JANUARY 3, 2019

U.S. Proposed Regulations Target Hybrid Structures and Instruments Retroactively

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The United States was initially reluctant to adopt the recommendations of the base erosion and profit shifting (BEPS) initiative spearheaded by the OECD and the G20 group of nations. However, the major tax reform legislation known as the *Tax Cuts and Jobs Act* includes several provisions dealing with the concerns that the BEPS recommendations are intended to address, a number of which we have covered in prior publications.[1] The Internal Revenue Service (IRS) and Treasury Department released sweeping proposed regulations (the Proposed Anti-Hybrid Regulations) under two of these new provisions on December 20, 2018 – namely, (i) section 267A,[2] which specifically targets "hybrid mismatches" in which a taxpayer and related parties could either create deductions in both the United States and one or more other jurisdictions or create deductions in the United States without an offsetting income inclusion in another country; and (ii) section 245A(e), which denies to "hybrid dividends" the tax exemption available to certain foreign source dividends.

The OECD called for measures similar to the Proposed Anti-Hybrid Regulations in a 2015 report under BEPS Action 2 and in a related 2017 report targeting foreign branches. The Proposed Anti-Hybrid Regulations would make the measures of the United States among the most comprehensive. Technically, the Proposed Anti-Hybrid Regulations would apply only once they are finalized; however final adoption is anticipated before the end of June 2019, which would make many of the new provisions effective retroactively to as early as January 1, 2018.

In 1997, section 894(c) was enacted, which had targeted hybrid structures under tax treaties,[3] but new sections 245A(e) and 267A affect inbound and outbound structures much more broadly and authorize additional reporting requirements. The Proposed Anti-Hybrid Regulations also target certain structures such as tower financings that used a "domestic reverse hybrid" (i.e., a U.S. entity that is not transparent under U.S. tax law but is treated otherwise under foreign tax law) under the dual-consolidated-loss regulations and highlight an outbound double-dip structure that might be restricted in the future (under section 1503(d)).

The new rules will adversely affect the U.S. tax treatment of certain cross-border arrangements previously used by Canadian multinationals to finance acquisitions and operations. The new rules are bound to be controversial and might be pared back in the face of what is expected to be broad criticism.

Code Limitations

Section 267A denies a deduction for interest and royalties paid by a U.S. taxpayer to a related foreign party to the extent that, because of the use of a hybrid instrument or hybrid structure, the recipient of the payment either does not include the payment in income in its country of residence or is entitled to a deduction for the payment there. Congress granted the IRS and Treasury Department broad regulatory authority to extend similar treatment to situations in which the recipient is a resident of more than one foreign country; in which conduit or branch structures are involved; in which the recipient is a domestic reverse hybrid; and that take into account certain rate reduction and territorial (i.e., dividend participation) tax systems. The legislative history of these new provisions includes references to the BEPS reports and suggests that long-term deferral might be considered the same as non-taxation under the new rules.

Section 245A(e) addresses hybrid dividends received by a U.S. corporate shareholder from a controlled foreign corporation (CFC). A hybrid dividend is generally a dividend from a CFC with respect to which a deduction is allowed for the foreign-source portion of that dividend. When this provision applies, the Code denies a deduction for dividends received under the new partial-territorial U.S. tax system, treats similar amounts received by a CFC from a lower-tier CFC as subpart F income with respect to the U.S. shareholders of the upper-tier CFC and denies any foreign tax credit with respect to such amounts.

Section 1503(d) disallows deductions to affiliates of certain dual-resident corporations and structures dating back to 1986.

Proposed Anti-Hybrid Regulations

In the Proposed Anti-Hybrid Regulations, separate rules are proposed under the anti-hybrid provisions of section 267A, the anti-hybrid dividend rules of section 245A(e) and the dual-consolidated-loss rules of section 1503(d).

Proposed Rules Under Section 267A

The Proposed Anti-Hybrid Regulations target payments that would otherwise have given rise to a (direct or indirect) "deduction in the United States and non-inclusion under law of foreign recipient outcome" (D/NI) due to the hybrid nature of the transaction or structure. Whether a transaction would give rise to a D/NI would depend largely on foreign tax law because the Proposed Anti-Hybrid Regulations would require consideration of whether the recipient would be subject to full ordinary income tax rates on that payment. Thus, for example, if the payment were subject to tax under a partial-inclusion (or partial-deduction) regime under foreign law, the Proposed Anti-Hybrid Regulations would treat the payment as having been only partially included. Timing differences would generally be tolerated, but in a proposed rule that is likely to be controversial, tax deferral of over 36 months would be treated as if the payment simply was not included in income.

Mechanically, the Proposed Anti-Hybrid Regulations would generally disallow a deduction for any "specified payment" (i.e., interest or royalty) made by a "specified party" (i.e., U.S. tax-relevant entity[4]) to a related "specified recipient."

Disallowance is triggered in any of the following situations: (i) the payment is a "disqualified hybrid amount," (ii) the payment is a "disqualified imported mismatch amount" or (iii) the payment is made pursuant to an anti-avoidance transaction (each of these situations is referred to as a "structured arrangement").

Disqualified Hybrid Amounts and Specified Recipients

Under the Proposed Anti-Hybrid Regulations, a payment made in a hybrid transaction is generally treated as a disqualified hybrid amount to the extent that a "specified recipient" does not include the payment in income (more or less currently at full ordinary rates). A *specified recipient* is any person who derives the payment under its tax law (or is a taxable branch to which the payment is attributable under the law applicable to the branch). *Note that under these definitions, there may be more than one specified recipient (e.g., members of a recipient treated as fiscally transparent in one or more jurisdictions or recipients that are subject to treatment in their own jurisdictions that differs from their treatment in the United States), and so the analysis of the impact of a potential hybrid transaction in many cases will not end with analyzing the treatment of a single direct recipient (see the example referenced below for a surprising result).* Surprisingly, even though a payment may be includible by a related foreign recipient, the inclusion may not be the only inclusion to be tested, and if one of the foreign recipients does not have adequate inclusion, adequate rates or prompt timing of inclusion, the deduction would be denied, seemingly even for returns filed for several prior taxable years.

The Proposed Anti-Hybrid Regulations look to a D/NI that arises under the laws of any foreign country, and include an example of a disallowed deduction where a hybrid instrument was held by a foreign parent corporation but was transferred to (or created in the hands of) a disregarded entity formed by the parent corporation in another, low-taxed, jurisdiction. In this example, the transaction would not have been treated as a hybrid transaction with respect to the specified payor because the result is the same in either jurisdiction, but the deduction is still denied because the foreign parent viewed the transaction as a non-taxable transaction and (naturally) did not include the income at full rates.[5] *This example illustrates how multiple taxation can result from denying a deduction in the United States under these rules.*[6]

An adjustment to the amount of lost deductions is available to the extent that the payment is includible by a U.S. taxpayer (such as under our foreign anti-deferral regimes) or by a taxable U.S. branch. No adjustment is available, however, for withholding tax arising in the United States or in any foreign jurisdiction.

The Proposed Anti-Hybrid Regulations also provide detailed rules for particular structures. For example: (i) in a transaction that is characterized differently under U.S. and foreign law (e.g., securities lending, sale-repurchase or similar transactions), the specified recipient is determined by reference to the amount connected to the specified payment and treated as regarded under foreign tax law; (ii) disregarded payments are subject to limited deduction to the extent that they exceed dual-inclusion income; (iii) payments made to a reverse hybrid entity[7] are not deductible to the extent that an investor does not include the payment in income currently (without regard to any distribution made by the recipient[8]); and (iv) payments are not deductible to the extent that they are considered to be paid to a branch under the foreign law applicable to the home office, but the home office is not considered to have a taxable presence in the branch country or the payment is considered attributable to the home office and the home office does not include the payment in income.

Disqualified Imported Mismatch Amounts

The Proposed Anti-Hybrid Regulations also would deny a deduction for certain payments that do not involve hybrid entities or transactions if the foreign recipient directly or indirectly benefits from a "hybrid deduction." This means that the Proposed Anti-Hybrid Regulations would deny a deduction if the hybrid mismatch has been shifted offshore and the impact imported indirectly into the United States due to availability of offshore deductions in another hybrid transaction.

Underscoring the enormous potential reach of this provision, the preamble of the Proposed Anti-Hybrid Regulations describes how, under these rules, a U.S. payor would be required to determine whether a disallowed deduction would have arisen under foreign law if the foreign jurisdiction had adopted a set of rules substantially similar to those of the Proposed Anti-Hybrid Regulations.

In one example illustrating this principle, a U.S. corporation pays interest on a straight debt instrument to a foreign affiliate (W) that includes the interest in taxable income, but which obtains a deduction for dividends paid with respect to hybrid equity that it has issued to its foreign parent corporation (X). X does not include the dividend in income. *A related example reaches the same conclusion even where the instrument issued by W to X is also debt in both countries, but W obtains a current deduction and X's inclusion occurs more than 36 months later. This illustrates how it may, as a practical matter, be impossible to know the deduction consequences in the United States until years after the deduction is taken in the United States.*

These rules are likely to affect certain non-interest-bearing loan and hybrid stock structures commonly used by Canadian multinationals to finance their U.S. acquisitions and operations.

Structured Arrangements

A deduction can also be denied under the Proposed Anti-Hybrid Regulations if the payment involves a "structured arrangement," which includes transactions in which the D/NI result is "priced into the terms" of the arrangement or, under a facts-and-circumstances test, the hybrid mismatch is a principal purpose of the arrangement.[9] In such cases, even unrelated taxpayers can be adversely affected.

Proposed Rules Under Section 245A

Following the Code, the Proposed Anti-Hybrid Regulations would deny the partial-territorial dividend-received deduction to a domestic corporate shareholder under section 245A for any hybrid dividend received from a CFC. Such a dividend is one in which the CFC or a related person was allowed a deduction or other tax benefit under relevant foreign tax laws. Relevant foreign tax laws are income taxes with respect to income of the CFC or its branches (but not tax imposed under an anti-deferral regime). A deduction would include an interest or notional interest deduction, but not an exclusion from income by a CFC under an exemption system or the availability or use of an integrated tax system (such as consolidated returns or credits to shareholders for income tax imposed at the corporate level).

As in the case of imported hybrid instruments, the Proposed Anti-Hybrid Regulations would test dividends received by a CFC from a lower-tier CFC for hybrid dividend treatment. These rules would treat as subpart F income to its U.S. shareholders any amount received as a dividend by one CFC from a lower-tier CFC if the amount would have been a hybrid dividend if received by a domestic corporation instead.

The Proposed Anti-Hybrid Regulations require the establishment and tracking of a "hybrid dividend account" with respect to each share of CFC stock to which the disallowance could apply. This account must be maintained in the functional currency of the CFC in order to track and apply the disallowance as amounts are paid up from the affected CFC.

A specific anti-abuse rule is included in the Proposed Anti-Hybrid Regulations to permit the IRS to make "appropriate adjustments," including disregarding a transaction or arrangement if a principal purpose of the transaction or arrangement was to avoid the purposes of the Proposed Anti-Hybrid Regulations.

Reprise of the Dual-Consolidated-Loss Rules

Included in the package of new rules is a proposed amendment to the dual-consolidated-loss regulations under section 1503(d), originally enacted in 1986 and last revisited in 2007. The preamble to the 2007 regulations had considered, but did not affect, common tower financing structures involving the use of a domestic reverse hybrid entity. The IRS said then that it would continue to study similar structures.

Domestic reverse hybrid structures typically involve a U.S. limited partnership that checks the box to be treated as a corporation solely for U.S. tax purposes. That structure could permit a foreign partner to access deductions while avoiding additional U.S. tax by generating deductions to offset other payments made to a lower-tier disregarded entity. The commonly accepted net result of such structures was a double deduction (one in the United States and one abroad). In 2007, the IRS concluded that it would not or could not apply the dual-consolidated-loss rules to domestic reverse hybrids, because such structures involved neither a dual-resident corporation nor a separate unit of another domestic corporation.

The preamble to the Proposed Anti-Hybrid Regulations includes a statement that the IRS has since determined that such structures are "inconsistent with the principles of section 1503(d) and, as a result, raise significant policy concerns." *As a result, the Proposed Anti-Hybrid Regulations include proposed amendments to regulations under sections 1503(d) and 7701 that would require a domestic eligible entity, as a condition to being classified as a corporation for U.S. tax purposes, to consent to being treated as a dual-resident corporation for purposes of section 1503(d) for every taxable year in which a related foreign tax resident is treated as deriving income or incurring losses of the entity.* An entity that has already made the election would be deemed to have consented to this treatment for taxable years beginning on or after the date that is 12 months after the Proposed Anti-Hybrid Regulations were published, but additional time is permitted to change the classification of the entity for U.S. tax purposes if desired to avoid these new rules.

The Proposed Anti-Hybrid Regulations also describe a structure that might in the future be included in the dual-consolidated-loss regulations. That structure involves a domestic borrowing to fund a foreign stock acquisition. In such a structure, a U.S. parent corporation (USP) typically borrows from a third party lender and contributes the proceeds to a wholly owned consolidated subsidiary (USS); USS then forms a foreign subsidiary that elects to be disregarded for U.S. tax purposes (FDE); FDE borrows from USS and finally buys stock of a foreign target. The United States would disregard the borrowing by FDE from USS, but the foreign tax law may permit FDE to deduct interest on the internal loan. The preamble of the Proposed Anti-Hybrid Regulations notes that such structures also "raise significant policy concerns that are similar to those relating to the D/NI outcomes addressed in the section 245A(e) and 267A regulations."

Huge Compliance Burden

Along with digesting and understanding the new rules, multinationals and their advisers would be required to analyze current and future structures to determine how the Proposed Anti-Hybrid Regulations will directly and indirectly affect them as a result of the interaction of U.S. and foreign tax rules. As a further example, a U.S. multinational would be required to create and maintain the hybrid deduction accounts described above with respect to each block of shares of each of its direct and indirect CFC shareholders (to track subpart F inclusions, previously taxed income and denial of foreign tax credit with respect to hybrid deductible payments made at each level), as well as report any hybrid transactions or payments. Foreign-owned U.S. corporations will also have to digest the new rules and search and analyze intercompany transactions to determine the possible application of the new Proposed Anti-Hybrid Regulations to them, and to disclose hybrid payments.

It is normally difficult to estimate the impact of a new set of tax rules. In this case, however, the preamble to the Proposed Anti-Hybrid Regulations does it for us. Although the preamble notes that there is some duplication in its estimate of the burden on the private sector, the estimated time necessary to comply with the new rules may be as high as *3.2 billion hours* (at an estimated cost of $58.2 billion).

Conclusions

Due to their broad reach and inherent complexity, the Proposed Anti-Hybrid Regulations are bound to prove controversial and will likely affect existing as well as future financing structures and broadly affect tax practice in the cross-border area.

Proposed Effective Dates

As mentioned above, the Proposed Anti-Hybrid Regulations would have some retroactive effects:

1. The new rules under section 245A would apply to all distributions made after December 31, 2017.
2. The new rules under section 267A would generally apply to taxable years (of specified payors) beginning after December 31, 2017. (If the Proposed Anti-Hybrid Regulations are not finalized by June 22, 2019, however, they will apply to taxable years ending on or after the date the Proposed Anti-Hybrid Regulations were published in December 2018.) Certain provisions of the section 267A regulations, including the provisions applicable to disregarded payments, deemed branch payments, branch mismatch payments, disqualified imported mismatch amounts and structured payments, apply to taxable years beginning after December 20, 2018.
3. The reporting of hybrid transactions would generally apply to payments and dividends received for taxable periods beginning on or after December 20, 2018, though the draft forms have already been modified to include questions about such payments.
4. The new dual-consolidated-loss rules and consenting dual-residency treatment are to apply to taxable years ending on or after December 20, 2018. The required consent is to apply for elections filed on or after that date (regardless of the effective date of the election).

[1] See IRS Proposes Regulations Under the Base Erosion and Anti-Abuse Tax; Proposed Regulations Would Implement U.S. Interest Stripping Rules After Tax Reform; Republicans Poised to Enact Transformative U.S. Federal Tax Reform.

[2] Any reference to a "section" in this document is to a section of the Internal Revenue Code of 1986, as amended (the Code), or related U.S. Treasury Department regulations (Treas. Reg.), unless otherwise indicated.

[3] Those rules deny treaty relief from U.S. withholding taxes with respect to payments to hybrid entities (i.e., entities that are transparent under U.S. tax law but are treated otherwise abroad under foreign tax law). Later regulations recharacterize otherwise-deductible payments made by a domestic reverse hybrid entity to a related foreign interest holder as dividends and deny treaty access to reduce 30% withholding tax on such amounts. T.D. 8999 (June 11, 2002).

[4] Specified parties include U.S. taxpayers (including a taxable U.S. branch) and CFCs with 10% or greater U.S. shareholders. A partnership is generally not a specified party, but a deduction for a payment by the partnership would be denied where the payment would not have been deductible if it were paid by a U.S. taxable partner of the partnership.

[5] Prop. Reg. section 1.267A-6(c)(1)(iii) (Example 1, alternative facts-multiple specified recipients).

[6] The IRS requested comments about whether an exception should apply in accommodation transactions in which income is included under the laws of any foreign jurisdiction.

[7] For this purpose, a reverse hybrid entity is treated as a flow-through entity in its country of incorporation but as non-transparent in the country where the investor is a tax resident.

[8] Thus, inclusion under an anti-deferral regime would be considered taxable to the investor, but subject to timing and tax rate rules in the investor's country of tax residence.

[9] The Proposed Anti-Hybrid Regulations include as factors how the arrangement is marketed and to whom, whether the terms are below market before the hybrid mismatch and whether the terms are subject to change if the mismatch becomes no longer available.

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