taxnotes® international
Volume 93, Number 6 ■ February 11, 2019

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Reprinted from *Tax Notes International*, February 11, 2019, p. 623

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Nathan Boidman

Michael N. Kandev

Nathan Boidman and Michael N. Kandev are with Davies Ward Phillips & Vineberg LLP in Montreal.

In this article, the authors examine the extensive regulations proposed under the already wide-ranging anti-hybrid provision of the U.S. Tax Cuts and Jobs Act, focusing on the possible impact of the proposals on the structures that Canada-based multinationals and other foreign entities use to finance U.S. acquisitions and expansions.

The U.S. Internal Revenue Service and the Treasury Department have released proposed regulations under the new anti-hybrid rules in the Tax Cuts and Jobs Act,[1] and the existing dual-consolidated loss rules. The proposed regulations would substantially eliminate the use in respect of the U.S. of hybrid instrument and entity financing and licensing structures. This is ironic given the U.S.'s initial skepticism of the OECD base erosion and profit shifting project, which spearheaded the anti-hybrid rules that the proposed regulations have now eagerly adopted. None of this is completely surprising, however, considering that since 1997 the U.S. has been a leader, not a follower, in developing anti-hybrid tax legislation.[2]

This article focuses on the proposed regulations (REG-104352-18) as they relate to the inbound structures and arrangements that multinationals use when investing from Canada into the United States.[3] The proposed regulations, if finalized in their existing form, will adversely affect the U.S. tax treatment of almost all cross-border hybrid mismatch structures used by Canadian (and other) MNEs to finance U.S. acquisitions and operations. While observers expect some of the rules to be retroactive to January 1, 2018, it helps that a significant portion affecting inbound arrangements would apply prospectively to tax years starting after December 20, 2018. Still, calendar-year taxpayers in particular must still act quickly to restructure their affairs.

Background: Section 267A and Its Context

In the 15-point action plan that forms the heart of the BEPS initiative, a project that the OECD and the G-20 began in 2013, action 2 focuses on developing model treaty provisions and offering recommendations for domestic rules to neutralize

[1] *See* Nathan Boidman, "The Tax Cuts and Jobs Act: Canada-U.S. Comparative for Multinational Enterprises," *Tax Notes Int'l*, Mar. 19, 2018, p. 1169.

[2] Boidman and Michael Kandev, "BEPS: The OECD Discovers America?" *Tax Notes Int'l*, Dec. 16, 2013, p. 1017.

[3] A follow-up piece will focus on how section 245A affects investments from the United States into Canada.

the effects of hybrid instruments and entities.[4] While the United States was initially a reluctant participant in the BEPS process — suspecting (rightfully so) that many of the proposed measures targeted some large U.S. companies — it has now wholeheartedly adopted the OECD dogma, specifically the prescriptions of the OECD's action 2 final report and the related 2017 report targeting branch mismatch situations. While the TCJA (P.L. 115-97), enacted on December 22, 2017, slashes the federal corporate tax rate from 35 percent to 21 percent and contains many other tax cuts, it also includes several draconian anti-base-erosion measures, such as much tougher limitations on interest deductibility,[5] the base erosion and antiabuse tax,[6] and the anti-hybrid rules.[7] The focus of this article is section 267A (TCJA section 14222(a)), the outbound payment anti-hybrid rule that applies to Canadian and other foreign MNEs that have U.S. operations. Section 245A is the corresponding inbound payment rule that targets specific foreign-source hybrid dividends.

The anti-hybrid rule in section 267A(a) simply states that the law will not allow a deduction for any disqualified related-party amount paid or accrued in accordance with a hybrid transaction[8] or either by or to a hybrid entity.[9] For this purpose, a disqualified related-party amount is defined as:

> any interest or royalty paid or accrued to a related party to the extent that —
>
> (A) such amount is not included in the income of such related party under the tax law of the country of which such related party is a resident for tax purposes or is subject to tax, or
>
> (B) such related party is allowed a deduction with respect to such amount under the tax law of such country.[10]

In other words, section 267A targets deduction/non-inclusion (D/NI) situations.

A broadly worded grant of regulatory authority giving the Secretary of the Treasury the power to issue any regulations or other guidance that might be necessary or appropriate to carry out the purposes of the section accompanies this simple rule. This grant (section 267(A)(e)) includes the following specific examples of possible regulations or guidance:

> (1) rules for treating certain conduit arrangements which involve a hybrid transaction or a hybrid entity as subject to subsection (a),
>
> (2) rules for the application of this section to branches or domestic entities,
>
> (3) rules for treating certain structured transactions as subject to subsection (a),
>
> (4) rules for treating a tax preference as an exclusion from income for purposes of applying subsection (b)(1) if such tax preference has the effect of reducing the

[4] *See* Boidman and Kandev, "BEPS on Hybrids: A Canadian Perspective," *Tax Notes Int'l*, June 30, 2014, p. 1233.

[5] Section 163(j). *See also* Peter Glicklich, Gregg M. Benson, and Heath Martin, "Proposed Regulations Would Implement U.S. Interest Stripping Rules After Tax Reform," Davies Bulletin (Nov. 29, 2018).

[6] Section 59A. *See also* Glicklich and Martin, "IRS Proposes Regulations Under the Base Erosion and Anti-Abuse Tax," Davies Bulletin (Dec. 18, 2018).

[7] For U.S. controlled foreign corporations, the global intangible low-taxed income rules are another novel way to approach alleged base erosion. *See* Boidman, "The U.S.'s Illusionary Turn to Territoriality," *Tax Notes Int'l*, Feb. 12, 2018, p. 619; and Boidman, "GILTI — Congress Ignored Its Own Stated Intention With Misguided Statutory Drafting," *Tax Notes Int'l*, Apr. 23, 2018, p. 553.

[8] Under section 267A(c):

> The term "hybrid transaction" means any transaction, series of transactions, agreement, or instrument one or more payments with respect to which are treated as interest or royalties and which are not so treated for purposes the tax law of the foreign country of which the recipient of such payment is resident for tax purposes or is subject to tax.

[9] Under section 267A(d):

> The term "hybrid entity" means any entity that is either
>
> (1) treated as fiscally transparent for [U.S. purposes] but not so treated for purposes of the tax law of the foreign country of which the entity is resident for tax purposes or is subject to tax, or
>
> (2) treated as fiscally transparent for purposes of such tax law but not so treated for [U.S. tax purposes].

[10] Section 267A(b)(1). Under section 267A(b)(2):

> The term "related party" means a related person as defined in section 954(d)(3), except that such section shall be applied with respect to the person making the payment described in paragraph (1) in lieu of the controlled foreign corporation otherwise referred to in such section.

generally applicable statutory rate by 25 percent or more,

(5) rules for treating the entire amount of interest or royalty paid or accrued to a related party as a disqualified related party amount if such amount is subject to a participation exemption system or other system which provides for the exclusion or deduction of a substantial portion of such amount,

(6) rules for determining the tax residence of a foreign entity if the entity is otherwise considered a resident of more than one country or of no country,

(7) exceptions from subsection (a) with respect to —

(A) cases in which the disqualified related party amount is taxed under the laws of a foreign country other than the country of which the related party is a resident for tax purposes, and

(B) other cases which the Secretary determines do not present a risk of eroding the Federal tax base,

(8) requirements for record keeping and information reporting in addition to any requirements imposed by section 6038A.

As noted above, the U.S. Treasury released proposed regulations under section 267A — as well as under sections 245A, 1503(d) (disallowing deductions to affiliates of some dual resident corporations and structures), and 7701 — on December 20, 2018.

Proposed Regulations Under Section 267A

Prop. reg. 1.267A contains the proposed regulations under section 267A. More specifically:

- section 1.267A-2 describes hybrid and branch arrangements;
- section 1.267A-3 offers rules for determining income inclusions and identifies some categories that are not amounts for which a deduction is disallowed (or, in other words, are not disqualified hybrid amounts);
- section 1.267A-4 includes an imported mismatch rule;
- section 1.267A-5 provides definitions and special rules that apply to prop. reg. 1.267A;
- section 1.267A-6 contains examples to illustrate the application of section 267A; and
- section 1.267A-7 specifies applicability dates.

Prop. reg. 1.267A-1(b) specifies that any of the following three situations can trigger an interest or royalty deduction disallowance:

- the specified payment is a "disqualified hybrid amount";
- the specified payment is a "disqualified imported mismatch amount"; or
- the specified payment triggers the antiavoidance rule.

Prop. reg. 1.267A-5 defines both interest and royalties broadly.

The core of the proposed regulations is the description in prop. reg. 1.267A-2 of hybrid and branch arrangements that give rise to disqualified hybrid amounts. The taxonomy of prop. reg. 1.267A-2 is also relevant to reg. 1.267A-4, which deals with imported mismatch arrangements.

Disqualified Hybrid Amounts

The first category of specified payments that prop. reg. 1.267A-2 addresses includes basic hybrid transactions. Example 1 describes a scenario in which foreign company FX holds an instrument issued by US1 that is interest-bearing debt for U.S. purposes but equity in Country X.[11] One of the so-called alternative fact scenarios in Example 1 clarifies that if Country X does not tax the receipt because it has a territorial regime or imposes no corporate tax, then the proposed regulations would not deny the deduction of the specified payment. Prop. reg. 1.267A-2(a)(3) focuses specifically on repo financings and other similar transactions. This is notable since those arrangements have been a popular way to fund U.S. activities — although, both direct and indirect repos have created tax issues in Canada.

The second category of specified payments is disregarded payments (prop. reg. 1.267A-2(b)), which can involve a branch and a head office or entities that are part of the same tax consolidated group. Example 3 describes a simple situation in

[11]The examples referenced are in prop. reg. 1.267A-6(c).

which FX owns US1, which is a disregarded entity for tax purposes in Country X such that Country X ignores payments that the United States would otherwise regard as deductible interest for US1.

The third category of specified payments is deemed branch payments (reg. 1.267A-2(c) and Example 4), which are otherwise allowed as a deduction in computing the taxable income of a U.S. taxable branch when that branch is a permanent establishment of a foreign party that resides in a country with which the United States has a tax treaty and the payments are not taxable in the hands of the head office.

The fourth category of specified payments is payments to reverse hybrids. A reverse hybrid is an entity that is fiscally transparent under the tax laws of the country in which it was created, but opaque in the country of its owner or investor. Example 5 involves FX, which holds all the interests of US1 and FY. While FY is fiscally transparent for tax purposes in Country Y, it is opaque for tax purposes in Country X. US1 pays interest to FY, which both the United States and Country X treat as interest for tax purposes. Section 894(c) — part of the Taxpayer Relief Act of 1997 (P.L. 105–34, section 1054(a)) — blocks some reverse hybrid structures and generally denies the benefits of a tax treaty to a foreign party for U.S.-source payments derived through an entity that is fiscally transparent for U.S. purposes and opaque for purposes of the foreign country. Section 894(c) also requires that the treaty not contain a provision that addresses its applicability to an item of income derived through a partnership when the foreign country does not tax a distribution of that item of income from the reverse hybrid entity. Under the TCJA and the proposed regulations, the denial of deductibility applies to a much broader category of situations. Thus, in the above example, while the United States and Country Y may agree that FY is a fiscally transparent entity that FX (a treaty-resident entity) owns, it is the hybridity of FY between Country X and Country Y that gives rise to nontaxation in Country X and triggers deductibility denial under the proposed regulations.

The fifth category of specified payments is branch mismatch payments. This category involves situations in which the tax law in the head office's country attributes an item of income to a branch and the tax law of the branch's country either treats the branch as nontaxable or does not attribute the item of income to the branch. Example 6 describes FX, which holds all the interests in US1 and FZ. FZ owns BB, a country B branch that gives rise to a taxable presence in country B under the tax law of country Z but not under the tax law of country B. US1 pays an amount to FZ that both the United States and country Z treat as a royalty for tax purposes. Country Z treats the amount as income attributable to BB, and because country Z's tax law exempts income attributable to a branch, it excludes the amount from FZ's income.

While branch mismatch payments already result in a denial of treaty benefits under modern limitation on benefits provisions in U.S. treaties — for example, article 24(5) of the 1996 Luxembourg-U.S. tax treaty — the proposed regulations plug the few remaining loopholes.

Disqualified Imported Mismatch Amount

In keeping with the OECD's recommendations, the proposed regulations stretch the scope of section 267A to include situations that do not involve hybridity directly relevant to the United States but effectively "import" the effects of a foreign hybrid mismatch arrangement to the United States.

Prop. reg. 1.267A-4(a) states that a specified payment is a disqualified imported mismatch amount — assuming it is not already considered a disqualified hybrid amount under reg. 1.267A-2 — to the extent that the income attributable to the payment is directly or indirectly offset by a hybrid deduction incurred by a tax resident or taxable branch that is related to the specified party. Under the setoff rules of reg. 1.267A-4(c), the key issue is that the payment directly or indirectly funds the hybrid deduction.

A hybrid deduction is a deduction that the relevant foreign tax law allows for an amount paid or accrued that it considers interest or a royalty, and that the foreign tax law would disallow if that body of law included rules substantially similar to those under prop. reg. 1.267A-1 through 1.267A-3 and 1.267A-5. Importantly, prop. reg. 1.267A-4(b) specifies that a hybrid deduction includes a deduction involving equity, such as a notional interest deduction

(NID),[12] but importantly the test is silent regarding non-interest-bearing debt structures.

Example 8 describes a typical imported mismatch situation targeted by the proposed regulations:

> FX holds all the interests of FW, and FW holds all the interests of US1. FX holds an instrument issued by FW that is treated as equity for Country X tax purposes and indebtedness for Country W tax purposes (the FX-FW instrument). FW holds an instrument issued by US1 that is treated as indebtedness for Country W and U.S. tax purposes (the FW-US1 instrument). In accounting period 1, FW pays $100x to FX pursuant to the FX-FW instrument. The amount is treated as an excludible dividend for Country X tax purposes (by reason of the Country X participation exemption) and as interest for Country W tax purposes. Also in accounting period 1, US1 pays $100x to FW pursuant to the FW-US1 instrument. The amount is treated as interest for Country W and U.S. tax purposes and is included in FW's income. The FX-FW instrument was not entered into pursuant to the same plan or series of related transactions pursuant to which the FW-US1 instrument was entered into.

An alternative scenario under Example 8 clarifies that the proposed regulations would also apply to long-term (that is, over 36 months (prop. reg. 1.267A-3(a)(i))) deferral cases, such as when the debtor deducts interest on an accrual basis while the creditor recognizes interest income on a cash basis.

Structured Arrangements and Antiavoidance Rule

Proposed rules regarding structured arrangements and a specific antiavoidance rule would police the highly prescriptive rules for disqualified hybrid amounts and disqualified imported mismatch amounts.

Prop. reg. 1.267A-2(f) specifies that beyond the fundamental requirement that the proposed regulations only apply between related parties, a deduction can also be denied if the payment involves a structured arrangement under prop. reg. 1.267A-5(a)(20), which includes arm's-length transactions in which the D/NI result is priced into the terms of the arrangement.

Prop. reg. 1.267A-5(b)(6) provides an antiavoidance rule that applies when a D/NI result occurs and "a principal purpose of the plan or arrangement is to avoid the purposes of the regulations under section 267A." A detailed critique of this rule is beyond the scope of this article. Notably, however, it reflects the principle purpose test that the OECD adopted in its BEPS recommendations and signals Treasury's intent to eradicate hybrid mismatch arrangements relevant to the U.S. tax base.

Proposed Effective Dates

The proposed regulations would only apply once they are finalized. Since most observers anticipate that final adoption will occur before the end of June, many of the new provisions would be retroactively effective to a date as early as January 1, 2018. In this regard, prop. reg. 1.267A-7 provides that the new regulations under section 267A would generally apply to tax years of specified payers beginning after December 31, 2017. If the proposed regulations are not finalized before the 18-month mark — that is, if they are not finalized before June 22 — they will apply to tax years ending on or after the date on which the proposed regulations were published — that is, December 20, 2018.

However, the favorable news is that prop. reg. 1.267A-7(b) provides that a significant portion of the regulations — including the provisions applicable to disregarded payments, deemed branch payments, branch mismatch payments, disqualified imported mismatch amounts, and structured payments — apply to tax years beginning after December 20, 2018.

Proposed Regulations Under the DCL Rules

The proposed regulations include a proposed amendment to the DCL regulations under

[12] Several countries have a NID (for example, Belgium and Brazil), and a few countries have recently considered enacting one (for example, Luxembourg and Switzerland). However, NIDs seem to have fallen out of fashion, and the proposed regulations are likely to mark their end. Since 2018 Belgium has reformed its NID, making it more or less irrelevant; Luxembourg has failed to adopt a NID; and many attribute the failure of Swiss Corporate Tax Reform III to the inclusion of a NID (which was ultimately adopted only for Canton Zurich).

existing section 1503(d) that would adversely affect domestic reverse hybrid double-dip structures. Those structures typically involve a U.S. limited partnership that checks the box to be treated as a domestic corporation and borrows from an arm's-length financial institution. That structure could permit a double deduction situation in which a foreign partner could claim deductions in its home jurisdiction that the United States also allows.

Section 1503(d) states that a DCL of a corporation cannot reduce the taxable income of any other member of the affiliated group for that or any other tax year. A DCL is any net operating loss of a domestic corporation that is subject to income tax in a foreign country without regard to whether the taxed income is from sources inside or outside the foreign country or is subject to foreign income tax on a residence basis (that is, a dual resident corporation). The regulations indicate that a DCL does not include any loss that does not offset the income of any foreign corporation under the foreign income tax law. Historically, the DCL rules of section 1503(d) and related regs have not affected domestic reverse hybrid structures.

The preamble to the proposed regulations states that the Treasury Department and the IRS have determined that domestic reverse hybrid structures are "inconsistent with the principles of section 1503(d) and, as a result, raise significant policy concerns." Thus, the proposed regulations include suggested amendments to the regulations under sections 1503(d) and 7701. These would require that, as a condition for electing to be treated as a corporation for U.S. tax purposes, a domestic entity must consent to being treated as a dual resident corporation for purposes of section 1503(d) for any tax year in which the tax laws applicable to a related foreign tax resident treat it as deriving income from or incurring losses of the entity. This, in essence, force-feeds qualifying entities into the DCL limitations. Any entity that has already made the election would be deemed to have consented to this treatment for tax years beginning on or after December 20, 2019 — that is, 12 months after the publication of the proposed regulations. However, the proposed regulations provide entities with additional time to change their classification if they wish to avoid these new rules.

Adverse Effects for Canadian MNEs

If enacted, the proposed regulations will adversely affect Canadian (and other non-U.S.) MNEs that have U.S. operations. MNEs will need to review — and, often, restructure — their existing financing and licensing structures to avoid nondeductibility.

While the changes to U.S. tax law in 1997 eliminated some Canada-U.S. hybrid financing structures,[13] Canadian MNEs have long used a variety of hybrid mismatch techniques to finance U.S. acquisitions and operations in a tax-efficient manner. For example, one common approach has been the so-called repo structure. A simple repo would involve a U.S. holding company selling special preferred shares in a subsidiary U.S. operating company to the U.S. group's foreign parent subject to a forward (re)purchase agreement under which the foreign parent would sell the preferred stock back to the U.S. holding company (or a disregarded LLC subsidiary). Under the substance-over-form principle, U.S. tax law would see this arrangement as secured lending by the foreign parent to the U.S. group giving rise to otherwise deductible interest. In Canada, the U.S. company's preferred shares would normally entitle a Canadian parent to dividends that can benefit from the exempt surplus dividend received deduction. However, prop. reg. 1.267A-2(a)(3) and Example 2 show that when (and if) the regulations become final, repo financings would give rise to nondeductible interest in the U.S.

Another structure that Canadian MNEs have frequently employed is a direct financing technique known as the tower. Admittedly, its popularity has waxed and waned over the years: When an amendment that added Article IV(7) to the Canada-U.S. tax treaty took effect in 2010, it increased the tax leakage of the tower structure and some companies dismantled them in favor of simpler and more efficient structures, but the

[13]Previously, Canadian MNEs would equity fund a disregarded U.S. LLC that would then make a loan at interest to the MNE's U.S. group. U.S. tax law would see interest paid to Canada, subject to withholding tax, and Canada would see a foreign affiliate earning interest recharacterized as active business income that could be distributed by the U.S. group to Canada as exempt surplus dividends. This form of financing was eliminated by section 894(c), which denies U.S. tax treaty benefits in this context.

tower structure has regained popularity recently because companies often see them as more robust than the alternatives. The tower is a domestic reverse hybrid structure in which a Canadian parent and Canadian subsidiary form a U.S. partnership that checks the box to be treated as a corporation for U.S. tax purposes. The partnership then borrows from a bank and invests in a Canadian unlimited liability company that funds a U.S. limited liability company, both of which the U.S. tax laws disregarded. The LLC then lends, at interest, to the U.S. operating company or acquisition entity. The proposed regulations under section 1503(d) would adversely affect the tower's double-dip structure.

Canadian MNEs have also used a variety of imported hybrid mismatch arrangements to finance U.S. activities indirectly through one or more third countries. One simple structure that was very popular — at least until the start of the BEPS initiative — used a Canadian parent to fund a Luxembourg subsidiary with mandatorily redeemable preferred shares. Then, the Luxembourg subsidiary would make a loan at interest to the MNE's U.S. group. Subparagraph 95(2)(a)(ii) of the Income Tax Act (Canada) would deem the interest income of the Luxembourg company active business income that it could distribute as exempt surplus dividends to the Canadian parent. Reg. 1.267A-4 and Example 8 would adversely affect that structure. Further, these structures would expire on January 1, 2020, under the EU's anti-tax-avoidance directive (Council Directive 2016/1164/EU of July 12, 2016).

Another imported mismatch structure that has been popular for a very long time involves a Canadian parent funding a third-country foreign affiliate that would set up a branch in yet another foreign country, which would extend an interest-bearing loan to a U.S. subsidiary. The structure was efficient as long as the foreign affiliate's country attributed the interest income to the branch while the branch either imposed a low corporate tax rate or only recognized a small portion (or none) of that income. The original branch mismatch structure used a Luxembourg company with a Swiss or Irish branch. When the countries amended the Luxembourg-U.S. tax treaty in 1996 to include an LOB that targets branch mismatches, many of the structures moved to Hungary since its treaty with the United States still does not have an LOB.[14] Under prop. reg. 1.267A-2(e) and -4, this structure would no longer work.

Accordingly, under the proposed regulations, Canadian MNEs would be unable to sustain most — if not all — of the tax-efficient structures that they use to fund their U.S. operations, and the entities would need to restructure their international arrangements.

Conclusion

It will take time for even experts to fully digest the proposed regulations.[15] By Treasury's own estimates, which appear in the preamble to the proposed regulations, it may take companies up to 3.2 billion hours and $58.2 billion to comply with the new rules — although Treasury does note that those numbers contain some duplication.

Even a cursory review of the proposals leaves a reader with the clear impression that the U.S. government wants hybrid mismatch arrangements to be off limits. As noted, Canadian and other MNEs will need to quickly restructure inbound-to-U.S. financing and licensing hybrid structures that face nondeductibility under the proposed regulations.

Only time will tell what new norms will emerge out of the regime. The inventiveness and creativity of tax planners and financial engineers is boundless. Some taxpayers may persist, exploring clever technical changes to their existing hybrid structures and diligently searching for any potential gaps in the proposed regulations. Still, this approach seems risky and may bump against the PPT antiavoidance rule in the proposed regulations.

Other taxpayers may throw in the towel and completely dismantle their inbound financing of U.S. operations using debt-to-equity refinancing. Depending on individual circumstances, this approach may have merit given the significant decrease in the effective corporate tax rates in the United States — particularly in low- or no-tax

[14]Because the renegotiated treaty with Hungary that includes an LOB has been held hostage by Sen. Rand Paul, R-Ky., the pre-LOB-era 1979 Hungary-U.S. tax treaty is still applicable.

[15]*See* Alexander Lewis, "U.S. Hybrid Regs Will Take Time to Digest," *Tax Notes Int'l*, Jan. 7, 2019, p. 125.

states — combined with the substantial added complexity that section 163(j), the BEAT, and the proposed regulations bring to inbound financing approaches.

However, other MNEs based in Canada (and elsewhere) might opt for a third approach that relies on simpler, non-hybrid, third-country financing structures. Some countries that have tax treaties with the United States — for example, Bulgaria, Hungary, Ireland, and Switzerland — have been carefully preparing for a post-BEPS world and offer very competitive corporate tax rates around 10 percent[16] that may bring in business. Trading a 21 percent rate for a 10 percent rate is likely to be an attractive option for many tax managers. Ironically, this shift would make the proposed regulations largely ineffective for protecting the U.S. tax base, at least on their own.

Finally, it remains to be seen whether Treasury's determination to eliminate hybrid financing and licensing structures — structures that, in essence, are efforts to increase an entity's return on investment — may cause a drop in foreign direct investment in the United States. ■

[16] In some cases, outbound dividend withholding taxes are an aspect that requires management.