taxnotes federal

Volume 163, Number 13 ■ June 24, 2019

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Reprinted from *Tax Notes Federal*, June 24, 2019, p. 1977

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Angela W. Yu is a partner and Daniel J. Paulos is a principal in KPMG LLP's asset management practice in New York. Yu is also a former staff member of the Joint Committee on Taxation. The authors thank Peter H. Blessing, formerly of KPMG's Washington National Tax practice, for his review and helpful comments. They also thank Jason Binder for his assistance.

In this article, Yu and Paulos examine the new anti-hybrid rules of section 267A and the proposed regulations issued thereunder.

I. Background

This is the second of two articles[1] that examine the implications of several new statutory provisions enacted by the Tax Cuts and Jobs Act[2] that significantly curtail the U.S. tax benefits of cross-border intercompany interest payments made by foreign-owned U.S. corporations (blockers). This article considers the section 267A anti-hybrid rules, which generally target arrangements that exploit differences under U.S. and foreign tax laws' respective treatment of an entity as, for example, opaque or transparent; or a financial arrangement, for example, whether an instrument or arrangement is treated as debt, equity, or something else. An example of the latter is a sale-repurchase transaction[3] whereby a payment regarding the transaction is treated as deductible interest under the tax law applicable to the U.S. payer and as a nontaxable dividend under the tax law of the resident country of a related recipient.

As drafted, these rules are complex and far reaching. When it applies, section 267A may permanently deny a blocker's U.S. tax deductions for some interest and royalty[4] payments made to foreign "related parties."[5] By limiting the general application of the rules to transactions between related parties, Congress was able to assume that their reach generally would affect only taxpayers knowingly and intentionally exploiting the differences in the tax laws of two countries.

Section 267A(e), added by the conference agreement,[6] contains a broad regulatory mandate. In general, the regulatory guidance may provide rules for application of the section to conduit arrangements involving a hybrid transaction or a hybrid entity;[7] branches or domestic entities;[8] application of the section to structured transactions;[9] denying the deduction for payments included in the recipient's income under a preferential tax regime that has the effect of reducing the country's applicable tax rate by at least 25 percent;[10] and denying the deduction for payments subject to a participation exemption regime.[11] The statute authorized Treasury to provide exceptions to section 267A(a) if the relevant income is taxed under the laws of a foreign country other than the country of which

[1] The first article, Angela W. Yu and Daniel J. Paulos, "New Limitation on Business Interest Expense Deductions," *Tax Notes*, May 13, 2019, p. 993, addresses three issues raised by new section 163(j).

[2] P.L. 115-97, 115 Stat. 2054 (Dec. 22, 2017).

[3] *See* H.R. Rep. No. 115-466, at 663 (2017) (Conf. Rep.). Such a transaction is typically structured legally as the sale and repurchase of preferred stock. However, U.S. tax principles, applying the substance-over-form doctrine, generally recharacterize the transaction as a loan and treat the payment on it as interest in some circumstances. *See, e.g.*, *First American National Bank of Nashville v. United States*, 467 F.2d 1098 (6th Cir. 1972).

[4] While section 267A also applies to royalty payments, this article refers only to interest payments.

[5] Section 267A(b)(2) cross-references section 954(d)(3) for the definition of related party.

[6] *See* Conf. Rep. at 663.

[7] Section 267A(e)(1).

[8] Section 267A(e)(2).

[9] Section 267A(e)(3).

[10] Section 267A(e)(4).

[11] Section 267A(e)(5).

the related recipient is a resident,[12] and when there isn't a risk of eroding the U.S. income tax base.[13]

Treasury and the IRS issued proposed regulations in December 2018 to implement the statute, which generally is effective for tax years beginning after 2017.[14] The proposed section 267A regulations, relying on the authority under section 7805(b)(2), generally would apply to tax years beginning after 2017. This retroactive effective date applies only to those provisions that are interpreting the operative provisions of the statute. The proposed section 267A regulations that rely on the authority granted in section 267A(e), however, would be effective for tax years beginning on or after December 28, 2018.[15] To taxpayers' benefit, several provisions are subject to the deferred effective date, including the branch mismatch payments rules[16] and the rules regarding disqualified imported mismatch amounts (DIMAs),[17] discussed below.[18] Thus, for example, for a calendar-year blocker, interest expense regarding a DIMA only became nondeductible January 1, 2019 (but amounts accrued up to that point, even after 2017, might be grandfathered).

The Joint Committee on Taxation report[19] sheds some light on the scope of the section 267A(e) regulatory authority. According to the TCJA blue book, the Treasury secretary has the authority to address the "overly broad or under-inclusive application" of section 267A.[20] The blue book provides several examples of such underinclusive applications to illustrate how taxpayers can use some arrangements not explicitly covered by the language of section 267A(a) to circumvent the statute.[21] The examples deny interest deductions for some payments by or to foreign "reverse hybrids" (referred to here as foreign reverse hybrid entities)[22] and branches of a foreign corporation, as well as ones involving foreign intermediary payees.[23]

II. The Proposed Regulations

A. In General

The proposed section 267A regulations introduce many new defined terms and create a new and different taxonomy of transactions subject to the anti-hybrid regime. Specifically, a threshold issue under the proposed regulations is whether a blocker's interest payments to a foreign related party constitute "specified payments."[24] A specified payment includes any payments that are either disqualified hybrid amounts (DHAs)[25] or DIMAs.[26] DHAs, in turn, may take the form of five distinct types of amounts.[27]

Three of the five types of DHAs involve branches. Disregarded payments involve a

[12] Section 267A(e)(7)(A).

[13] Section 267A(e)(7)(B).

[14] *See* REG-104352-18.

[15] *See* prop. reg. section 1.267A-7(b). The proposed section 267A regulations were published in the *Federal Register* on December 28, 2018. Therefore, the effective date of the rules issued under the section 267A(e) authority would be for tax years beginning on or after December 28, 2018, instead of December 20, 2018, which is the date printed in the *Federal Register*.

[16] *See* prop. reg. section 1.267A-2(e).

[17] *See* prop. reg. section 1.267A-4.

[18] The deferred effective date applies to other rules, including the disregarded payments rules of prop. reg. section 1.267A-2(b); the deemed branch payments rules of prop. reg. section 1.267A-2(c); the special rules of prop. reg. section 1.267A-5(b)(5) applicable to structured payments; and the rules involving structure arrangements, *i.e.*, prop. reg. section 1.267A-5(a)(20) (defining structure arrangement) as well as the portions of prop. reg. section 1.267A-1 through -3 that relate thereto. *See* prop. reg. section 1.267-7(b).

[19] *See* JCT, "General Explanation of Public Law 115-97," JCS-1-18, at 389-391 (2018).

[20] *Id*. at 390.

[21] *Id*.

[22] A foreign reverse hybrid entity, for this purpose, is defined as an entity that is treated as fiscally transparent in the foreign country in which it is resident or subject to tax but that is treated as a corporation in a different foreign country in which its owner is resident or subject to tax. *Id.*

[23] *See* JCS-1-18, *supra* note 19, at 390-391.

[24] The proposed section 267A regulations contain a de minimis exception that generally exempts from the section 267A disallowance rule a blocker that has aggregate interest and royalty deductions, determined without regard to section 267A, of less than $50,000 in a tax year; in effect, such de minimis amounts are deemed to not be specified payments. *See* prop. reg. section 1.267A-1(c).

[25] *See* prop. reg. section 1.267A-1(b)(1).

[26] *See* prop. reg. section 1.267A-1(b)(2) and -4 and the discussion of DIMAs below. Technically, there is a third category of specified payments — *i.e.*, amounts paid in accordance with a principal purpose transaction entered into to avoid the application of section 267A. *See* prop. reg. section 1.267A-1(b)(3) and -5(b)(6). The antiavoidance rule applies if a principal purpose of the plan or arrangement is to avoid the purposes of the proposed section 267A regulations.

[27] *See* prop. reg. section 1.267A-2(a), (b), (c), (d), and (e).

foreign parent that uses a U.S. branch (not viewed to have a taxable presence from the U.S. perspective) to make loans to a U.S. subsidiary. Branch mismatch payments involve the same structure, but the tax laws (of the foreign parent and the United States) attribute the income to a different recipient, resulting in income that is not taxed by either country. Deemed branch payments, a variation of these two types of branch payments, arise in other situations involving a foreign corporation.[28] These three types of branch payments may not involve hybridity, but the statute expressly granted the Treasury secretary authority to address them,[29] so their inclusion as specified payments under the proposed section 267A regulations should come as no surprise.

A fourth type of DHA involves payments under a hybrid transaction, which is defined as a transaction, agreement, or instrument under which one or more payments are treated as interest for U.S. tax purposes but are not so treated for purposes of the tax law of the foreign recipient (a hybrid transaction).[30] A specified payment under a hybrid transaction is treated as a DHA to the extent that a "specified recipient"[31] of the payment does not include the amount in income, and the noninclusion is "a result of" a hybrid transaction.[32] In other words, the specified payment causes a "deduction/no-inclusion outcome" (D/NI outcome). While the statute can be read to disallow an interest expense deduction made to a foreign related party regarding a hybrid transaction "to the extent" of the D/NI outcome regardless of whether that outcome is linked to hybridity, the proposed section 267A regulations clarify that the deduction is only disallowed if the D/NI outcome is "a result of" the hybrid transaction.[33]

B. Application to Reverse Hybrid Entities

The fifth and final type of DHA are payments to reverse hybrid entities. The proposed section 267A regulations generally define a reverse hybrid as an entity, domestic or foreign, that is fiscally transparent under the tax law of the country in which it is created, organized, or otherwise established but opaque under the tax law of the country of residence of an investor of the entity.[34] In other words, a reverse hybrid is, from the investor's standpoint, a hybrid blocker, which is a different concept of reverse hybrid than the one used in the more U.S.-centric regulations under section 894.

The proposed section 267A regulations define a reverse hybrid based on disparate treatment by the country of residence of the entity and of the (different) country of residence of the entity's investor(s). Under such a definition, the United States may, but need not, be part of the equation in determining whether an entity is a reverse hybrid,[35] which makes sense because the entity may be part of a transaction creating a DIMA.[36] A payment made to a reverse hybrid is a DHA to the extent that an investor of the reverse hybrid does not include the payment in income under the laws of the investor's resident country (that is, only a portion of the payment would be disallowed under the proposed section 267A regulations if the balance thereof is included in income by the investor of the reverse hybrid).

The proposed regulations' treatment of payments to foreign reverse hybrid entities as disallowed payments aligns with an example in the TCJA blue book, illustrating the underinclusive application of the statutory rules

[28] Deemed branch payments arise when a foreign corporation uses the so-called treaty method in determining its U.S. interest deduction for purposes of section 882. *See* prop. reg. section 1.267A-2(e)(1)(i). Deemed branch payments do not apply to blockers that are U.S. corporations. Therefore, further discussion regarding them is beyond the scope of this article.

[29] *See* section 267A(e)(2).

[30] *See* prop. reg. section 1.267A-2(a)(2).

[31] *See* prop. reg. section 1.267A-5(a)(19). A specified recipient is any tax resident that derives the payment under the tax law of the country in which it is resident. As so defined, it is possible that "there may be more than one specified resident with respect to a specified payment." *Id.*

[32] *See* prop. reg. section 1.267A-2(a)(1).

[33] *See* prop. reg. section 1.267A-2(a)(1)(ii). This is consistent with OECD base erosion guidelines. *See* OECD/G-20, "Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2: 2015 Final Report" (Oct. 5, 2015); and OECD/G-20, "Neutralising the Effects of Branch Mismatch Arrangements, Action 2: Inclusive Framework on BEPS" (July 27, 2017).

[34] Prop. reg. section 1.267A-2(d)(2).

[35] In contrast, section 267A(d) defines a hybrid entity as an entity that is classified differently by the United States and by the foreign country in which it is a resident. Thus, under the statute, the United States is always part of the equation for purposes of this determination.

[36] *See* Section II.D below for a discussion of DIMAs.

of section 267A and the perceived need for more expansive coverage by regulation.[37] However, it appears that such treatment might fall outside the scope of the Treasury secretary's authority to issue guidance as provided by section 267A(e)(2), which specifically refers to application of the provision to *domestic* entities, and a foreign reverse hybrid entity is, by definition, a *foreign* entity.[38] As a result, it is not clear whether the proposed regulations' extension to payments to foreign reverse hybrid entities truly reflects the legislative intent of section 267A.

Another point to note is that the proposed section 267A regulations determine whether there is a D/NI outcome regarding payments to a reverse hybrid entity based on whether there is noninclusion at the owner-investor level in comparison with the same payment being made directly to the owner-investor of the entity.[39] Unlike in the case of hybrid transactions, which look to whether there is noninclusion at the entity level,[40] noninclusion at the entity level exists in the case of a reverse hybrid by definition given its fiscal transparency under the laws of its resident country.

C. Application to Foreign Branches

As mentioned above, the proposed section 267A regulations deny deductions for three types of foreign branch payments, but the discussion here focuses on only one of those three types: branch mismatch payments. The transactions for which such payments are made necessarily involve two conditions. First, there are always three countries in play, including the United States, where the blocker (payer) is located; a second country where the home office of a foreign related party (payee) is located; and a third country where a branch of the payee is located. Second, the blocker makes an interest payment to the foreign related party that is attributable to the branch, or directly to the branch. These two facts, on their own, do not produce a D/NI outcome. A D/NI outcome does arise, however, if the tax laws of the home office do not impose a tax on the interest payment (because it is attributable to an offshore branch) and the tax laws of the offshore branch do not tax such income (because, under local law, either the branch does not have a "taxable presence" or the income is not attributable to it).[41]

Branch mismatch payments do not involve a hybrid transaction because all three of the relevant countries' tax laws may be aligned in their respective characterizations of the payment as interest. Moreover, neither the blocker, the home office, nor the branch is necessarily a hybrid entity. Technically, however, this application of the section 267A rules to foreign branches may be appropriate considering the Treasury secretary's mandate to provide "rules for the application [of section 267A] to branches."[42] This category of transactions is also one of the underinclusive applications of the provisions discussed earlier.[43]

D. Application to DIMAs

Unlike DHAs, of which there are five distinct types, DIMAs are themselves an entire category of specified payments under the proposed section 267A regulations.[44] According to the preamble, this rule is intended to prevent the use of hybrid arrangements between two foreign corporations completely outside U.S. taxing jurisdiction from being imported into the United States through the use of a domestic non-hybrid arrangement. In this regard, the proposed section 267A regulations are in alignment with the TCJA blue book's description of the "imported mismatch arrangement" as an example of an underinclusive application of the section 267A rules for which the Treasury secretary was granted authority under section 267A(e) to address.[45]

[37] *See* JCS-1-18, *supra* note 19, at 391.

[38] Another source for the regulatory authority might be section 267A(e)(1), which references a "hybrid entity" without specifying whether such entity is domestic or foreign. But that provision relates only to "certain conduit arrangements," whereas the rules in the proposed section 267A regulations regarding foreign reverse hybrid entities are not limited to such entities' involvement in conduit arrangements.

[39] *See* prop. reg. section 1.267A-2(d)(1).

[40] *See* discussion in Section III.

[41] *See* prop. reg. section 1.267A-6(c)(6) for an example of a branch mismatch payment.

[42] Section 267A(e)(2).

[43] *See* JCS-1-18, *supra* note 19, at 390.

[44] This new rule is proposed to apply to tax years beginning on or after December 28, 2018. *See* prop. reg. section 1.267A-7(b).

[45] *See* JCS-1-18, *supra* note 19, at 390-391.

Like branch mismatch payments, DIMAs always involve three countries. First, the United States where the blocker (payer) is located. Second, where the "Related Foreign Payee 1" that holds an instrument (Instrument 1) issued by blocker, is located. Finally, where a third party, "Related Foreign Payee 2," that holds an instrument (Instrument 2) issued by Related Foreign Payee 1, is located. The tax laws of the United States and of Related Foreign Payee 1's resident country treat Instrument 1 as a debt instrument, so amounts paid in accordance with it are non-hybrid in nature. But while Instrument 2 also is a debt instrument under the tax law of Related Foreign Payee 1's country of residence, it is, for example, treated as equity under the tax law of Related Foreign Payee 2's country of residence.[46] Thus, there may be an offshore D/NI outcome arising from Related Foreign Payee 1's interest deductions deriving from Instrument 2 and Related Foreign Payee 2's corresponding dividend income noninclusion, the latter of which is, for example, attributable to a local country participation exemption. Those deductions are called hybrid deductions in the proposed section 267A regulations.[47]

A payment by a blocker is a DIMA to the extent that the income attributable to the payment offsets a hybrid deduction incurred by a related party in another jurisdiction.[48] The proposed section 267A regulations, however, state that the U.S. deduction would be allowed if the relevant foreign tax law contains rules "substantially similar" to those under section 267A, which would presumably cause the foreign related party's deduction to be disallowed. Otherwise, if the section 267A rules were to disallow the blocker's deduction, there would be a "double disallowance outcome," a result that this special rule seeks to prevent. The DIMA provisions extend the anti-hybrid policy to circumstances that normally would not be within the reach of U.S. taxing jurisdiction. To comply with these rules, a blocker needs to have knowledge about the entity classifications, character of financial instruments, and dealings of foreign related parties that otherwise have no U.S. tax nexus whatsoever. The presumption here is that such knowledge is obtainable for transactions among related parties.

An example in the proposed section 267A regulations, depicted in Figure 1 below, demonstrates how unwieldy the application of these rules could become. The example involves a group of six related companies resident in four countries, including the United States.[49] The ultimate foreign parent of the group, FX, owns all the interests in FW, which owns two blockers, US1 and US2, and a foreign subsidiary, FZ. FZ owns another blocker, US3. Each subsidiary receives an advance from its respective parent. All except one advance are treated as debt by the relevant countries. The FX-FW Instrument is creating a hybrid deduction. Also, US1's loan from FW was obtained "pursuant to the same plan" involving the creation of this hybrid deduction. For the year in question, FW pays FX $125x of interest regarding the FX-FW Instrument, and each of US1, US2, US3, and FZ pays $50x of interest to its respective parent. Under the section 267A proposed regulations, US1's $50 payment is a DIMA because it is "factually related" and directly funds the hybrid deduction. Also, all or a portion of the payments by US2 and US3, respectively, are treated as funding the hybrid deduction, even though these are "factually unrelated" payments.

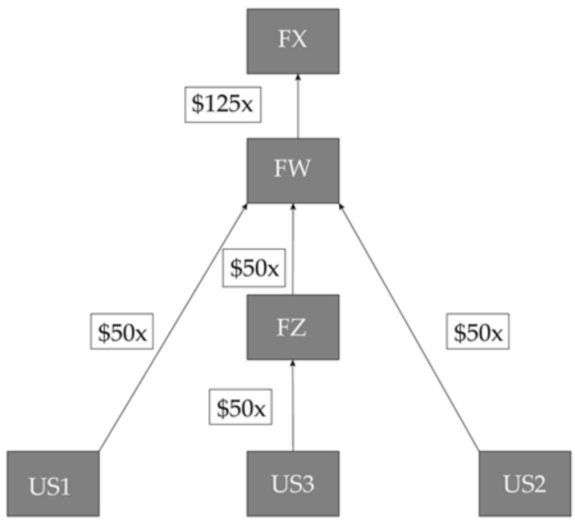
[46] Also within scope may be when the interest is not regarded, as could be the case if interest in respect of an interest-free loan is not deemed to exist under the laws of the jurisdiction in which Related Foreign Payee 2 is a resident.

[47] *See* prop. reg. section 1.267A-4(b).

[48] *See* prop. reg. section 1.267A-4(c).

[49] *See* prop. reg. section 1.267A-6(c)(10), Example 10.

Figure 1. Example 10 of Prop. Reg. Section 1.267A-6(c)(1)



All entities are wholly owned by their immediate parent entity. The arrows reflect the direction of interest payments. The FX-FW Instrument creates a Hybrid Deduction. Accordingly, the $50x payment from US1 to FW and from US2 to FW, as well as $25x of the $50x payment from US3 to FZ, are disallowed.

It is evident from the above example that the proposed regulations disallow the full amount of the hybrid deduction, and require US2 and US3 to have knowledge of the goings on of various upstream, offshore related parties. It is not clear how the IRS could effectively administer compliance with this rule; presumably, information document requests would be worded to elicit responses. The New York State Bar Association Tax Section recommends that as an alternative to avoid the double disallowance outcome, the analysis should be whether the other jurisdictions have BEPS-compliant anti-hybrid rules; if they do, and the payments are not disallowed under the rules, any such payments should not be treated as DIMAs.[50]

E. Hybrid Transactions With Multiple Recipients

A provision in the proposed regulations disallows a blocker's U.S. interest deduction when there are multiple specified recipients of a single specified payment. Under this rule, unless all of the recipients have to include the amount of interest paid by the blocker, as a result of the payment being made under the hybrid transaction, section 267A would apply to deny the deduction for the entire amount paid by the blocker.[51] The fact that any one recipient includes the amount in determining its resident country taxation does not change this result.

The example in the proposed regulations, depicted in Figure 2 below, involves a payment under a hybrid transaction (the payer's jurisdiction treats the payment as interest, but at least one of the recipient's jurisdictions treats it as an excludable dividend).[52] In the example, a blocker, US1, is wholly owned by FZ (a tax resident of Country Z), which is wholly owned by FX (a tax resident of Country X). US1 pays interest to FZ, which is opaque for Country Z tax purposes but fiscally transparent for Country X tax purposes. Both the United States and Country Z treat the payment as interest, but Country X treats it as an excludable dividend. Despite FZ's including the interest payment in income, the fact that Country X treats the payment as excludable dividend derived by FX results in the disallowance of the blocker's interest expense deduction.

The reason there may be multiple recipients of a payment does not derive from the statute, which covers "interest . . . paid or accrued to a related party."[53] The concept is an example of the intentionally broad scope of the proposed section 267A regulations, which define specified recipient as "any tax resident that derives the payment under the tax law of the country in which it is resident."[54] As the example above illustrates, this is the result notwithstanding the fact that the

[50] *See* NYSBA, "Report on Proposed Regulations Under Sections 267A, 245A(e) and 1503(d)," Report No. 1411, at 40-42 (Feb. 26, 2019). It is not clear if Treasury would adopt such a policy if the proposed section 267A regulations are not necessarily intended to mimic the BEPS rules.

[51] *See* prop. reg. section 1.267A-2(d)(1).

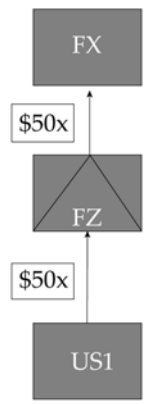
[52] *See* prop. reg. section 1.267A-6(c)(1), Example 1(iii). NYSBA recommended that, to conform with the OECD's approach, this rule should not be adopted by the final section 267A regulations. *See* Recommendation A.1 of the NYSBA report, *supra* note 50.

[53] *See* section 267A(b)(1).

[54] *See* prop. reg. section 1.267A-5(a)(19).

actual recipient is opaque under the tax law of its own country of residence.

Figure 2. Example 1(iii) of Prop. Reg. Section 1.267A-6(c)(1)



All entities are wholly owned by their immediate parent entity. The arrows reflect the direction of the interest payments. FZ is fiscally transparent for Country X purposes. Both the United States and Country Z treat the payment as interest, but Country X treats it as an excludable dividend. Accordingly, US1's $50x interest expense deduction is disallowed despite the fact that the $50x is taxable in Country Z.

This is a very broad rule and requires extensive analysis in the case of a multinational group with operations or holdings in various countries. As drafted, the analysis to determine whether there are multiple recipients would keep going if the owner of the actual recipient were itself to be fiscally transparent under the tax law of its owner, and so on. In other words, under the proposed section 267A regulations, blockers must apparently trace their payments to foreign related parties until they reach a payee that is opaque under the tax law of its owner, or theoretically, if none are, all the way up to the individual owners of the highest-tier, fiscally transparent entity. Some commentators have described this result as "surprising" because the rule set forth in the example leads to an "income inclusion/no deduction" result rather than a "no inclusion/no deduction" result.[55] On the other hand, it is easy to see that taxpayers could easily structure around section 267A if the rule were not in the regulations.

F. Application to Long-Term Deferrals

The proposed regulations include a rule that treats a long-term deferral benefit — that is, if there is no income inclusion within 36 months from the year in which the payer receives a U.S. deduction — as a hybrid transaction that constitutes a D/NI outcome (that is, as a DHA).[56] The preamble to the proposed section 267A regulations notes the Senate's expressed intention to cover arrangements that "achieve double non-taxation, including long-term deferral."[57]

The length of deferral for this purpose has been the subject of comments. The Silicon Valley Tax Directors Group has recommended that the arbitrary 36-month rule be replaced, if not altogether eliminated, with an almost equally arbitrary 10-year rule because, "for debt instruments, long-term can mean 10 years or longer."[58] Another industry group, the United States Council for International Business, has recommended that the 36-month rule be replaced, if not altogether eliminated, with a "reasonable period of time" standard.[59] Yet neither the proposed replacement rule nor the proposed replacement standard would adequately address the actual underlying issue regarding the administrability of any tax law targeting long-term deferral of income inclusion.

III. Transactions Not Covered by the New Rules

There had been some concern that the proposed section 267A regulations would deny U.S. interest deductions *in all instances* in which the recipient was not taxed on the income whenever there is a hybrid transaction in the

[55] *See* Peter A. Glicklich, Gregg M. Benson, and Heath Martin, "U.S. Proposed Regulations Target Hybrid Structures and Instruments Retroactively," Mondaq (Jan. 8, 2019).

[56] Prop. reg. section 1.267A-2(a)(2).

[57] *See* REG-104352-18.

[58] *See* Silicon Valley Tax Directors Group, "Comments on Proposed Sections 245A(e) and 267A Regulations in REG-104352-18" (Feb. 26, 2019) (the SVTDG comments).

[59] *See* United States Council for International Business, "IRS REG-104352-18 — Guidance Related to Section 245A(e) and 267A (Rules Regarding Certain Hybrid Arrangements)" (Feb. 26, 2019).

structure, even if the nontaxation is not caused by that transaction.[60] In that regard, taxpayers can breathe a partial sigh of relief.

In general, a D/NI outcome is not treated as caused by hybridity, just because the income is disregarded or not characterized as interest under the tax law of the recipient's resident country. For instance, interest payments that a blocker makes regarding a hybrid transaction to a foreign related party that is resident in a tax haven (that is, a jurisdiction that does not impose any income tax) should not be disallowed under the section 267A rules because the interest would not have been taxable anyway.[61] Similarly, interest paid to a recipient in a country that administers a pure territorial tax system (that is, the country does not tax income unless it has a domestic source) is also not subject to the section 267A rules because the income would not have been taxable even if the resident country were to treat the amount as interest.[62]

Further, even if a payment is made under a hybrid transaction, section 267A would not apply if the amounts are reduced or offset by a "generally applicable" deduction or other tax attribute of the local tax law.[63] Examples of those deductions include depreciation and net operating losses.[64]

The proposed section 267A regulations generally would apply only when a D/NI outcome is linked to the hybridity of an arrangement. In the case of payments made to a reverse hybrid, the focus is only on whether the owner (investor) would include the payments in income to the same extent that it would if the payments were made directly to the owner (investor) of the entity. This is because, by definition, there is noninclusion at the entity level. Under the proposed regulations, hybridity is deemed to exist if the investor's noninclusion is "a result of" the specified payment being made to the reverse hybrid.[65] This, in turn, leads to the disallowance of payments whenever there is a payment to multiple specified recipients.[66]

IV. Double Deduction Outcomes

Along with the release of the proposed section 267A regulations, Treasury and the IRS released proposed changes to regulations under other code sections to address section 267A(b)(1)(B)'s reference to double deduction outcomes — U.S. deductions for interest paid or accrued to a foreign related party to the extent that the related party is allowed a deduction for that amount under the foreign country tax law where it is resident or subject to tax.

Specifically, proposed regulations were promulgated under the dual consolidated loss (DCL) rules of section 1503(d) to address double deduction outcomes arising from the use of U.S. entities that are treated as fiscally transparent for foreign tax purposes but that have elected to be treated as corporations for U.S. tax purposes.[67] Before the release of these proposed section 1503(d) regulations, such an entity (referred to in the regulations as a domestic reverse hybrid entity, a term with a different meaning than the reverse hybrid concept in the section 267A proposed regulations) would not have been subject to the DCL rules under section 1503(d) because it was neither a "dual resident corporation"[68] nor a "separate unit."[69]

Concomitantly, amendments were made to the section 7701 check-the-box regulations to require, as a condition to a domestic entity electing to be treated as a corporation, consent to be treated as a dual resident corporation and thus subject to the DCL rules. Further, the proposed

[60] *See* discussion in Section II.A above.

[61] This is consistent with the 2015 OECD report, which, among other things, concludes that cross-border interest payments made to a hybrid entity wholly owned by a tax-exempt entity are not caught by the hybrid mismatch rules. *See* Example 4.1 of OECD 2015 report, *supra* note 33, at 299. *See also* prop. reg. section 1.267A-6(c)(1), Example 1(v).

[62] *See id.*

[63] Prop. reg. section 1.267A-3(a)(1)(ii).

[64] *Id.*

[65] *See* prop. reg. section 1.267A-2(d)(1)(ii).

[66] *See* discussion in Section II.F above.

[67] NYSBA determined that Treasury's "scope of authority to treat a [domestic reverse hybrid entity] as a dual resident corporation is beyond the scope of [its] Report." *See* NYSBA report, *supra* note 50, at 91.

[68] A dual resident corporation is generally defined as a domestic corporation that is subject to an income tax of a foreign country on its worldwide income or on a resident basis. *See* reg. section 1.1503(d)-1(b)(2).

[69] A separate unit is generally defined as a foreign branch or an interest in a hybrid entity owned by a domestic corporation. *See* reg. section 1.1503(d)-1(b)(4). A hybrid entity, for purposes of section 1503(d), is generally an entity that is not taxable as a corporation for U.S. tax purposes but is taxable as a corporation under foreign law. *See* reg. section 1.1503(d)-1(b)(3).

regulations provide that domestic reverse hybrid entities in existence before December 28, 2018, are deemed to consent to being treated as dual resident corporations as of their first tax year beginning on or after a 12-month transition period.[70]

Owners of affected blockers may wish to evaluate whether it would be worth exploring an alternative structure for U.S. tax purposes to avoid the application of this new rule. Obviously, the decision needs to take into account any collateral consequences, such as forgoing the tax deductions in the resident country of the owners of the domestic reverse hybrid entity.

V. Final Words

The section 267A rules and the newly issued proposed regulations clearly confirm Congress's and Treasury's concerted, rigorous efforts to disallow interest deductions for payments to foreign related parties using hybrid transactions or hybrid entities. Affected blockers should review all related-party cross-border transactions that include any hybrid elements (including those involving only branches or foreign entities) to determine whether any existing arrangements are adversely affected by the new rules.[71] Some structures caught by the new rules may have to be unwound. Taxpayers with some reverse hybrid structures, for instance, may have to restructure the arrangement and decide whether to use the interest deduction in the United States or in the relevant foreign country.[72]

The proposed section 267A regulations also provide an expansive definition of interest that is substantially similar to the definition in the proposed section 163(j) regulations[73] (discussed at length in the section 163(j) companion article). It is uncertain whether the final section 267A regulations will retain this definition. Meanwhile, section 267A does not recharacterize or disregard the interest payments; hence, disallowed interest payments are still subject to 30 percent U.S. withholding tax unless an exception or an applicable treaty applies. NYSBA recommended that the final section 267A regulations provide an exception to the disallowance rule for payments that are subject to U.S. withholding tax.[74] This result would be consistent with the proposed section 59A regulations, which exclude from the definition of base erosion tax benefit those benefits attributable to base erosion payments that are subject to withholding tax.[75]

Unlike sections 163(j) and 59A,[76] the section 267A rules can apply to disallow deductions for interest payments made by a real estate investment trust.[77] A REIT that is affected by this provision could reduce the impact of section 267A by increasing the amount of its dividends paid deduction.[78] This alternative, however, comes with a cost because REIT dividends to foreign persons may be subject to a higher U.S. withholding tax rate than interest payments under most U.S. income tax treaties.[79] ■

[70] NYSBA recommends that Treasury and the IRS, instead of conditioning a check-the-box election on such treatment, seek a legislative amendment to provide for authority to issue regulations to directly subject losses of domestic reverse hybrid entities to the DCL rules if they do not believe they otherwise have authority to do so. *See* Recommendation C.1 of the NYSBA report, *supra* note 50.

[71] Blockers obviously should consider the potential application of sections 163(j) and 59A regarding any restructuring. Regarding the order in which sections 267A and 163(j) should apply, there is a conflict within their respective proposed regulations. *Compare* prop. reg. section 1.163(j)-3(b)(1) and (2) (section 267A applies before section 163(j)), *with* prop. reg. section 1.267A-5(b)(1) (section 267A applies after section 163(j)). Because section 267A is an all-or-nothing regime and section 163(j) is a now-or-later one, it makes sense mechanically for section 267A to apply first. *See* Section II.D.2 of the SVTDG comments for an example that demonstrates why application of section 267A should come before application of section 163(j).

[72] If no action is taken, then the proposed section 267A regulations could deny U.S. interest deduction if the same amount is not included in the taxable income of a foreign person. *See* prop. reg. section 1.267A-2(d).

[73] *See* prop. reg. section 1.267A-5(a)(12).

[74] *See* Recommendation A.4.c of the NYSBA report, *supra* note 50.

[75] *See* prop. reg. section 1.59A-3(c)(2).

[76] Given the outpouring of opposition to the proposed section 59A regulations, there is substantial uncertainty regarding how much the base erosion and antiabuse tax rules will themselves be beaten back by the time final regulations are promulgated. *See, e.g.*, Delegation of the EU to the United States, "Base Erosion and Anti-Abuse Tax," REG-104259-18 (Dec. 21, 2018) (noting that the rules are "discriminatory" and "could lead to double taxation").

[77] REITs may elect out of the reach of section 163(j) and are expressly excluded from the reach of section 59A. *See* prop. reg. section 1.163(j)-9(g) and section 59A(e)(1)(A), respectively.

[78] *See* section 857(b)(2)(B).

[79] This article represents the views of the authors only and does not necessarily represent the views or professional advice of KPMG. The information herein is of a general nature and based on authorities that are subject to change. Its applicability to specific situations should be determined through consultation with your tax adviser.