TAX ALERT

FINAL IRS ANTI-HYBRID, OTHER PROPOSED REGULATIONS IMPACT CROSS-BORDER STRUCTURES

BY TIMOTHY EVANS WITH IVINS, PHILLIPS & BARKER, CHTD.

September 10, 2020

MAZARS USA TAX LEADERSHIP

Tifphani White-King
212.375.6523
tifphani.white-king@mazarsusa.com

Faye Tannenbaum
212.375.6713
faye.tannenbaum@mazarsusa.com

Howard Landsberg
212.375.6604 | 516.282.7209
howard.landsberg@mazarsusa.com

James Toto
212.375.6797
james.toto@mazarsusa.com

EDITOR

Richard Bloom
732.475.2146
richard.bloom@mazarsusa.com

Earlier this year, the IRS published final anti-hybrid regulations (T.D. 9896) under sections 245A(e), 267A, and 1503(d) and new proposed regulations under sections 245A(e) and 881. The final anti-hybrid regulations mostly adopt the proposed regulations issued in December 2018, with some revisions, and are generally effective for distributions made after December 31, 2017, with some exceptions. The proposed regulations provide taxpayer-favorable rules regarding the calculation of hybrid deduction accounts and expand the scope of the anti-section 881 conduit rules to apply to hybrid financing arrangements.

Dividends Received Deduction (DRD) Anti-Hybrid Rule
Enacted as part of the Tax Cuts and Jobs Act provisions allowing corporate shareholders to claim a 100% deduction on dividends from qualified foreign corporations, section 245A(e) contains a rule designed to ensure that taxpayers can't claim both a deduction in a foreign jurisdiction and an exemption in the U.S. on the same amount. It denies the section 245A(a) DRD for hybrid dividends received by a domestic shareholder and mandates an inclusion under subpart F for hybrid dividends received by a controlled foreign corporation (CFC).

In general, a hybrid dividend is a payment where the amount is deductible or there is another tax benefit allowed to a CFC under foreign law for an amount paid, accrued, or distributed on an instrument treated as stock for U.S. tax purposes. Under a concept introduced by the proposed regulations (83 FR 67612), shareholders are required to maintain a hybrid deduction account for each share of CFC stock reflecting the amount of hybrid deductions allocated to the share. The final regulations retain the hybrid deduction account, with some modifications including additional rules regarding the maintenance of hybrid deduction accounts and the carryover of accounts for ownership changes. Also new in the final regulations is a provision defining foreign tax law for this purpose to include a tax law of a political subdivision or other local authority.

While the U.S. anti-hybrid rules mostly follow the OECD recommendations, they differ in a few important respects. For example, the U.S. rules treat a notional interest deduction as a hybrid deduction, in contrast to the OECD recommendations (the effective date for this rule is delayed to tax years beginning on or after December 20, 2018). There are also exceptions for deductions or other tax benefits allowed under integration or imputation systems and regimes that provide for group-relief.

> *Mazars' Insight*
> *Corporate structures that may contain hybrid instruments, including equity instruments in jurisdictions that allow for notional interest deductions, should be carefully reviewed to determine how the rules of section 245A(e) may apply. Restructuring to eliminate the hybrid instrument may be desirable if possible. Taxpayers should be aware that the anti-hybrid rule also applies to dividends from lower-tier subsidiaries to upper-tier subsidiaries. The requirement to maintain hybrid deduction accounts represents a significant compliance burden and applies to lower-tier CFCs as well.*

Hybrid Interest, Royalty Payments & Branch Mismatches
In general, section 267A denies a deduction for interest and royalties paid or accrued on a hybrid transaction or from or to a hybrid entity. The proposed regulations narrowed the statute by making clear that a hybrid deduction is disallowed only to the extent it results in what is referred to as a deduction/no inclusion (D/NI) outcome that is due to the hybridity. But they also expanded the statute by denying the deduction to the extent the payment produces what is referred to as an imported mismatch, in which the effects of an offshore hybrid or branch arrangement are imported into the U.S. tax system. The final regulations mostly follow the scope of the proposed regulations, with an effective date of December 31, 2017. Here, too, the IRS has gone beyond the OECD recommendations in treating imputed interest on an interest free loan as a hybrid transaction (the interest free loan rules apply only to taxable years beginning on or after December 20, 2018).

Under the proposed regulations, a payment is treated as a hybrid transaction if there is more than a 36-month deferral between the timing of the U.S. deduction and the foreign law inclusion.

The final regulations modify that rule to provide a reasonable expectation standard, looking to whether, at the time of the payment, it is reasonable to expect that it will be included in income under foreign law within the 36-month period. They also provide for an exemption for hybrid sale/license transactions. Reg. § 1.267A-2(a)(2)(ii)(B) now specifically exempts from the general rule a payment that is treated as a royalty for U.S. tax purposes and a payment of consideration in exchange for property under foreign law.

Other taxpayer favorable modifications include a rule exempting from scope payments deductible in the U.S. but not taxable in the recipient's jurisdiction because the country does not impose an income tax.

The definition of an imported mismatch payment has also been modified to exclude amounts includible in a shareholder's U.S. taxable income as subpart F, GILTI or pursuant to the PFIC regime. But note that these rules can apply even when there is no actual payment. Amounts allocated to a U.S. branch under the rules of section 882 or by treaty may be treated as a disqualified payment (and the deduction denied) if the recipient does not include the amount in income.

> *Mazars' Insight*
> *The final regulations are largely consistent with the OECD BEPS anti-hybrid recommendations. But there are some key differences. For example, the U.S. rules only apply to payments of interest and royalties (and dividends pursuant to section 245A(e)) while many other countries include all deductible payments in scope.*

At the same time, the U.S. rules are broader in some respects. When structuring cross-border financing, careful attention needs to be paid to each country's anti-hybrid rules, even for those entities that are not direct parties to the transaction.

Reverse Hybrids

The final regulations include special rules to address cases in which, given the definition of fiscally transparent under the section 894 regulations (Reg. §1.894-1(d)(3)), a recipient might not be considered a reverse hybrid under the proposed regulations with respect to a payment, even though neither the recipient entity nor its investor take a payment into account in income.

The regulations treat an entity as fiscally transparent with respect to an item of income under the tax law of the country where it is organized if, pursuant to local law, the entity allocates the payment to an investor, meaning that the investor is viewed as deriving the payment through the entity. A parallel rule looks to whether the entity is fiscally transparent with respect to the payment under an investor's tax law. A special rule treats collective investment vehicles and similar arrangements as fiscally transparent in cases where they may not be treated as such under the anti-conduit regulations.

The proposed regulations had provided that an otherwise deductible payment made to a reverse hybrid is considered a hybrid payment to the extent that an investor does not include the payment in income, regardless of any subsequent distribution by the reverse hybrid.

The final regulations modify this rule and make it slightly more taxpayer-friendly by exempting situations in which the reverse hybrid distributes its income during a taxable year. They also make clear that in cases of a less-than 100% investor in the reverse hybrid, only the no-inclusion that occurs for its portion of the payment is treated as a disqualified hybrid amount. Also excluded from scope are payments made to a reverse hybrid to the extent that, under the tax law of the reverse hybrid's jurisdiction, the investor's taxable branch includes the payment in income.

For notional interest deductions, the final regs provide some taxpayer relief by providing that NIDs are not hybrid deductions if the investor's tax law has a pure territorial regime or if such tax law does not impose an income tax.

Definition of Interest

The final regulations modify the definition of interest for section 267A purposes, narrowing it in certain respects. Excluded from the definition of interest are adjustments to the amount of interest expense to reflect the impact of derivatives that alter a taxpayer's effective cost of borrowing, cleared swaps and non-cleared swaps subject to margin or collateral requirements. The changes to the section 267A definition of interest are consistent with the definition of interest in the final section 163(j) regulations.

Anti-Avoidance Rule

While the proposed regulations had included a very broad anti-avoidance rule under section 267A, the final regulations adopt more of a bright-line approach: a deduction for a hybrid payment is disallowed to the extent that the payment (or income attributable to the payment) is not included in the income of a tax resident or taxable branch and a principal purpose of the terms or structure of the arrangement is to avoid the application of section 267A in a manner contrary to the purposes of section 267A (there are also broad anti-avoidance rules that apply under section 245A(e).

Proposed Regulations

Together with the final regulations, the IRS also issued proposed regulations under section 245A(e) addressing the interaction of subpart F and GILTI inclusions and hybrid deduction accounts, and under the anti-conduit regulations of section 881. The proposed regulations are effective when final.

The new proposed section 245A regulations provide that hybrid deduction accounts for CFC stock are reduced in cases where the CFC's earnings and profits that have not been taxed due to a hybrid arrangement are nevertheless included in U.S. taxable income, specifically as subpart F, GILTI, and pursuant to section 956, adjusted to take into account associated foreign tax credits and any deduction allowable under section 250(a)(1)(B).

The proposed section 881 regulation expands the definition of a financing transaction in the current anti-conduit rules. Under current regulations, the IRS generally has the authority to disregard the participation of an intermediate entity in a financing arrangement if it is acting as a conduit entity for purposes of sections 871, 881, 1441, and 1442. While the current section 881 regulations exclude from the definition of a financing transaction a transaction in which the instrument received is treated as stock for U.S. tax purposes. However, as indebtedness in the issuer's jurisdiction, the proposed regulations would expand the types of equity interests treated as a financing transaction to include stock or a similar interest if foreign tax law allows the issuer a deduction or another tax benefit for an amount paid, accrued or distributed with respect to the stock. They also treat stock or a similar interest as a financing transaction if a person related to the issuer (i.e., a shareholder or other interest holder in an entity) is entitled to a refund or similar tax benefit for taxes paid by the issuer to its country of residence.

Mazars' Insight
The proposed regulations expand the universe of financing transactions to include scope of financing transactions. The second structure in scope is believed to be designed specifically to capture financing arrangements structured through Malta, which otherwise would not be covered under the hybrid rules or current anti-conduit regulations.

Please contact your Mazars USA LLP professional for additional information.

This alert was produced in conjunction with Ivins, Phillips & Barker, Chtd.

FOR MORE INFORMATION CONTACT:

TIMOTHY EVANS

SENIOR MANAGER
+1 646.435.1580
timothy.evans@mazarsusa.com

VISIT US AT www.mazarsusa.com