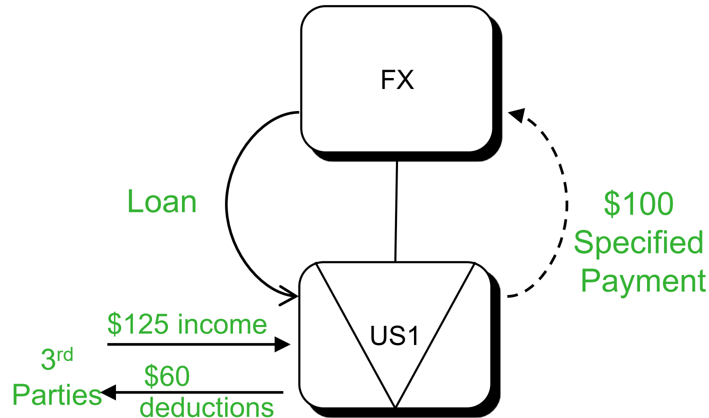
Disregarded Payments

- Dual-inclusion income is the excess of:

(i) The specified party's items of income or gain for US tax purposes that are also included in income of the tax resident or taxable branch to which the disregarded payments are made under the tax law of the tax resident or taxable branch, <u>over</u>

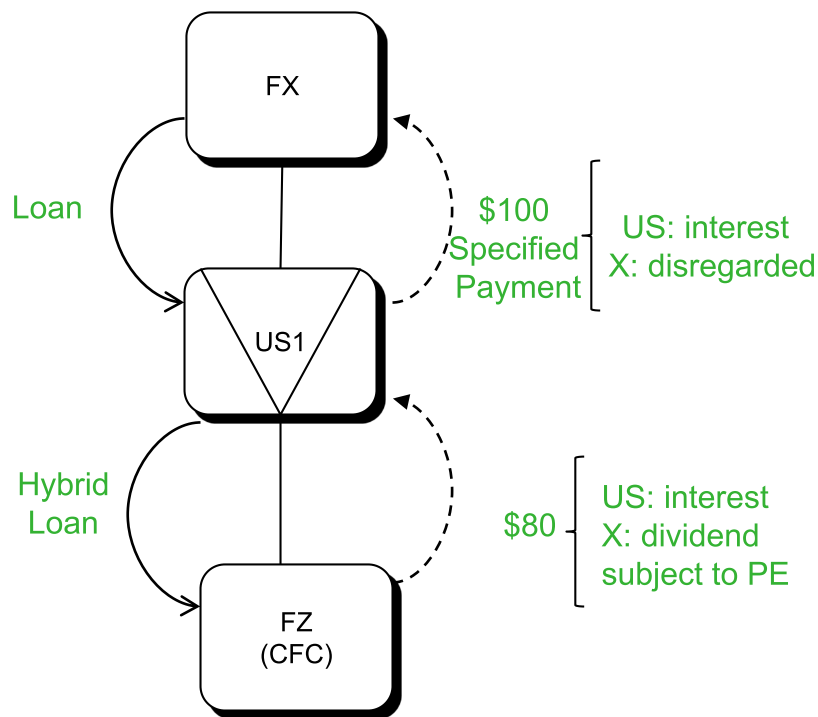
(ii) The specified party's items of deduction or loss for US tax purposes (other than for disregarded payments) that are allowable (or have been or will be allowable no more than 36 months after the end of the specified party's taxable year) under the tax law of such tax resident or taxable branch.

Example 3(i) – Disregarded Payment



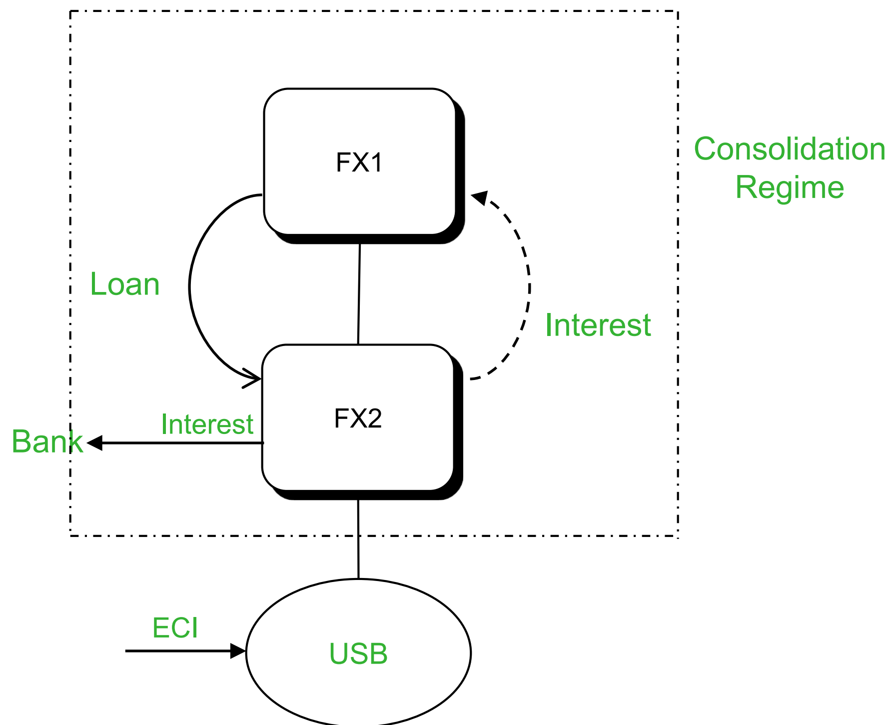
- US1 is regarded for US tax purposes but disregarded for Country X purposes
- US1 has $125 of income and $60 of deductible payments from and to third parties
- FX must include $125 - $60 = $65 in income for Country X purposes, so $65 of dual inclusion income
- <u>Results</u>:
- DHA = specified payment – dual inclusion income
- DHA = $100 - $65 = $35
- <u>Overlap</u>
- DRH regulations apply first– may be recharacterized as a non-deductible dividend.

Example 3(iii) – Non-Dual Inclusion Income Arising From Hybrid Transaction



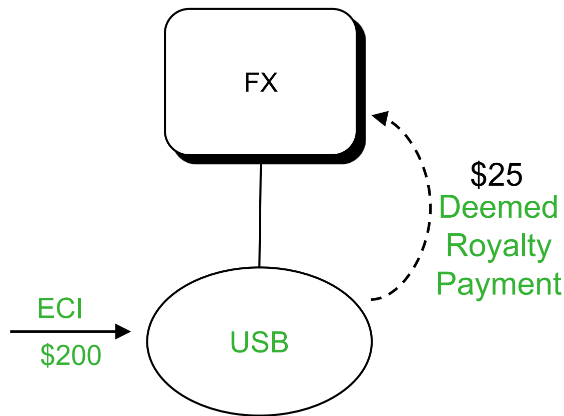
- Country X disregards the $100 payment by US1 to FX
- Since USI is disregarded for Country X purposes, FX is treated as receiving the $80 payment from FZ to US1
- Results:
- US1 – FZ Loan
- The US1 – FZ loan is a hybrid transaction
- There is an $80 no-inclusion arising from that hybrid transaction
- However, since US1, the specified recipient is a US tax resident and includes the income, the tentative DHA of $80 is reduced by $80, so no portion of the $80 is a DHA
- FX – US1 Loan
- As in the prior example, the $100 specified payment arises due to a hybrid transaction
- However, there is no dual-inclusion at the level of FX (the participation exemption applies to the $80 payment received from FZ).
- Thus, all $100 of the specified payment to FX is a DHA

Example 4 (i) – Disregarded Payments Allocable to a US Branch



- FX1 & FX2 file a consolidated return in Country X
- FX2 has a US taxable branch, USB. Thus, interest paid by FX2 to FS1 is eliminated for Country X purposes
- FX2 pays interest to an unrelated bank
- FX Group excludes the income earned by USB due to a territorial system
- Interest is allocated against ECI under Reg. §1.882-5
- <u>Results</u>:
- Interest paid by FX2 to FX1 which is a specified payment subject to possible disallowance
- Bank interest is not a specified payment.
- Allocate interest deducted against ECI proportionately between the bank interest (non-DHA) and interest paid to FX1 (DHA)

Example 4 (iii) – Deemed Branch Payment

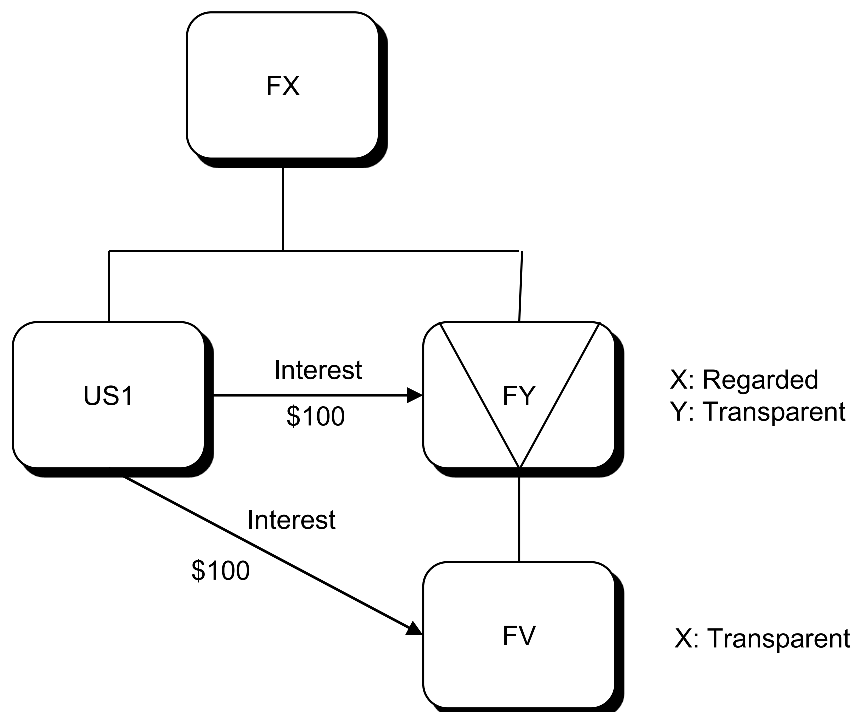


- FX and USB are entitled to the benefits of a tax treaty
- The treaty imputes a royalty deduction of $25 to USB in calculating income attributable to the permanent establishment
- As in Ex. 4(i), Country X excludes USB's $200 of ECI under territorial regime
- Results:
- The $25 is a specified payment that is a DHA because it is excluded from income in Country X
  - Exception to the extent that Country X includes income of the branch in income

Payments to Reverse Hybrids

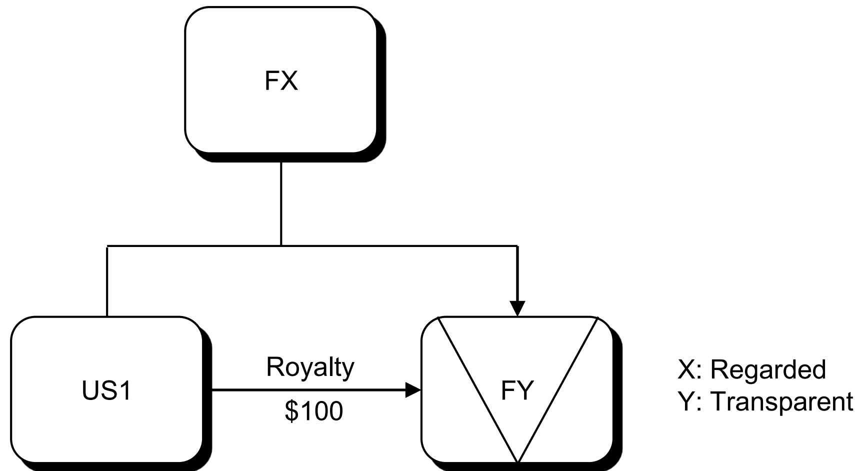
- If a specified payment is made to a reverse hybrid, the payment is a DHA to the extent of:
  - An investor has a no-inclusion.
  - The no-inclusion is a result of the reverse hybrid status of the entity, *i.e.*, the non-inclusion would not occur if the investor's tax law treated the reverse hybrid as fiscally transparent (and treated the payment as interest or a royalty, as applicable).
- A "reverse hybrid" is an entity (US or foreign) that is fiscally transparent where it is organized but not fiscally transparent under the tax laws of <u>an</u> investor.

Example 5(i) – Payment to a Reverse Hybrid



- FY is a reverse hybrid – transparent for Country Y purposes and regarded for Country X purposes.
- Country X does not tax FX on the specified payment under any anti-deferral regime
- Results
- Specified payment of $100 to FY is a DHA
- All of the payment is no-inclusion income
- Basically, the payment is not taxed in either Country X or Country Y due to the reverse hybrid status of FY
- Same result would apply if the payment were made to FV
- Payment not a DHA if it is fully taxed in Country X under a CFC regime (*See* Ex. 5(iii))
- Overlap
- No treaty benefits due to Reg. §1.894–1(d)(1)
- As noted above, no exception for amounts subject to full 30% US WHT

Example 5(v) – No-Inclusion Not the Result of Hybridity

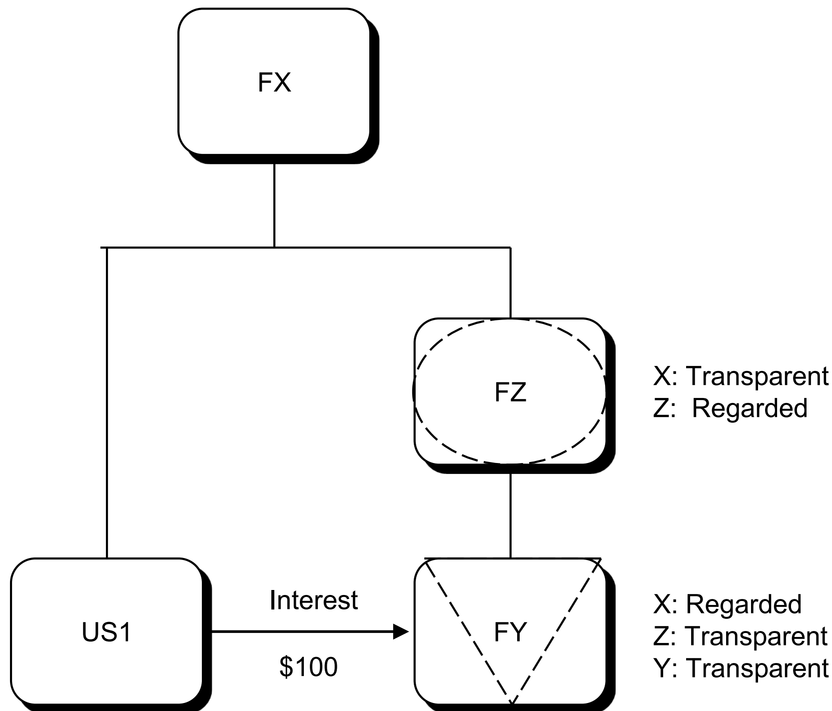


- Country X has a patent box regime which allows an 80% deduction against royalty income.
- Results
- If FY is transparent under County X law, then only $20 would be no-inclusion income due to FY's reverse hybrid status.
- The remaining $80 of no-inclusion income would be exempt due to X's patent box regime.
- Thus, only $20 of the $100 is a DHA.

Payments to Reverse Hybrids
Multiple Investors

- An “investor” in an entity is any tax resident or branch that owns directly or indirectly (under §958(a) principles) an interest in that entity. Reg. §1.267A-5(a)(13)
- Does not matter if intermediary entities are domestic or foreign.
- Thus, an entity in a chain of entities would have multiple investors and each one of them may need to be tested for a no-inclusion.

Example 5(iv) – Reverse Hybrids – Multiple Investors

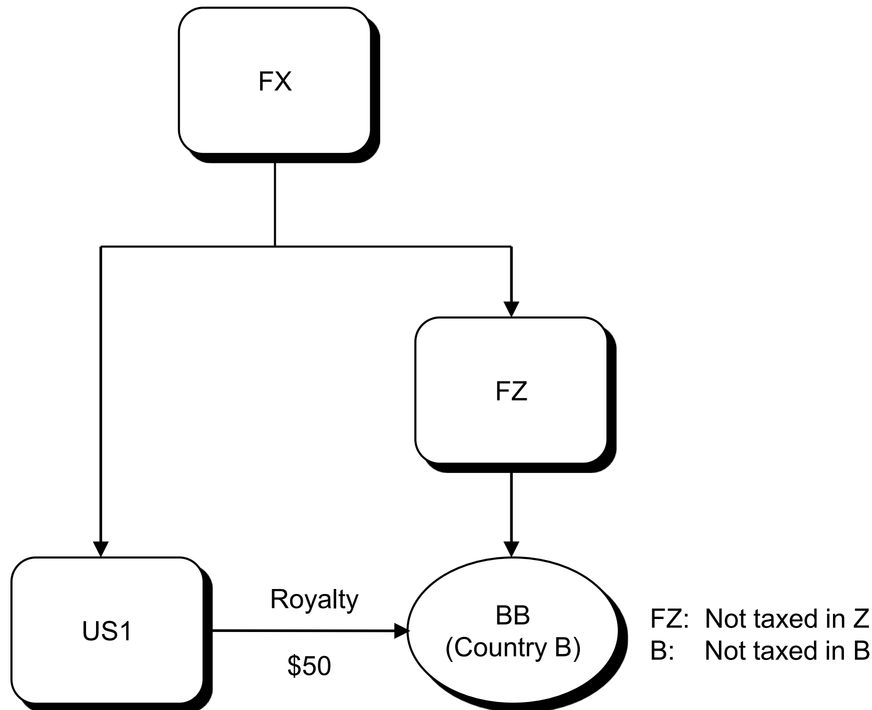


- FZ includes the $100 payment received by FY in income
- FX does not include the $100 payment received by FY in income
- Results
- FX and FZ are both investors in FX
- FZ does not have a no-inclusion with respect to the $100
- FX has a no-inclusion with respect to the $100
- If FY were not transparent for Country X purposes, FX would include $100 of income, so the FX no-inclusion results from FY being a reverse hybrid
- Thus, the $100 payment to FY is a DHA
- The Country Z tax imposed on FZ is irrelevant

Branch Mismatch Payments

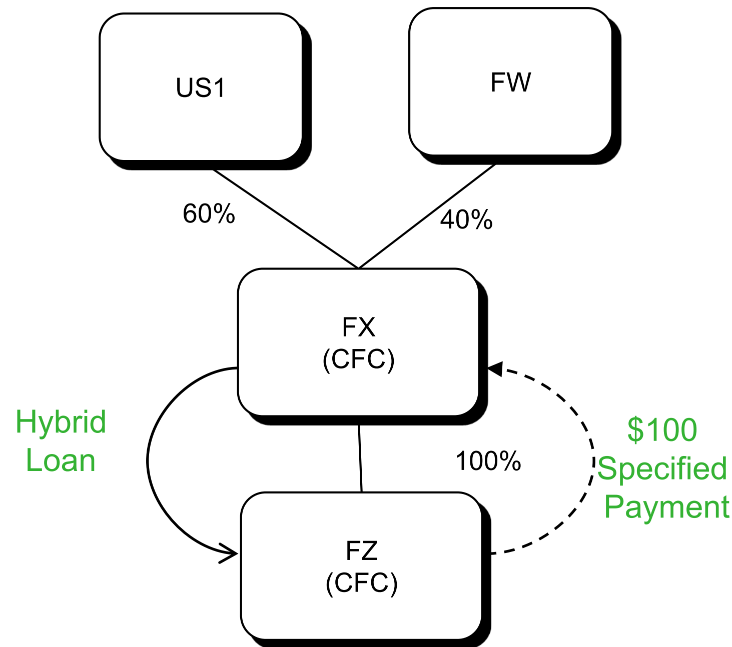
- A specified payment that is a branch mismatch payment is a DHA to the extent that
  - A home office has a no-inclusion (i.e., excludes the income as attributable to a foreign branch); <u>and</u>
  - The home office's no-inclusion would not occur were the home office's law to treat the income as not attributable to a foreign branch
- A branch mismatch payment is a specified payment that:
  - Under a home office's tax law, the income is attributable to a branch of the home office; and
  - Either
    - The branch is not a taxable branch; or
    - Under the branch's tax law, there is a taxable branch <u>but</u> the payment is not treated as income attributable to the branch

Example 6 – Branch Mismatch Payment



- Under Country B tax law, BB is not a taxable branch
- Results
- The $50 royalty is a branch mismatch payment
- The income is no-inclusion income to FZ, *i.e.*, FZ would include the income if the payment were not attributable to the foreign branch
- Thus, the $50 royalty payment is a DHA
- Same result if BB were taxable, but Country B viewed the royalty as income of FZ and not BB

Example 7 – Reduction of DHA For Amounts Includible in Income



- FX loans money to FZ.
- For US tax purposes, it is treated as a loan and FZ pays "interest" to FX.
- For Country X purposes, the instrument is treated as equity, and the $100 "dividend" is subject to an 80% participation exemption.
- FX includes $20 of income
- <u>Results</u>
- There is a tentative DHA of $80, *i.e.*, the amount of the specified payment excluded under Country X law.
- Since the $80 is included in tested income for GILTI purposes, the tentative DHA is reduced for US1's share (60%).
- Thus, the DHA is $80 x 40% = $32.

Disqualified Imported Mismatch Amounts

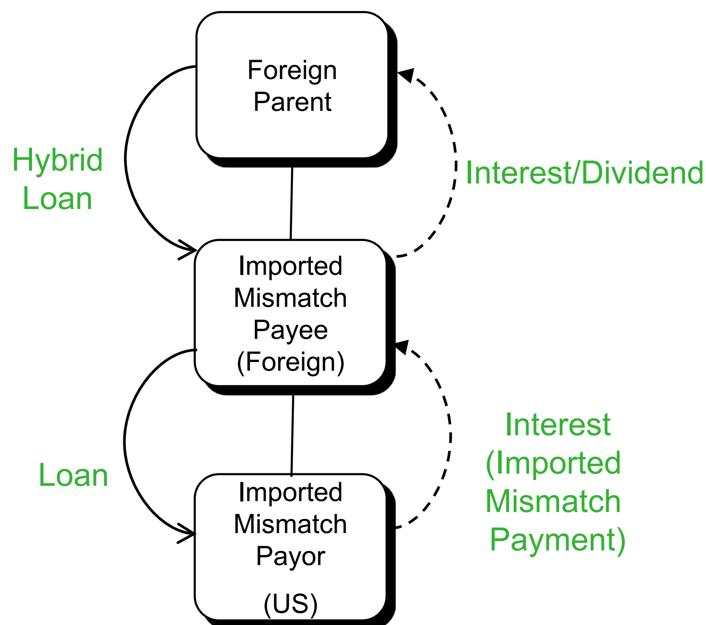
A DIMA is a specified payment (other than a DHA) to the extent that, under broad "set-off" rules, the income attributable to such payment is **directly or indirectly** offset by a "hybrid deduction" incurred by a foreign tax resident/taxable branch related to the specified party (or party to the structured arrangement).

- Some key terminology:
  - Imported mismatch payment = specified payment other than a DHA or a payment that is included or includable in the US
  - Imported mismatch payor = the specified party
  - Imported mismatch payee = the foreign tax resident or taxable branch that includes the imported mismatch payment in income

DIMA: What is a Hybrid Deduction?

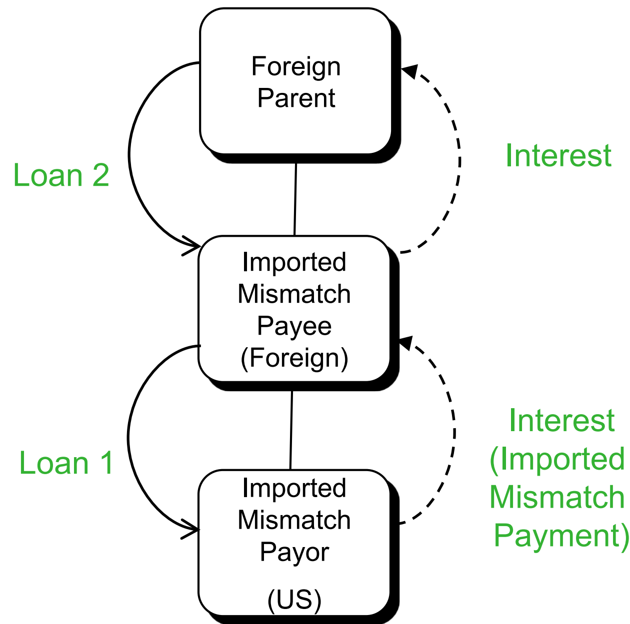
- A **deduction allowed to the foreign tax resident/taxable branch under its foreign tax law** for an amount that is interest or royalty under such tax law, to the extent a deduction for the amount would be disallowed if such tax law contained rules similar to Reg. §§1.267A-1-3 and 1.267A-5.
  - Includes notional interest deductions and deductions for payments made pursuant to interest-free loans

Example 8(i) - Disqualified Imported Mismatch Amounts (DIMA)



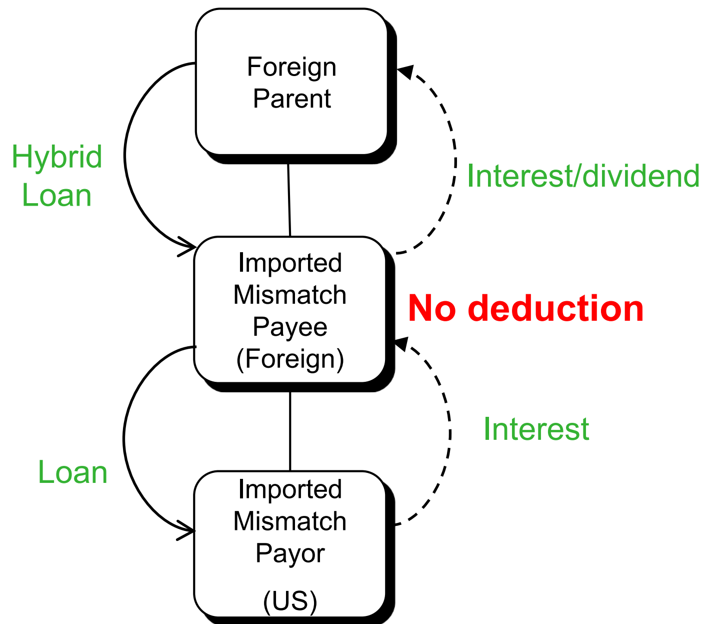
- Foreign Parent excludes the (hybrid) dividend from income under a participation exemption
- Result:
- interest payment by a US payor is a DIMA to the extent income attributable to the payment is offset by a "hybrid deduction" incurred by foreign payee related to the US payor.
- A "hybrid deduction" arises here because the foreign Imported Mismatch Payee is allowed a deduction under its tax law that would be a DHA under § 1.267A-2 if its country had applicable US rules.
- The interest paid by US Payor is therefore a DIMA and the US deduction is disallowed

Examples 8(iii) & (iv) – DIMA



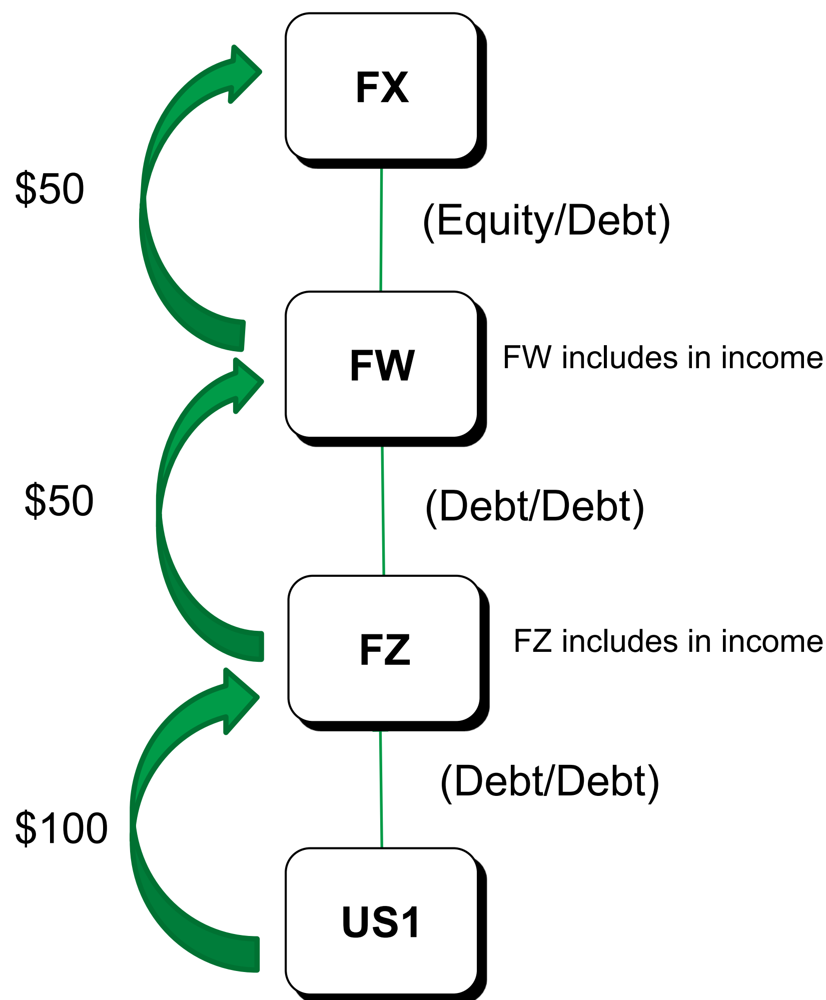
- Same results would apply if Loan 2 were *not* a hybrid loan, but there is a "long-term deferral." *E.g.*, if under applicable foreign accounting rules FP will be taxable on the interest income more than 36 months after the accounting period in which the foreign Payee is entitled to the interest deduction.
- Same results would apply if there is no Loan 2 at all, but the Payee is allowed a notional interest deduction under foreign law.

Example 8(v) – DIMA



- The payment may not be a DIMA if foreign law expressly disallows the Payee from deducting its payment to Foreign Parent pursuant to hybrid mismatch rules similar to certain of the anti-hybrid rules contained in the US regulations.

Simplified Example – DIMA Funding Rule



- US1 borrows from FZ and FZ borrows from FW, both treated as debt in all relevant countries.
- However, FW borrowed from FX with a hybrid debt-equity instrument.
- The instruments are factually unrelated
- Result: $50 is a disqualified imported mismatch amount and the deduction is disallowed to US1

Coordination with Other Provisions (Or Not)

- In contrast with BEAT and old earnings-stripping rules, no exception for payments subject to full 30% withholding tax
- §267A generally applies to items that are otherwise deductible under the Code.
  - For example, §267(a)(3) deferral would be applied first.
  - Apply domestic reverse hybrid rules of Treas. Reg. §1.894-1(d)(2) first. If interest recharacterized as a dividend, it is not a specified payment.
  - If a payment is not a hybrid payment when paid, but the deduction is deferred under §163(j), the payment is not tested again under §267A when the deduction is eventually allowed.

Coordination with Other Provisions (Or Not)

- §267A is applied before §163(j) (interest deferral), §461(l) (excess business losses), §465 (at risk rules) and §469 (passive loss rules).
- If a deduction is disallowed pursuant to §267A it is disallowed for all purposes of the Code (i.e., it is not taken into account for purposes of computing costs that are capitalized and recovered through depreciation, amortization or COGS).

Anti-Avoidance Rule

- A specified party's deduction for a specified payment is disallowed to the extent:
  1) The payment (or the income attributable thereto) is not included in the income of a tax resident or taxable branch, as determined under certain rules set forth in Reg. §1.267A-3(a), but disregarding certain de minimis and full inclusion rules, and
  2) There is a principal purpose of the terms or structure of the arrangement (including the form and tax laws of the parties) avoid the §267A Regulations in a manner contrary to the purposes of the regulations under §267A

Effective Date of Section 267A Regulations

- Regulation Sections 1.267A-1 through 1.267A-6 generally effective for tax years **ending** on or after December 20, 2018.
- Certain provisions, however, are effective for taxable years **beginning** on or after December 20, 2018.
  - Disregarded payments
  - Deemed branch payments
  - Interest free loans
  - Branch mismatch payments
  - Disqualified imported mismatch amounts
  - Application to structured arrangements
  - Structured payments

Expanded Anti-Conduit Regulations

Background on Anti-Conduit Rules

- IRS may disregard for purposes of gross basis taxation participation of one or more conduit entities in conduit financing arrangement
- Conduit financing arrangement is financing arrangement effected through one or more conduit entities
- Conduit entity is intermediate entity with respect to financing arrangement if:
  - participation of intermediate entity reduces gross basis tax,
  - participation of intermediate entity is pursuant to tax avoidance plan, and
  - either:
    - intermediate entity is related to financing entity or financed entity, or
    - intermediate entity would not have participated in financing arrangement on substantially same terms but for fact that financing entity entered into financing transaction with intermediate entity

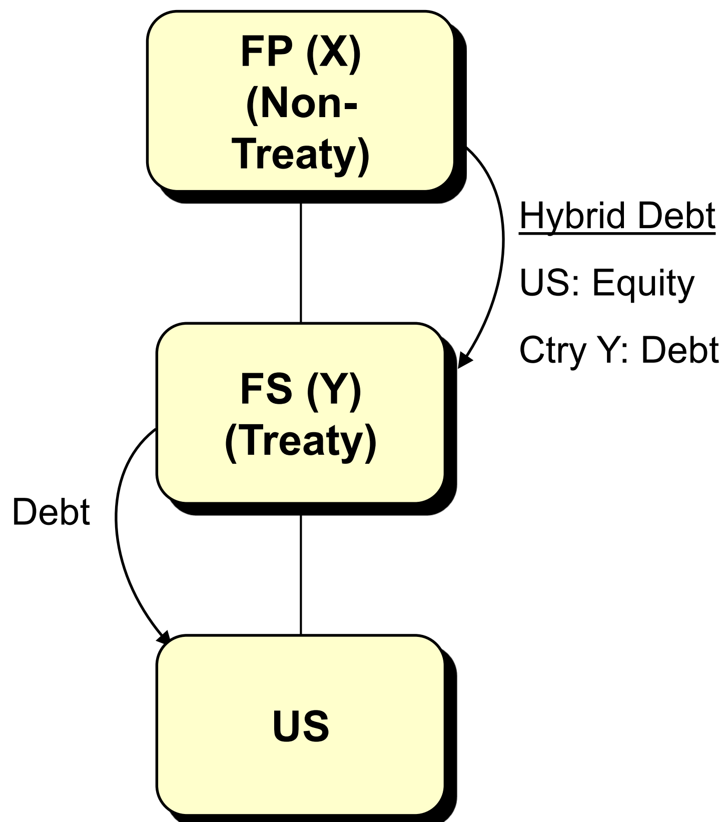
Background on Anti-Conduit Rules

- Financing arrangement is series of transactions:
  - by which financing entity advances money or other property, or grants rights to use property, and financed entity receives money or other property, or rights to use property,
  - advance and receipt are effected through one or more intermediate entities, and
  - there are financing transactions linking financing entity, each intermediate entity, and financed entity
- Financing transaction includes only certain stock or partnership interests

Anti-Hybrid Rule

- Financing transaction includes stock in a corporation or a similar interest in a partnership, trust, or other person if "the stock or similar interest is treated as debt under the tax law of the issuer's country of residence or, if the issuer is not a tax resident of any country, such as a partnership, the tax law of the country in which the issuer is created, organized, or otherwise established"
- Rule applies to payments made on or after November 12, 2020
- Final regulations, contrary to proposed regulations, did not treat notional interest deductions or deductions on net equity as giving rise to financing transaction and are continuing to study their treatment

Anti-Hybrid Rule Example



- FS is permitted a deduction on a FP-FS hybrid instrument
- FP-FS hybrid instrument is a financing transaction, so FP-FS hybrid instrument and FS-US loan constitute financing arrangement
- Conduit financing rules potentially apply to disregard FS as conduit entity

Conduit Entities

Introduction

The IRS and Treasury issued proposed regulations on April 7, 2020 that would restrict foreign persons' ability to minimize U.S. tax through "conduit" financing arrangements. On the same date, Treasury and the IRS issued additional 2020 Proposed Regulations under Section 881 (with respect to the 'anti-conduit regulations'). These proposed regulations and other regulations potentially impact a number of types of financing structures used by foreign persons into the United States.

Conduit Entities

The 30% Withholding Tax

Internal Revenue Code Section 871(a) (for nonresident aliens) and Section 881(a) (for foreign corporations) impose a 30-percent tax on certain passive types of U.S. source income such as interest, dividends, rents, annuities, and certain types of fixed or determinable annual or periodical income. This enumeration is sometimes referred to as “FDAP income.”

Although FDAP income is typically subject to a statutory 30-percent U.S. withholding tax, many bilateral U.S. income tax treaties reduce or eliminate this withholding tax.

Conduit Entities

Treaty Benefits

To qualify for treaty benefits, a non-U.S. taxpayer must be a resident of a particular treaty jurisdiction, as well as satisfy the treaty's limitation of benefits (LOB) provision, if any. Even if a non-U.S. taxpayer qualifies for treaty benefits, there are two statutory provisions that may prevent the non-U.S. taxpayer from claiming treaty benefits: Section 894(c) and Section 7701(1).

Conduit Entities

Section 894(c)

Section 894(c) denies treaty benefits when a non-U.S. taxpayer invests in the U.S. through an entity that is "fiscally transparent" under the laws of the U.S. and/or any other jurisdiction. The regulations under Section 894(c) deny treaty benefits on payments of U.S. source income to the extent such income is not "derived by" a treaty resident.

Conduit Entities

Section 7701(1)

The conduit financing regulations under Section 7701(1) prevent a non-U.S. taxpayer from claiming treaty benefits with respect to U.S. payments.

Conduit Entities

Overview of Anti-Conduit Rules

Allows tax authorities to disregard participation of intermediate entity in certain conduit financing arrangements.

Conduit financing arrangement- series of financing effected through one or more intermediate entities if

1. The participation of the entity reduces U.S. tax imposed under Sections 871, 881, 1441, or 1442.

2. Participation of the entity in the arrangement is pursuant to a tax avoidance plan; and

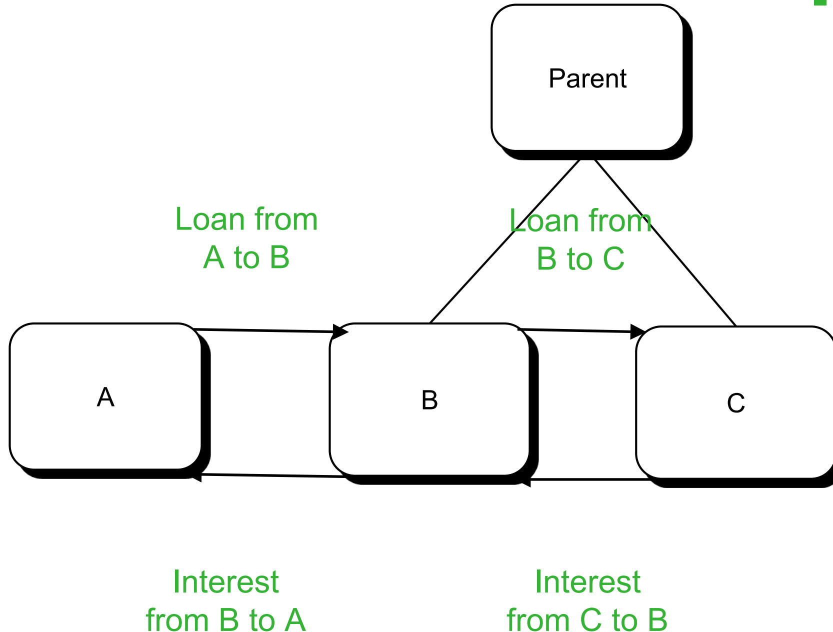
3. The entity is related to financing or financed entity (or the entity would not have participated but for the fact that the financing entity engaged in the transaction with the intermediate entity).

Example 1– Anti-Conduit Rules IP

Anti-Conduit Rules IP Example

Assume that a Cayman Island corporation owns certain intellectual property (IP) that it intends to license for use in the United States. Since the U.S. does not have an income tax treaty with the Cayman Islands, any U.S. source royalties paid to the Cayman Island corporation pursuant to such a license would be subject to a 30% U.S. withholding tax. If the Cayman Island corporation licenses the IP to a Dutch corporation, which in turn sublicenses the IP for use in the U.S., then any U.S. source royalties paid to the Dutch corporation may be exempt from U.S. withholding tax under the U.S.-Netherlands tax treaty. However, under the IRS may disregard the conduit entity (the Dutch corporation) and treat the royalties as being paid directly to the Cayman Island corporation, in which case the royalties would be subject to a 30% U.S. withholding tax.

Example 2– Anti-Conduit Rules



- Suppose A lends money to B, for which B pays interest to A, and B turns around and lends that money to C, for which C pays interest to B. The conduit regulations give the IRS authority to collapse the loans and treat A as having lent money to C. As a result, the IRS will treat A as having lent money to B, as having derived interest from C for purposes of the 30 percent withholding tax. In this example, B is the conduit entity, and the IRS is disregarding B's participation in the loan because it appears that the parties intended the loan proceeds from the A-to-B loan to go to C.

Conduit Entities

Existing final regs define "financing transaction" to include debt, lease, or license, but not equity (except for certain redeemable equity)

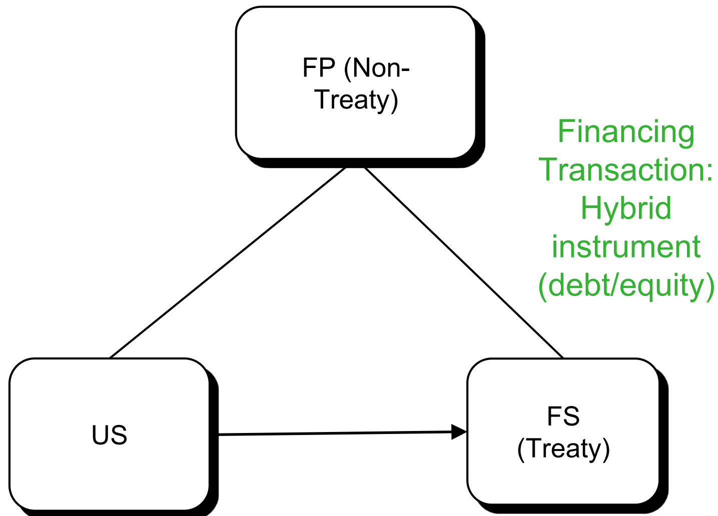
Given that stock that stock typically does not constitute a financing transaction, it was common for non-U.S. taxpayers to utilize hybrid instruments (i.e., an instrument treated as debt for foreign tax purposes but equity for U.S. tax purposes) to capitalize an IP holding company (foreign licensor), which would in turn license IP to the U.S. In this situation, the payment of royalties from the U.S. to the foreign licensor, followed by a payment that was treated as interest for foreign tax purposes, was typically not subject to the conduit financing regulations because the U.S. treated the subsequent payment by the IP holding company as a dividend.

Conduit Entities

Under the 2020 proposed regs, certain interest treated as equity for U.S. purposes will now be considered a "financing transaction"

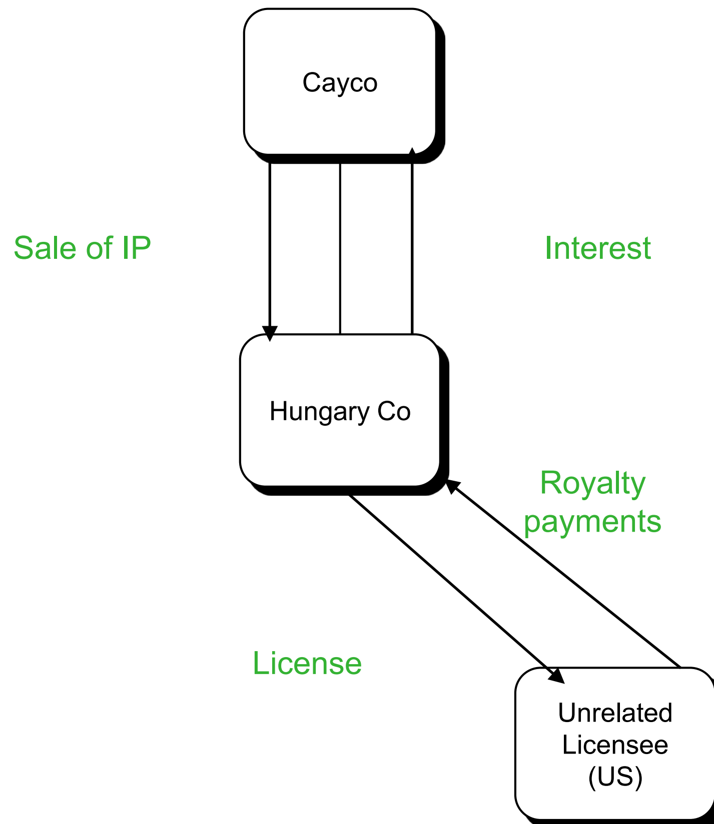
The 2020 proposed Section 881 regulations create two new categories of equity that constitute a financing transaction: 1) an equity interest with respect to which the issuer is allowed a tax break (i.e., a deduction) for an amount paid, accrued, or distributed with respect to such interest either under the laws of the issuer's country of residence or a country in which the issuer has a taxable presence (i.e., a permanent establishment) to which a payment on a financing translation is attributable; or 2) an equity interest with respect to which a person related to the issuer is allowed a refund (including a credit) or similar tax benefit for taxes paid by the issuer to its country of residence, without regard to the related person's tax liability under the laws of the issuer.

Proposed Conduit Regulations



- Previously, the anti-conduit regulations generally did not attack a foreign finance company capitalized with equity under U.S. tax principles.
- For example, a hybrid instrument treated as debt for foreign purposes but equity for U.S. purposes was not caught by Treas. Reg. Section 1.881-3.
- The new regulations could not result in FS being a conduit because it is capitalized with a hybrid equity instrument.
- Treas. Reg. Section 1.881-3(a)(2)(ii)(B)(1)(iv).

Example– Leveraged License



- Cayco owns valuable IP and wishes to license the IP to an unrelated U.S. licensee.

  Royalties would be subject to 30 percent U.S. withholding.

  Cayco forms Hungarian sub, which is opaque for U.S. and Hungarian purposes and sells IP to Hungary Co for a note.

  U-S- Hungary treaty has no LOB provision and provides source country exemption from withholding on royalties.

  Hungary Co is not a hybrid entity, and neither license nor note are hybrid instruments.

  Through both license and loan are financing transactions under conduit financing rules also do not apply.

  Preamble to 1995 final conduit regs supports excluding leveraged licenses from their scope- a “leveraged lease generally will not be recharacterized as a conduit arrangement if the ultimate lender would be entitled to an exemption from withholding tax on interest from the financed entity, even if rental payments made by the financed entity would have been subject to withholding tax.

Dual Consolidated Loss Rules

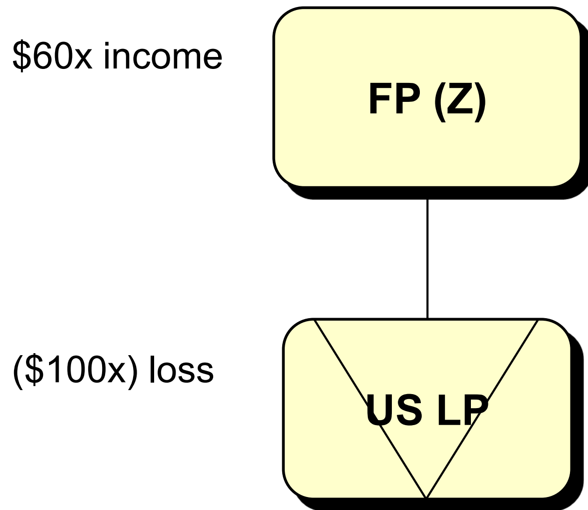
Background on DCL Rules

- A DRC is a domestic corporation that is subject to income tax of a foreign country on its worldwide income or on a residence basis
- A DRC determines its income or dual consolidated loss (DCL) based on its items of income, gain, deduction, and loss, excluding:
  - any carryover or carryback losses, and
  - items of income, gain, deduction, and loss attributable to a separate unit or an interest in a transparent entity of the DRC
- Generally, under the domestic use limitation rule, a DRC's DCL cannot be used to offset income of a domestic affiliate other than the DRC that incurred the DCL
- The DCL may carried forward for use in future taxable years to offset income of DRC

Domestic Reverse Hybrid Rule

- Domestic eligible entity that elects to be classified as association is treated as domestic consenting corporation (DCC) for purposes of DCL rules
- Dual resident corporation (DRC) includes DCC if on any day during tax year:
  - specified foreign tax resident (SFTR) derives or incurs items of income, gain, deduction, or loss of (DCC) (because, for example, DCC is fiscally transparent under relevant foreign tax law), and
  - SFTR and DCC are related within meaning of §§ 267(b) or 707(b)
- SFTR is body corporate or other entity or body of persons liable to tax under foreign tax law as resident

Example



- US LP is a DCC (by electing to be classified as association it consents to be treated as DRC)
- US LP is treated as a DRC for the tax year because FP is a related SFTR that derives or incurs items of income, gain, deduction, or loss of US LP
- FP derives or incurs items of income, gain, deduction, loss of US LP because, under Country Z tax law, US LP is fiscally transparent
- US LP has $100 DCL for the tax year, and there is a foreign use because the items of deduction or loss are made available to, and do, offset income of FP under Country Z tax law
- $100 DCL is subject to the domestic use limitation rule

Dual Consolidated Loss Rules

Background on DCL Rules

Opportunities for tax savings through international arbitrage arise when there are inconsistencies between the rules in two countries for determining the residence of corporations. Under Section 1501 and regulations issued pursuant to Section 1502, a U.S. corporation is permitted to file a consolidated tax return with other U.S. corporations in an affiliated group.

A dual resident corporation is frequently the U.S. parent corporation of one affiliated group of corporations in the United States and another affiliated group in the foreign country that also treats the group as a taxable resident.

To deal with the double-dip international tax arbitrage opportunities for dual resident corporations, congress enacted Section 1503(d) as part of the 1986 Tax Reform Act.

Dual Consolidated Loss Rules

Section 1503(d)

Section 1503(d)(1) provides that the dual consolidated loss of a dual resident corporation for any tax year cannot reduce the taxable income of any other U.S. member of the affiliated group for that or any other tax year.

Dual Consolidated Loss Rules

Regulations under Section 1503(d)

The regulations state that the Section 1503(d) limitations are aimed at dual-resident corporations (DRC). A DRC is a domestic corporation subject to a foreign country's income tax on either a worldwide or a residence basis. *See* Treas. Reg. Section 1.1503(d)-1(b)(2).

Dual Consolidated Loss Rules

Regulations under Section 1503(d) and Separate Units of a Corporate Entity

The same limitation on loss use applies to a separate unit of a U.S. corporation as if the separate unit were the corporation's wholly subsidiary. *See* Treas. Reg. Section 1.1503-2(b)(1). "Separate unit" includes either of the following that is carried on or owned, directly or indirectly (indirect ownership means through a partnership, disregarded entity, or grantor trust, regardless of whether such entities are U.S. persons), by a U.S. corporation (including a DRC): 1) a foreign business operation that if carried on by a U.S. person, would constitute a foreign branch or 2) an interest in a hybrid entity.

Dual Consolidated Loss Rules

Determining the DCL

Once the existence of a DRC or separate unit of a U.S. corporation is established, the next step is to determine whether the DRC or separate unit occurred a dual consolidated loss (DCL). A DCL is generally defined as a Section 172(c) Net Operating Loss (NOL) incurred in a year in which the entity is a DRC. *See* Treas. Reg. Section 1.1503(d)-1(b)(5)(i). To determine if the DRC has income or an NOL, only items of income, gain, deduction, or loss incurred by the DRC in the current year will be taken into account. Under Treas. Reg. Section 1.1503(d) 5(b)(2), items that will not be taken into account include 1) the DRC's net capital losses; 2) carryover or carryback losses; and 3) items of income, gain, deduction, and loss attributable to a separate unit or transparent entity of the DRC.

Dual Consolidated Loss Rules

Offsetting US Income with a DCL

A DRC may offset U.S. income with a DCL if the DCL makes a domestic use election under Treasury Regulation Section 1.1503(d)-6(d) and the taxpayer certifies that there has not been, and will not be, a foreign use of the DCL during a certification period. The certification period is defined in Treasury Regulation Sections as the five-year period following the year the DCL was incurred. Under Treasury Regulation Section 1.1503(d)-3, foreign use occurs when a DCL is made under foreign income tax laws to offset income that U.S. tax principles consider to be income of a foreign corporation or hybrid entity owner.

Dual Consolidated Loss Rules

Compliance Requirements

An elector must file a domestic-use agreement by the due date (including extensions) of the elector's U.S. income tax return for the tax year in which the DCL was incurred. Format for the election is stated in Treas. Regulation Section 1.1503(d)-6(d)(1). The elector must also file a certification, labeled "Certification of Dual Consolidated Loss" at the top page of the tax return, by the due date (including extensions) of its income tax return for each year during the five-year certification period.

Dual Consolidated Loss Rules

Mirror Legislative Rules

The regulations also contain “Mirror Legislative Rules.” The mirror legislative rules in Treasury Regulation Section 1.1503(d)-3(e) prevent a domestic use election when a foreign jurisdiction has legislation like Section 1503(d) preventing foreign use of the DCL. A foreign use is deemed to occur if:

1) The income tax laws of a foreign country deny any opportunities for foreign use of the DCL because the DRC or separate unit is subject to tax in another country.

2) The DCL can offset income under the laws of another country; or

3) The deductibility of a DCL input depends on another country’s laws.

The intent of the rule is to prevent the foreign country from enacting a law that would give a taxpayer the sole option of using dual consolidated loss to offset U.S. income.

Dual Consolidated Loss Rules

Reverse Hybrids- The Exception to the DCL Limitations on Double Deduction

On April 18, 2007, the IRS and Treasury issued new regulations applicable to DCLs.

Under the 2007 rules, domestic reverse hybrids could be used to obtain double deduction outcomes because they were not subject to limitation under the regulations promulgated under Section 1503(d). A domestic reverse hybrid is basically a U.S. entity that elects under Treas. Reg. Section 301.7701-3(c) to be treated as a corporation for U.S. tax purposes but a passthrough entity or fiscally transparent under the tax laws of a foreign country.

Under the 2007 regulations, a reverse hybrid structure could lead to double deduction outcomes.

Dual Consolidated Loss Rules

New Proposed Regulations

The IRS and Treasury recently issued proposed hybrid regulations under Internal Revenue Code Sections 1503(d) and 7701 to curb double deductions. In order to do so, the definition of DCL in Treas. Reg. Section 1.1503(d)-1(b)(2) has been broadened to include a "domestic consenting corporation." This term is defined in Treas. Reg. Section 301.7701-3(c)(3)(i) as an entity that has elected to be taxed as a corporation.

Dual Consolidated Loss Rules

Prop. Reg. Section 1.1503(d)-1(c)

Prop. Reg. Section 1.1503(d)-1(c) states that a domestic consenting corporation is treated as a DRC if both requirements are satisfied:

1. Under the tax laws of a foreign country where a “specified foreign tax resident” resides, the specified foreign tax resident derives items of income or loss of the domestic consenting corporation because, for example, the domestic consenting corporation is fiscally transparent under foreign tax law; and

2. The specified foreign resident bears a relationship to the domestic consenting corporation that is described in Section 267(b) or Section 707(b) (that is to say, direct or attributed ownership or more than 50 percent of value).

Dual Consolidated Loss Rules

Prop. Reg. Section 1.1503(d)-1(c)

If a domestic entity has elected to be treated as a corporation before December 20, 2018, the entity is deemed to consent to be treated as a DCR for its first year beginning after the end of a 12-month transition period. Deemed consent can be avoided, however, if the entity elects to be treated as a partnership or disregarded entity before then.

The proposed regulations to Section 1503(d) and 7701 require that a reverse hybrid that is being treated as a corporation for U.S. tax purposes consent to being treated as a dual-resident for purposes of Section 1503(d).

Thank you

Contact Information

Devon M. Bodoh
Partner
Weil, Gotshal & Manges LLP
devon.bodoh@weil.com
202 682 7060 Direct

Anthony Diosdi
Partner
Diosdi Ching & Liu, LLP
adiosdi@sftaxcounsel.com
415 318 3990, Ex. 102 Direct

Amanda Varma
Partner
Steptoe & Johnson LLP
avarma@steptoe.com
202 429 8116 Direct

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