KPMG report: Initial impressions, proposed regulations implementing "anti-hybrid" provisions of new tax law

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The U.S. Treasury Department and IRS on December 20, 2018, released for publication in the Federal Register proposed regulations implementing the "anti-hybrid" provisions that were enacted as part of the new U.S. tax law (Pub. L. No. 115-97) (also referred to as the "Tax Cuts and Jobs Act" (TCJA)). The proposed regulations include new rules issued under sections 245A(e) and 267A, as well as modifications to the regulations implementing the section 1503(d) dual consolidated loss (DCL) rules.

Section 245A(e)

New section 245A(e) denies the benefit of the section 245A dividends received deduction (DRD) to certain "hybrid dividends," thus treating such items as taxable at ordinary rates. This treatment also applies to "tiered dividends" between controlled foreign corporations (CFCs), by treating the dividend as subpart F income in the recipient CFC. The proposed regulations address the following key points:

- **Connection between foreign tax benefit and the dividends**: U.S. shareholders would be required to maintain a "hybrid deduction account" with respect to each share of CFC hybrid stock that tracks the amount of foreign deduction (arising in years after December 31, 2017) associated with the CFC's earnings as an unfavorable tax attribute. Successor and reorganization rules similar to those contained in the section 959 PTEP (previously taxed earnings and profits) rules would also be included and would substantially restrict taxpayers' ability to restructure or recapitalize the hybrid stock in a manner that removes the section 245A(e) "taint."

- **Definition of hybrid deduction**: The proposed regulations would define a "hybrid deduction" as a deduction or "other tax benefit (such as an exemption, exclusion, or credit, to the extent equivalent to a deduction)." The legislative text in section 245A(e) disallows a dividend received deduction to the extent that the CFC payor is entitled to a deduction or "other tax benefit" under local law. There was some question prior to the issuance of the proposed regulations what Congress had in mind when it referred to "other tax benefits." The example used in the proposed regulations to illustrate what might be included in this category is a refund to a shareholder of taxes paid by a CFC on the earnings that fund the distribution—whether through an actual refund or with a credit.

KPMG observation

The definition of hybrid deduction in the proposed regulations remains sufficiently broad to capture other arrangements that may not, on their face, involve a deduction under foreign law, so care should be taken to carefully analyze the foreign tax treatment of any distribution out of section 245A eligible earnings.

- **Application to PTEP distributions:** The proposed regulations would confirm that section 245A(e) does not apply to distributions of previously taxed earnings and profits (PTEP) to U.S. shareholders, nor to distributions of PTEP between CFCs (which arguably could have been the result because section 959(b) does not literally exclude the distribution from being a dividend at the recipient CFC level). The proposed regulations also would treat certain amounts treated as a dividends under section 1248 as hybrid dividends.

- **Tiered dividends:** The proposed regulations would provide that a subpart F inclusion may result from an actual distribution of non-PTEP E&P between CFCs, as well as to gain that is recharacterized under section 964(e). Also included would be coordinating rules on the effect of the inclusion on the CFCs' and U.S. shareholders' E&P to ensure that the dividend income is actually included as subpart F income by the U.S. shareholder.

- **Anti-abuse rule:** In similar form to the other proposed regulations that have been issued in connection with the TCJA, the proposed regulations would contain an anti-avoidance rule, which is broadly drafted to the allow the IRS to make "appropriate adjustments … if a transaction or arrangement is undertaken with a principal purpose of avoiding the purpose of this section."

- **Effective date:** The regulations, if finalized prior to the 18-month rule contained in section 7805(b), would be effective for distributions made after December 31, 2017.

Section 267A

New Code section 267A disallows a deduction for any "disqualified related-party amount" paid or accrued pursuant to a "hybrid transaction" or by, or to, a "hybrid entity."

The statute provides the Secretary with expansive regulatory authority to carry out the purposes of section 267A.

The *General Explanation of Public Law 115-97* (JCS-1-18) prepared by the Joint Committee on Taxation and released on December 20, 2018 (the "Bluebook") contains a summary of the statute, but particularly emphasizes the broad regulatory authority granted to Treasury to issue regulations or other guidance to not only implement the statute but to also "carry out the purposes" of the provision. Specifically, the Bluebook states that Treasury has the authority to address the "overly broad or under-inclusive application of this provision" and provides examples of such over-breadth and under-inclusiveness. Examples provided in the Bluebook as potentially not being caught by the legislative text are branches (to which they devote a lengthy footnote but are otherwise not mentioned in the statute itself) and reverse hybrids, which (as discussed in more detail below), appear to have been inadvertently omitted from the definition of hybrid entities in the statute. An example of an overly broad application of the statute is a type of hybrid instrument that is primarily targeted and sold to tax-exempt domestic entities but may also be acquired by persons who benefit from the hybridity in their respective jurisdictions.

The proposed regulations definitely take the broad grant of regulatory authority seriously. They would broaden the reach of section 267A, as contemplated by the drafters of the statute, to encompass transactions—such as branch payments and reverse hybrids—that appeared to escape a literal reading of the statute. They would even expand the scope of section 267A to include the long-term deferral of inclusions as a prohibited hybridity. In fact, and interestingly, the proposed regulations would adopt an entirely new lexicon of defined terms, not otherwise contained in the statutory language, while not ignoring the defined terms specifically provided for the in the statute—such as the definition of "disqualified related party amount," as described above. Yet at the same time, the Treasury Department exercises a bit of regulatory restraint by not applying the proposed regulations to areas otherwise within its delegated authority, such as preferential tax regimes.

The following features of the proposed regulations are noteworthy:

- **U.S. outbound structures now generally unaffected by section 267:** The section 267A statutory provision is seemingly broad in reach, generally disallowing interest and royalty expense deductions for CFCs and U.S. entities alike to the extent such payments would constitute disqualified related-party amounts pursuant to a hybrid transaction or by, or to, a hybrid entity. Under the statute, an exception applied to exclude from the definition of disqualified related-party amounts certain related-party interest and royalty payments to the extent such payment would be taken into account as subpart F income by a U.S. shareholder. However, no similar exception was provided to the extent such payment would be included directly in the income of a U.S. person or U.S taxable branch or deemed included under section 951A. The broad application of section 267A to situations in which a payment is taken into account under section 951A, or otherwise directly included in a U.S. taxpayer's income, would effectively result in double taxation because the amount would be included in the U.S. shareholder's taxable income directly and indirectly as GILTI. Accordingly, the proposed regulations would provide that interest and royalty payments are not subject to disallowance under section 267A to the extent that: (1) the U.S. tax resident or U.S. taxable branch would take such payment into account in its gross income; or (2) the U.S. shareholder would include such item in its gross income under subpart F or take such item into account under section 951A. As a result, the preamble to the proposed regulations explains that the population of taxpayers affected by section 267A will seldom include U.S.-based companies, since those companies are taxed under section 951A and subpart F.

- **Payments resulting in deduction / non-inclusion ("D/NI") broadly targeted:** The proposed regulations would generally disallow a deduction for certain interest and royalty payments ("specified payments") only if the specified payment results in a D/NI outcome. Notably, the proposed regulations would not target double-deduction outcomes under section 267A. The proposed regulations would interpret section 267A(b)(1)(B) as referring only to dividends received deductions and other items directly related to the receipt of the specified payment (which the proposed regulations view as a form of D/NI rather than as a double-deduction) and would not broaden the scope to encompass deductible payments made as part of an overall arrangement of which the specified payment was only a part. Thus, the proposed rules would apply to a specified payment only if such payment would constitute a: (1) "disqualified hybrid amount" (i.e., D/NI resulting from a hybrid or branch arrangement); (2)) "disqualified imported mismatch" (i.e., importation of an offshore hybrid or branch arrangement); or (3) payments pursuant to a principal purpose transaction entered into to avoid the application of section 267A and resulting in a D/NI outcome. However, double-deduction outcomes are targeted by the proposed regulations using tools other than section 267A in the proposed changes to the DCL rules, discussed in more detail below.

KPMG observation

Although the limited scope of section 267A as implemented by the proposed regulations as applying only to D/NI outcomes would be narrower than the anti-hybrid rules contained in Action 2 of the OECD's base erosion and profit sharing (BEPS) initiative and adopted by some countries in various forms, the proposed regulations would otherwise implement rules that are similar in approach to the BEPS initiative, including the imported mismatch rule.

- **Timing differences:** Specified payments that result in "long term" D/NI timing differences would also be included within the scope of section 267A, apparently on the basis that a long-term accrual without taxation is deemed to be hybridity, as "payment" is defined in the proposed regulations to include "accrual" and non-taxation until payment is considered a form of exclusion). A deferral benefit is considered to be long-term if there is no corresponding inclusion after 36-months from the year in which the related-party payor received a deduction. Timing differences resolved within the 36-month period are considered insignificant, and therefore, the associated deduction will not be subject to disallowance under section 267A.

- **Linkage to hybridity generally required:** The proposed regulations would not disallow a deduction for an interest or royalty payment made in connection with a hybrid transaction or to a hybrid entity, as those terms are defined in the proposed regulations, if the foreign country's law would otherwise exclude the income from tax under a "generally applicable" provision of the local tax law. Examples provided of such generally applicable provisions are depreciation deductions and net operating losses and back-to-back financing. Further, regimes with preferential tax rates not based on hybridity are not subject to the proposed regulations.

KPMG observation

Based on the broad language in the statute, there was some concern that the payment of a royalty by a foreign entity owned by a CFC that is disregarded for U.S. tax purposes to a related U.S. company could result in the disallowance of the deduction because the payment would be eligible for the deduction for foreign derived intangible income (FDII) provided in section 250. Because the section 250 deduction is allowed to the U.S. taxpayer, regardless of whether it is paid by a hybrid entity, it does not appear to be linked to the hybridity, and therefore not subject to disallowance under the proposed regulations. Even if such linkage were deemed to exist, the proposed rules would seemingly allow a deduction for such payment because the U.S. taxpayer would include the entire amount of such item in its gross income, even if such U.S. taxpayer also received a corresponding section 250 deduction (read the discussion above regarding curtailed application of section 267A to U.S. outbound structures).

- **Treatment of reverse hybrids:** The legislative text of section 267A could be read to exclude reverse hybrids from the definition of a hybrid entity because the statute defines a hybrid entity as an entity treated as being fiscally transparent in the country in which such entity is tax resident or otherwise subject to tax. Invariably, a reverse hybrid entity is neither subject to tax nor a tax resident under the laws of a jurisdiction in which it is treated as fiscally transparent. As such, it seemed that a technical reading of the section 267A statutory definition of a hybrid entity would necessarily exclude reverse hybrid entities. As discussed above, the Bluebook acknowledges that the statutory language may be under-inclusive as it relates to reverse hybrids, so it is not surprising that the proposed regulations would capture them. Specifically, the proposed regulations would define a reverse hybrid entity for purposes section 267A as an entity that: (1) is fiscally transparent under the tax law of the country in which it is established; and (2) is not fiscally transparent under the tax law of an "investor" determined on an investor-by-investor basis, and generally subject such an entity to section 267A. This definition is different from the definition of reverse hybrid used in the current section 894 regulations.

KPMG observation

Technically, payments to a reverse hybrid present D/NI potential because the payor to a reverse hybrid would likely be entitled to a deduction, while there is no inclusion by a taxpaying entity either in the jurisdiction where the entity is formed or in the jurisdiction where the investor is resident. Notwithstanding the existence of such D/NI potential, it is worth observing that interest and royalty payments from U.S. persons to non-U.S. reverse hybrids generally are already ineligible for reduced rates of withholding tax under applicable U.S. income tax treaties. Arguably, the rationale for applying section 267A to reverse hybrid entities is less compelling, since the US tax base erosion potential is less evident in the reverse hybrid context.

- **Definition of interest broadly defined / definition for royalty based on U.S. tax treaty:** The proposed regulations would provide an expansive definition of interest, substantially similar to the definition proposed in the section 163(j) proposed regulations and the standard applied in Reg. section 1.861-9T. The proposed regulations would also provide a definition for royalties, which is based on the definition incorporated in the Article 12 of the 2006 U.S. Model Income Tax Treaty.

- **Category of persons subject to section 267A / treatment of partnerships:** The section 267A statutory language does not limit the application of section 267A to any particular category of persons. The proposed regulations would narrow the scope of section 267A to apply only to deductions of "specified parties." The preamble explains that a specified party means any (1) U.S. tax resident, (2) CFC for which one or more US shareholders directly or indirectly own 10% of the CFC stock, and (3) U.S. taxable branches. Notably, the proposed regulations would provide that partnerships would be excluded from the definition of a "specified party," but partners of a partnership may be a specified party, thereby treating partnerships as an aggregate of its partners for purposes of section 267A.

- **Coordination / overlap with other U.S. tax provisions:** The proposed regulations would provide that section 267A would generally apply after the application of other U.S. federal tax provisions that affect the deductibility of interest and royalties, unless another provision of the Code explicitly provides otherwise.

KPMG observation

Read in isolation, this coordination rule seems to suggest that the interest disallowance rule under section 163(j) would apply before section 267A. This is somewhat inconsistent with a similar coordination rule contained in the section 163(j) proposed regulations, which would apply section 163(j) after other interest limitation / deferral provisions in the Code. Neither the section 163(j) proposed regulations nor the section 267A proposed regulations cross-reference each other, so it is still unclear which provision should be applied first. It is also unclear how this coordination rule should be applied in the context of the base erosion alternative tax (BEAT) regime under section 59A. The BEAT regime may also effectively disallow a deduction for interest or royalty payments made to foreign related parties, but does so through the mechanism of the modified taxable income calculation, and it is unclear whether such calculation would be done prior the application section 267A or after.

- **Effective date generally retroactive to tax years beginning after December 31, 2017:** The section 267A proposed regulations generally would apply to tax years beginning after December 31, 2017, citing section 7805(b) as the authority for their retroactive application This retroactive effective date appears to apply only to those provisions that are interpreting the operative provisions of the statute, and not the provisions implementing Treasury's regulatory authority contained in section 267A(e). The proposed regulations that rely on the authority granted in section 267A(e) would be effective for tax years beginning on or after the date the proposed regulations are published in the Federal Register. Notably, and perhaps in recognition of the advancing calendar, the preamble also addresses the possibility that the proposed regulations may not be finalized within the 18-month window prescribed by section 7085(b), by providing that Treasury and the IRS generally expect that any provision of the proposed regulations that is finalized after June 22, 2019 (the date when the 18-month window expires) would apply to tax years ending on or after the date the proposed regulations are filed with the Federal Register.

- **Information reporting requirement:** The proposed regulations would provide that disallowed payments under section 267A and hybrid dividends / tiered hybrid dividends under section 245A must be reported in accordance with sections 6038 and 6038A

Changes to dual consolidated loss (DCL) rules

The proposed regulations propose to amend the section 1503(d) DCL rules to cover certain double deduction structures. As proposed to be amended, they would require taxpayers to treat domestic reverse hybrid (DRH) entities as dual resident corporations that are subject to the DCL rules as a pre-condition to electing corporate status for the entity under the "check-the-box" regulations.

- **Consent requirement:** To prevent the possibility of such losses of such "consenting domestic corporations" becoming "stranded" if their shareholders' country of tax residence imposes shareholder-level anti-double deduction restrictions, the "Mirror Legislation" restriction in the DCL rules would not apply. The proposed regulations expressly declined, however, to modify application of the Mirror Legislation rule to U.S.-owned "separate units," which leaves taxpayers still needing to assess the overlapping application of the DCL rules with foreign countries' anti-double deduction rules.

- **Request for comment:** Finally, the proposed regulations acknowledge that the current DCL regulations' exclusion of "disregarded" payments from the DCL calculation may facilitate undesirable D/NI and double deduction outcomes, and request comments on their treatment.

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