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IRS Issues Final and Proposed Regulations on Hybrid Entities and Transactions

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U.S. tax practitioners were the first to use hybrid instruments and entities in international tax planning. It is therefore neither surprising nor inappropriate that the United States was the first country (in 1997) to enact an anti-hybrid rule (in section 894(c) of the U.S. Internal Revenue Code [Code]), and 20 years later (in 2017) among the first to adopt (in the *Tax Cuts and Jobs Act of 2017* [TCJA]) recommendations for enhanced anti-hybrid rules published as part of the base erosion and profit shifting project spearheaded by the Organisation for Economic Co-operation and Development (OECD).

On April 7, 2020, the IRS released final and proposed regulations (Final Regulations and Proposed Regulations, respectively, and collectively New Regulations) under the TCJA's anti-hybrid provisions. The Final Regulations finalize regulations that the IRS issued in proposed form on December 28, 2018 (Prior Regulations).

Tax practitioners expected the New Regulations to be released after long-expected final regulations regarding the limitation on the deductibility of business interest under section 163(j) of the Code. The final version of the section 163(j) regulations has not been released yet, possibly because of changes to section 163(j) that were enacted at the end of March as part of the *Coronavirus Aid, Relief, and Economic Security Act* (CARES Act). Certain provisions of the New Regulations, however, offer some hope that the IRS may relax some of the rules previously proposed under section 163(j).

The anti-hybrid rules are provided in sections 267A and 245A(e) of the Code. 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.

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 foreign 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.

Discussion

The New Regulations leave the Proposed Regulations intact with minor modifications, some of which make the rules as a whole slightly more taxpayer-friendly than under the Prior Regulations (which were not very friendly). The New Regulations clearly cover arrangements involving non-interest-bearing loans (NIBs), despite the bluster (and hope) of some commentators.

General Approach of the Regulations

Section 267A denies a deduction when there is a deduction/non-inclusion (D/NI) result of a specified payment either directly or as a result of an imported hybrid mismatch. An example of such a mismatch is where an interest payment by a U.S. corporation to foreign related corporation leads to a dividend payment by the foreign related corporation to an ultimate third-country foreign parent with neither the latter two corporations being taxed on the interest payment or the dividend. Payments to or by a disregarded entity (or branch) may also be caught up in this limitation.

A related rule in section 245A(e) denies the benefit of the section 245A deduction (under the limited territorial taxation regime instituted under the TCJA) to hybrid dividends. For hybrid dividends, a separate "hybrid dividend account" is to be maintained for each share of stock of a CFC held by a U.S. C corporation, directly or indirectly, but a new anti-duplication rule is meant to avoid double denial of deductions. The Proposed Regulations (which can be relied on before they are finalized) would exclude from the hybrid dividend account an appropriate amount of subpart F income and global intangible low-taxed income (GILTI). The hybrid provisions generally do not apply to U.S. shareholders of CFCs, but do apply to foreign multinationals.

Specific Changes

Some specific changes that may be of particular interest are described below. These points are highly technical and are intended as an update for people who are familiar with the Prior Regulations.

1. The New Regulations take into account sub-national foreign tax rules as well as federal rules, as long as the taxes are covered by an applicable tax treaty.
2. The New Regulations provide that when an election under section 338(g) of the Code is made, the former hybrid dividend account is cleared out.
3. The New Regulations retain the 36-month prior-to-payment standard for a disregarded payment, but soften it with a reasonable expectation provision.
4. As noted above, NIBs are now clearly covered by the anti-hybrid rules (but under the main rule rather than the "disregarded payments" rule).
5. The preamble of the Final Regulations provides that section 267A does not result in discrimination under tax treaties because different tax consequences for different countries' taxpayers are produced by those countries' laws, and not by U.S. laws.
6. The New Regulations clarify that section 267A applies after the determination of (pre-section 267A) interest or royalty expense under an applicable tax treaty.
7. The New Regulations clarify that section 267A applies before section 163(j) (and only once, not again in the year that suspended interest is later allowed under section 163(j)).
8. The New Regulations continue to ignore imposition of withholding tax as an "inclusion" by the payee.
9. Subject to an anti-abuse rule, the New Regulations do not include borrowing costs (including commitment and guarantee fees) as subject to disallowance as "interest" under the anti-hybrid rules. Note that this provision may foreshadow how the IRS will treat borrowing costs under regulations expected to be issued soon under section 163(j).
10. Somewhat surprisingly, there is no "capitalization" exception to the application of the deduction disallowance under section 267A. It remains to be seen whether the section 163(j) may also lack such an exception when finalized, even though similar exceptions appeared previously under section 163(j) and for purposes of the base erosion anti-abuse tax.
11. The inclusion of "structured payments" as being subject to disallowance is streamlined and made more objective under the New Regulations.
12. The $50,000 *de minimis* amount now applies to hybrid interest and royalties, not all interest and royalties.
13. The New Regulations narrow the general anti-avoidance rule to apply only to D/NI outcomes that arise as a result of hybridity. (This differs from the OECD approach.)

14. The New Regulations add a new anti-abuse rule that disallows a deduction when subpart F income is purposely generated to avoid disallowance under section 267A.
15. The New Regulations retain a waiver of dual consolidated losses when a domestic reverse hybrid entity makes a check-the-box election.

Concluding Comments

The Prior Regulations generated substantial controversy among tax practitioners because of their dizzying complexity and broad reach. The softer approach of the New Regulations suggest that the IRS has listened to commentators where possible. It is hoped that the IRS will carry this approach over to the long-awaited final regulations under section 163(j).

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