ANTI-TAX ARBITRAGE THE U.S. WAY

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The 2017 Tax Cuts and Jobs Act ("T.C.J.A.") introduced two new rules targeting hybrid arrangements. The first deals with hybrid dividends. It denies the U.S. "participation exemption" introduced under the T.C.J.A., which, conceptually, is a 100% dividend received deduction, on a dividend received by a qualifying U.S. Shareholder[1] from a controlled foreign corporation ("C.F.C.")[2] if the dividend is a hybrid dividend.[3] The second relates to certain related-party transactions. More specifically, it disallows a deduction for certain related-party amounts paid or accrued (i) pursuant to a hybrid transaction or (ii) by, or to, a hybrid entity.[4]

In December 2018, the Treasury released proposed regulations to provide guidance on these new rules.[5] While the issues are complex, the following will highlight the main anti-hybrid items addressed by the proposed regulations.

BACKGROUND

In broad terms, hybrid arrangements come in various forms: either a specific type of intercompany payment (*i.e.*, dividend, interest, or royalty payment) or the use of specific types of entities. However, they have one goal in common: to exploit differences in tax treatment between two or more countries in order to secure a more beneficial tax result, also referred to as "tax arbitrage." The proposed regulations also address long-term deferrals.[6]

An example of a hybrid arrangement is a payment treated as interest in one country but as a dividend in the other. While the source country would allow deductibility of the interest payment, the recipient's country would not tax this income because it is treated as dividend exempt from taxation under its participation exemption regime.

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1 A U.S. Shareholder is defined as a U.S. person that owns shares of stock representing 10% or more of the total voting power of all stock or, as expanded under the T.C.J.A., the value of all shares of the foreign corporation.

2 A C.F.C. is a foreign corporation from the viewpoint of the U.S. for which more than 50% of its authorized and outstanding shares, measured by total voting power or value, is owned by U.S. Shareholders, as defined.

3 Code §245A(e).

4 Code §267A.

5 REG-104352-18. The proposed regulations contain effective dates that are tied to the date of publication in the Federal Register. They also propose modifications to the dual-consolidated loss ("D.C.L.") rules under Code §1503(d) and the check-the-box rules under Code §7701, as well as amendments to a number of tax reporting requirements under Code §§6038, 6038A, and 6038C.

6 This is consistent with the Senate Committee on Finance, Explanation of the Bill, at 384 (November 22, 2017).

In an intragroup scenario this would result in a reduced (or zero) effective tax rate for the payor and no tax for the recipient – in other words, double non-taxation. While the schemes may be more elaborate, the outcome will always be similar: deduction/no inclusion ("D./N.I.").

Both the O.E.C.D. and the E.U. have launched initiatives targeting these kinds of structures.[7] While the U.S. has been criticized for half-heartedly, if at all, embracing the O.E.C.D. initiative, hybrid arrangements and other schemes aimed at base erosion have been on the Treasury Department and the I.R.S.'s radar for a long time.[8] Undoubtedly, the O.E.C.D., the E.U., and the U.S. initiatives have influenced one another, and the U.S. regulations, in fact, defer to B.E.P.S. Action 2 in various places.

ANTI-HYBRID DIVIDEND RULES

Under the new rule, hybrid dividends received by U.S. companies that are U.S. Shareholders in a C.F.C. are denied the 100% dividend received deduction on the foreign-source portion of dividends under the new participation exemption as implemented by the T.C.J.A. Similarly, hybrid dividends received by a C.F.C. from a lower tier C.F.C. must be treated as Subpart F Income at the recipient C.F.C. level. A dividend is hybrid if the dividend received deduction of Code §245A(a) would otherwise be available but for the fact that the C.F.C. (or a related party) receives, or received, a deduction or similar benefit under the relevant foreign tax law with regard to the dividend. For this purpose, several provisions are significant:

- The proposed regulations delineate relevant foreign tax law as any foreign regime that imposes an income, war profits, or excess profits tax with respect to income of the C.F.C. (other than a foreign anti-deferral regime under which an owner of the C.F.C. is liable to tax).[9]
- Only deductions or other tax benefits that are "allowed" under the relevant foreign tax law are treated as hybrid deductions. Thus, payments that are disallowed as a deduction under foreign tax laws to prevent D./N.I. outcomes will not give rise to a hybrid deduction.[10]

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7 B.E.P.S. Action 2; European Council Directive 2016/1164 ("A.T.A.D. 1"); and Council Directive amending Directive 2016/1164 ("A.T.A.D. 2"). A.T.A.D. 2, adopted on May 29, 2017, following the publication of the O.E.C.D.'s final report on B.E.P.S. Action 2, entirely replaces the hybrid mismatch rules of A.T.A.D. 1. It includes rules on hybrid mismatches with non-E.U. countries, where at least one of the parties involved is a corporate taxpayer, or an entity in an E.U. Member State. For a comparison of A.T.A.D. 1 and 2 with the new anti-hybrid transaction rule, see "Hybrid Mismatches: Where U.S. Tax Law and A.T.A.D. Meet," *Insights* 5, no. 8.

8 The new rules are, indeed, not the first set of rules under U.S. domestic tax law targeting hybrid transactions. Regulations under Code 894(c) designed to prevent taxpayers from using hybrid entities in a treaty context were already in place. Treas. Reg. §1.894-1(d) finalized July 2000. These rules were, however, limited to the eligibility of payments subject to U.S. withholding tax under an applicable income tax treaty.

9 Other than a foreign anti-deferral regime under which an owner of the C.F.C. is liable to tax.

10 This should avoid double-taxation if the dividend would be subjected to both the

- The regulations provide that foreign rules similar to the U.S. foreign currency gain or loss rules must be taken into account when determining hybrid deduction amounts.

- Dividend distributions among tiered C.F.C.'s, to the extent they would have constituted hybrid dividends had they been received by a domestic corporation, constitute "tiered hybrid dividends." In the case of a tiered hybrid dividend distributed by one C.F.C. to another C.F.C. that has the same corporate U.S. Shareholder,

  ○ the tiered dividend constitutes Subpart F Income of the receiving C.F.C.;

  ○ the U.S. Shareholder includes its *pro-rata* share of such Subpart F Income; and

  ○ foreign tax credits or deductions for foreign income taxes paid are denied to the U.S. Shareholder.

  This Subpart F inclusion is even harsher than an "ordinary" Subpart F inclusion (*e.g.*, otherwise applicable Subpart F exceptions are disallowed and the current E&P limitation under Code §952(c) is absent).

- The proposed regulations exclude distributions of previously-taxed earnings and profits ("P.T.E.P.") to U.S. Shareholders. Distributions of P.T.E.P. from a lower-tier C.F.C. to an upper-tier C.F.C. are also expressly excluded from the definition of tiered hybrid dividends. Technically, these dividends would have been included absent this express exclusion.[11]

- The regulations introduce the hybrid deduction account ("H.D.A.") to address the potential difference in timing between when the U.S. considers an amount received and when foreign tax law allows the deduction. These events may occur at different times and, even, in different taxable years, which could result in a deduction being allowed for foreign tax law purposes without a matching dividend for U.S. tax purposes. Absent a dividend, the hybrid dividend rules would not be applicable. To resolve this issue, the proposed regulations provide that for each C.F.C. share that could trigger the application of the hybrid dividend rules, an H.D.A. must be maintained. This H.D.A. reflects the amount of hybrid deductions allowed to the C.F.C. and allocated to the specific share. Upon a dividend distribution, the dividend will be treated as a hybrid dividend or a tiered hybrid dividend to the extent of the shareholder's aggregate balance of the H.D.A. in the particular C.F.C. This, in turn, then triggers a corresponding decrease in the shareholder's H.D.A.'s.[12]

- An obscure anti-avoidance rule is also provided for transactions entered into with "a principal purpose of avoiding the purposes of proposed §1.245A(e)-1."

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foreign hybrid mismatch rule and the U.S. anti-hybrid dividend rule.

[11] Certain amounts treated as dividends under Code §1248 (*e.g.*, from the sale of stock in a C.F.C. by a U.S. Shareholder) are also treated as hybrid dividends under the proposed regulations and are subject to the tiered hybrid dividend rules (see Prop. Treas. Reg. §§1.245A(e)-1(c)(1) and (4)).

[12] Specific rules exist for transfers of stock-carrying H.D.A.'s and for certain Code §1248 dividends.

ANTI-HYBRID TRANSACTIONS RULES

In broad terms, Code §267A would deny a deduction for interest and royalty payments that are paid to a related party but not included in the recipient's income due to (i) a hybrid transaction or (ii) a payment by or to a hybrid entity. For this purpose, a party is related if the Code §954(d)(3) more-than-50% test is met.

Under the proposed regulations, the anti-hybrid rules should be limited to D./N.I. cases that result from the hybrid character of either the transaction or an entity involved.[13] Generally, Code §267A applies to qualifying interest and royalty payments made to C.F.C.'s. If a payment is included in a U.S. Shareholder's gross income under the Code §951(a) rules, Code §267A does not apply. According to the proposed regulations, the Code §267A denial was not designed to apply to payments made by a C.F.C. to either another related C.F.C. or to a U.S. Shareholder of a related C.F.C. More specifically, the proposed regulations deny the deduction for interest or royalties if, in addition to the presence of related parties, the following elements exist:

- An accrual or payment of interest or royalties (a "Specified Payment")
- The Specified Payment is disqualified (a "D.S.P.")
- The D.S.P. gives rise to a deduction for Specified Parties (defined below)
- A portion of the Specified Payment is not actually included in income and subject to tax at the full marginal rate applicable to ordinary income (the "D./N.I. Amount") (Long-term deferral rules are provided in this context.)

Specified Payments

The proposed regulations define both royalty payments and interest payments in a broad sense.

Royalties include amounts paid or accrued as consideration for the use of, or the right to use, certain intellectual property and certain information concerning industrial, commercial or scientific experience.[14] This definition is based on the one used in the 2006 U.S. Model Income Tax Treaty.

Interest is essentially defined as compensation for the use of funds or the time value of money. This definition is in line with the approach chosen by the proposed Code §163(j) regulations.[15] The proposed anti-hybrid regulations provide examples of compensation that qualifies as interest.[16]

D.S.P.

The D.S.P. definition is intended to target Specified Payments resulting in a D./N.I. outcome.

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13 Three categories of payments are introduced for this purpose: "disqualified hybrid amounts," "disqualified imported mismatch amounts," and specified payments satisfying anti-abuse rules, as defined under the same regulations.

14 Prep. Treas. Reg. §1.267A-5(a)(16).

15 Limitation on Deduction for Business Interest Expense, (proposed November 26, 2018) (to be codified at 26 CFR Part 1).

16 Prop. Treas. Reg. §1.267A-5(12).

With that logic in mind, a D.S.P. is any one of the following if it results in a D./N.I. Amount (discussed below):

- A Disqualified Hybrid Amount[17]
- A Disqualified Imported Mismatch Amount[18]
- A Specified Payment satisfying the requirements of the Code §267A anti-abuse rules[19]

"Disregarded payments are only taken into account to the extent they offset non-dual inclusion income."

A Disqualified Hybrid Amount is a payment resulting in D./N.I. due to a hybrid or branch arrangement. Such arrangements include any of the following:[20]

- Hybrid Transactions (Including Hybrid Financial Instruments and Similar Transactions): These transactions carry a mismatch in their characterization. While payments may be treated as royalties or interest in the payor's jurisdiction, the tax laws of the recipient's jurisdiction characterize the transaction differently. Long-term mismatches are included in the definition.
- Disregarded Payments: This generally entails Specified Payments that disregarded in the recipient's jurisdiction and, if they were regarded, would be subject to tax as interest or royalty. For a Specified Payment to constitute a Disqualified Hybrid Amount, it must exceed dual inclusion income. Dual inclusion income is the payor's income or gain for U.S. tax purposes that the payee must include in its income under its own tax laws, reduced by the payor's deductions or losses for U.S. tax purposes that the payee is allowed to claim as such under its own tax laws.[21] In other words, disregarded payments are only taken into account to the extent they offset non-dual inclusion income.
- Deemed Branch Payments: These payments generally are interest and royalty payments that are deductible for a branch or permanent establishment but not includible in that entity's home office jurisdiction.
- Reverse Hybrids: A reverse hybrid is a U.S. or foreign entity that
  - is treated as fiscally transparent for purposes of the tax laws of its jurisdiction of establishment and
  - is not so treated for purposes of the tax laws of its direct or indirect owner (whether a tax resident or a taxable branch, also referred to as an "investor").

  A payment to a reverse hybrid is a Disqualified Hybrid Amount only to the extent that an investor does not include it in income.
- Branch Mismatch Payments: These are payments that are attributable to a branch under the tax laws of its home office's jurisdiction and, under the

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[17] As defined under Prop. Treas. Reg. §1.267A-2.

[18] As defined under Prop. Treas. Reg. §1.267A-4.

[19] As defined under Prop. Treas. Reg. §1.267A-5(b)(6).

[20] Prop. Treas. Reg. §1.267A-2.

[21] Prop. Treas. Reg. §1.267A-2(b)(3).

tax laws of the branch's jurisdiction, either no branch exists or the payment is attributable to the home office and not the branch. A branch mismatch payment is a Disqualified Hybrid Amount to the extent it is not included in the home office's income.

A Disqualified Imported Mismatch Amount is a D.S.P. that results in a D./N.I. outcome as a result of the import of an offshore hybrid or branch arrangement into the U.S.

Deductions of Specified Parties

A Specified Party is (i) a U.S. tax resident, (ii) a C.F.C. in which at least one U.S. Shareholder owns a direct or indirect 10% interest, or (iii) a U.S. taxable branch (including a permanent establishment under an applicable treaty).

Partnerships are excluded from the definition, but partners are not.

D./N.I. Amount

To make certain that only deductions not giving rise to an income inclusion are disallowed, the proposed regulations look at what amount of an otherwise D.S.P. actually is or is not included in a tax resident's or a taxable branch's income for foreign tax law purposes. For this purpose, a payment is included in income if (i) it is subject to a full marginal income tax rate applicable to ordinary income and (ii) no reduction or offset particular to that specific payment applies. A mechanism is also provided to determine the includible income in the case of a partial reduction or offset or in the case of a preferential tax rate. Permanent exclusions, as well as long-term deferrals, are treated as not giving rise to an income inclusion. For this purpose, a long-term deferral is an inclusion that occurs during a taxable year that ends more than 36 months after the end of the Specified Party's taxable year.

Further, in the context of disqualified hybrid amounts, it is only if the absence of income inclusion is due to the hybridity of the transaction that an actual absence of income inclusion occurs for purposes of Code §267A.

MISCELLANEOUS PROVISIONS

In addition to the above, the following provisions are included in the proposed regulations:

- Clarification that certain payments made in connection with repo and securities lending transactions are subject to hybrid transaction treatment under Code §267A
- An exemption for certain payments included in the income of a U.S. tax resident or taken into account under the U.S. anti-deferral rules of Subpart F or the new G.I.L.T.I. (global intangible low-taxed income) regime, which would otherwise be subjected to double-taxation, for purposes of Code §267A
- Indication that transactions which produce double deductions are addressed through other provisions or doctrines (*e.g.*, the D.C.L.) and that Code §267A addresses only D./N.I. outcomes that are the result of a hybrid transaction or entity and not, for example, due to a territorial exemption or the absence of corporate income tax under the laws of the recipient's jurisdiction

- Reporting requirements using Form 5471, *Information Return of U.S. Persons with Respect to Certain Foreign Corporations*; Form 5472, *Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business*; or Form 8865, *Return of U.S. Persons With Respect to Certain Foreign Partnerships*, as applicable

CONCLUSION

Well after the release of the publication of the O.E.C.D. final report on B.E.P.S. Action 2 and the introduction of A.T.A.D. 1 and 2 in the E.U., the U.S. now presents its own set of anti-hybrid regulations.[22] The proposed regulations are highly technical and may have a significant impact on taxpayers with hybrid entity structures. Given that the effective date of final regulations may be December 31, 2017 (if the proposed regulations are adopted in final form by June 22, 2019), taxpayers are advised to examine the new regulations closely with their advisors to assess the impact.

22 Note, however, that regulations under Code §894(c) designed to prevent taxpayers from using hybrid entities in a treaty context were already in place (Treas. Reg. §1.894-1(d), finalized July 2000). These rules were, however, limited to the eligibility of payments subject to U.S. withholding tax under an applicable income tax treaty.