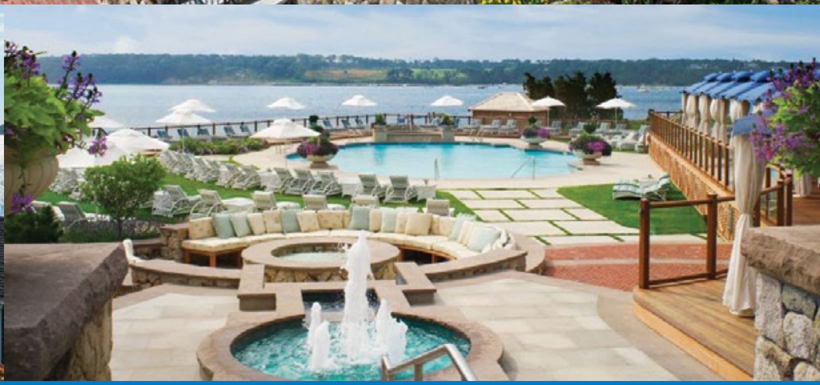
NEW YORK STATE BAR ASSOCIATION
TAX SECTION



Spring Meeting 2019

Harwich (Cape Cod), MA | May 31 – June 2, 2019

The Wequassett Resort
2173 Route 28, Harwich, MA

www.nysba.org/TAXSP19

This program is co-sponsored by the New York Bar Foundation

THE NEW YORK BAR FOUNDATION

Tax Section Spring Meeting

May 31 - June 2, 2019

The Wequassett Resort

Harwich, MA

Thank You! This program is made possible by the generous donation of time and expertise by members and volunteers. Thank you to our volunteers—and to you, for choosing NYSBA Programs.

This program is offered for educational purposes. The views and opinions of the faculty expressed during this program are those of the presenters and authors of the materials, including all materials that may have been updated since the books were printed or distributed electronically. Further, the statements made by the faculty during this program do not constitute legal advice.

NYSBA

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MCLE INFORMATION

Program Title: **Tax Section Spring Meeting 2019**

Dates: May 31- June 2, 2019 Location: Harwich, MA

Evaluation: https://nysba.co1.qualtrics.com/jfe/form/SV_2t70JQzf2TtmCEZ
This evaluation survey link will be emailed to registrants following the program.

Total Credits: **Up to 7.5 New York CLE credit hours**

Credit Categories:
6.0 in Areas of Professional Practice
Optional State & Local Tax Committees Session: 1.5 in Professional Practice

This course is approved for credit for **experienced attorneys only.**
(admitted to the New York Bar for more than two years).

Attendance Verification for New York MCLE Credit

In order to receive MCLE credit, attendees must:

1) **Sign in** with registration staff

2) Complete and return a **Verification of Presence form** (included with course materials) at the end of the program or session. For multi-day programs, you will receive a separate form for each day of the program, to be returned each day.

Partial credit for program segments is not allowed. Under New York State Continuing Legal Education Regulations and Guidelines, credit shall be awarded only for attendance at an entire course or program, or for attendance at an entire session of a course or program. Persons who arrive late, depart early, or are absent for any portion of a segment will not receive credit for that segment. The Verification of Presence form certifies presence for the entire presentation. Any exceptions where full educational benefit of the presentation is not received should be indicated on the form and noted with registration personnel.

Program Evaluation

The New York State Bar Association is committed to providing high quality continuing legal education courses, and your feedback regarding speakers and program accommodations is important to us. Following the program, an email will be sent to registrants with a link to complete an online evaluation survey. The link is also listed above.

Additional Information and Policies

Recording of NYSBA seminars, meetings and events is not permitted.

Accredited Provider

The New York State Bar Association's **Section and Meeting Services Department** has been certified by the New York State Continuing Legal Education Board as an accredited provider of continuing legal education courses and programs.

Credit Application Outside of New York State

Attorneys who wish to apply for credit outside of New York State should contact the governing body for MCLE in the respective jurisdiction.

MCLE Certificates

MCLE Certificates will be emailed to attendees a few weeks after the program, or mailed to those without an email address on file. **To update your contact information with NYSBA**, visit www.nysba.org/MyProfile, or contact the Member Resource Center at (800) 582-2452 or MRC@nysba.org.

Newly Admitted Attorneys—Permitted Formats

In accordance with New York CLE Board Regulations and Guidelines (section 2, part C), newly admitted attorneys (admitted to the New York Bar for less than two years) must complete **Skills** credit in the traditional live classroom setting or by fully interactive videoconference. **Ethics and Professionalism** credit may be completed in the traditional live classroom setting; by fully interactive videoconference; or by simultaneous transmission with synchronous interactivity, such as a live-streamed webcast that allows questions during the program. **Law Practice Management** and **Areas of Professional Practice** credit may be completed in any approved format.

Tuition Assistance

New York State Bar Association members and non-members may apply for a discount or scholarship to attend MCLE programs, based on financial hardship. This discount applies to the educational portion of the program only. Application details can be found at www.nysba.org/SectionCLEAssistance.

Questions

For questions, contact the NYSBA Section and Meeting Services Department at SectionCLE@nysba.org, or (800) 582-2452 (or (518) 463-3724 in the Albany area).

SCHEDULE OF EVENTS

Friday, May 31

4:30 – 6:30 p.m. **Registration** | Garden Terrace Building

6:30 – 7:30 p.m. **Welcome Cocktail Reception** | Outer Bar & Grille

7:30 p.m. Dinner on Your Own

Saturday, June 1 – All Programming will be in Cape Villa Building

8:00 a.m. – 12:00 p.m. **Registration** | Cape Villa Foyer

8:30 – 9:30 a.m. **Continental Breakfast** | Cape Villa Foyer

9:00 a.m. – 12:00 p.m. **General Session** | Cape Villa 1 & 2

9:00 – 9:10 a.m. **Tax Section Welcome**
Deborah L. Paul, Esq. | Section Chair

9:10 – 10:30 a.m. **Pass-Through and Group Concepts after the Tax Cuts and Jobs Act of 2017**
Numerous provisions of the Tax Cuts and Jobs Act and recent regulations present challenges for pass-through entities and groups of related taxpayers, including consolidated groups. For example, the interest limitations under Section 163(j) are applied at the partnership level, rather than at the partner level. Additionally, the TCJA contains numerous provisions governing transactions among related parties that, in one way or another, treat those entities as if they were a single taxpayer. This panel will consider some of these challenges, including, among other topics, treatment of pass-throughs and groups under the Section 163(j) interest limitations; application of the rules and basis adjustments under Section 965; special issues for related parties arising under, and use of pass-throughs to manage, GILTI; and taxation of members of pass-throughs with effectively connected income.

Panel Chair:
Stuart L. Rosow, Esq. | Proskauer Rose LLP | New York City

Panelists:
Andrew M. Herman, Esq. | Ernst & Young LLP | Washington, D.C.
Adam Kool, Esq. | Kirkland & Ellis LLP | New York City
Clifford M. Warren, Esq. | Senior Level Counsel, Associate Chief Counsel (Passthroughs) | Internal Revenue Service | Washington, D.C.

10:30 – 10:45 a.m. Refreshment Break

10:45 a.m. – 12:00 p.m. **International Comity after the Tax Cuts and Jobs Act of 2017 (Part I)**
Our two panels on international comity will discuss how the United States' tax regime fits within the international tax landscape after enactment of the Tax Cuts and Jobs Act of 2017. With the new quasi-territorial quasi-pass through system enacted by the Tax Cuts and Jobs Act as well as the international movement to address base erosion and profit shifting and an ever more global economy, the United States' tax regime confronts a host of new technical and big-picture issues in relation to tax regimes of other jurisdictions. Topics may include the BEAT, GILTI, hybrid transactions, foreign tax credits, Section 163(j), Section 245A, tax treaties and tax recommendations of the Organisation for Economic Co-operation and Development.

Panel Chair:
Lawrence M. Garrett, Esq. | Ernst & Young LLP | Washington, D.C.

Panelists:
John J. Merrick, Esq. | Senior Level Counsel, Associate Chief Counsel (International) | Internal Revenue Service | Washington, D.C.

Michael T. Mollerus, Esq. | Davis, Polk & Wardwell LLP | New York City

Ansgar A. Simon, Esq. | Covington & Burling LLP | New York City

SCHEDULE OF EVENTS

12:00 p.m. – 1:30 p.m. **State & Local Tax Committees Luncheon and CLE | Cape Villa 1 & 2**
Registered Attorneys Only. Pick up Lunches at Registration Desk.
PREREGISTRATION IS REQUIRED.
CLE program runs from 12:15 – 1:30 p.m.

New York State Taxation of GILTI
Under current law, the net amount of GILTI is included in entire net income under Article 9-A of the Tax Law and is, accordingly, subject to tax for New York State corporate income tax purposes. New York State has acknowledged that, where such amount is taxable business income, it should be included in the business apportionment factor to properly reflect the taxpayer's business income and capital in the state. Pending legislation would require that the net amount of GILTI be added to the denominator of the apportionment fraction, with zero added to the numerator. This panel will explore the nature of GILTI income for federal and state income tax purposes, discuss whether New York should decouple from the taxation of GILTI, and analyze the appropriateness of various sourcing methods should GILTI remain in the tax base for New York State tax purposes.

Panel Chair:
Jack Trachtenberg, Esq. | Deloitte Tax LLP | New York City

Panelists:
Kimberly S. Blanchard, Esq. | Weil, Gotshal & Manges LLP | New York City

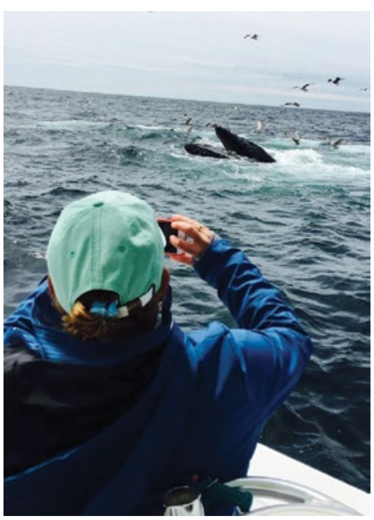
Elizabeth T. Kessenides, Esq. | Federal Reserve Bank of New York | New York City

Irwin M. Slomka, Esq. | Morrison & Foerster LLP | New York City

Optional Afternoon Activities:

2:00 – 4:00 p.m. **Chatham Shellfish Company Oyster Farm Tour and Taste**
Join us as we set off aboard an oyster barge from the company's historic facility on the scenic Oyster River and proceed up to Oyster Pond to Chatham's only oyster farm. Learn about the painstaking work and elaborate process of farming oysters and what it takes to bring these delicacies to your plate. We will even harvest some of our own oysters to enjoy at our private raw bar at the tour conclusion! Catch the shuttle from the Registration Building at 2:00 p.m. sharp.
Preregistration required. $130 per person.

2:00 – 5:00 p.m. **Private Whale Watch** | Departing from End of Wequassett Resort's Dock
CREATE YOUR OWN NATIONAL GEOGRAPHIC MOMENT! Enjoy an intimate encounter at eye level with these gentle giants. The most common sightings include Humpback, Finback and Minke whales. We may also spot dolphins, porpoise, gannet birds and possibly even a Great White Shark! Ages 8 and older. Dress warm as it can be cool on the water.
Preregistration required. $105 per person.



6:30 – 10:00 p.m. **Cocktail Reception & Dinner** | The Beach House at Chatham Bars Inn, 297 Shore Road, Chatham
Enjoys cocktails on the terrace steps away from the Atlantic Ocean. We will move inside for dinner. Meet at Registration Building for shuttles – we will make two trips to the Inn at 6:15 p.m. and and 6:25 p.m. sharp. Preregistration required.

SCHEDULE OF EVENTS

Sunday, June 2 – All Programming will be in Cape Villa Building

8:00 – 9:00 a.m.	**Executive Committee Breakfast Meeting** | Cape Villa 3
8:45 a.m. – 12:00 p.m.	**Registration** | Cape Villa Foyer
8:30 – 9:30 a.m.	**Continental Breakfast** | Cape Villa Foyer
9:15 a.m. – 12:00 p.m.	**General Session** | Cape Villa 1 & 2

9:15 – 10:30 a.m. **International Comity after the Tax Cuts and Jobs Act of 2017 (Part II)**

Our two panels on international comity will discuss how the United States' tax regime fits within the international tax landscape after enactment of the Tax Cuts and Jobs Act of 2017. With the new quasi-territorial quasi-pass through system enacted by the Tax Cuts and Jobs Act as well as the international movement to address base erosion and profit shifting and an ever more global economy, the United States' tax regime confronts a host of new technical and big-picture issues in relation to tax regimes of other jurisdictions. Topics may include the BEAT, GILTI, hybrid transactions, foreign tax credits, Section 163(j), Section 245A, tax treaties and tax recommendations of the Organisation for Economic Co-operation and Development.

Panel Chair:

Diana L. Wollman, Esq. | Cleary Gottlieb Steen & Hamilton LLP | New York City

Panelists:

Steve Edge, Esq. | Slaughter and May | London, England

Andrew R. Walker, Esq. | Milbank LLP | New York City

Peter H. Blessing, Esq. | Associate Chief Counsel, Office of Chief Counsel (International) | Internal Revenue Service | Washington, D.C.

10:30 – 10:45 a.m. Refreshment Break

10:45 a.m. – 12:00 p.m. **Opportunity Zones – What Fund Managers, Investors and Developers Should Know**

Join us to discuss the new opportunity zone program, the tax benefits it offers and the challenges fund managers, investors and developers face when investing and structuring qualified opportunity funds. The panel will not only cover the existing rules and any new developments but will also share the practical challenges and common pitfalls associated with the program. Among the topics that will be explored are single and multiple asset funds, one or two tier structures, related party acquisitions, treatment of leases, treatment of promotes, investment in LIHTC deals, dealing with phantom income, exit strategies as well as other topics.

Panel Chair:

Michael B. Shulman, Esq. | Shearman & Sterling LLP | New York City

Panelists:

Daniel Z. Altman, Esq. | Sidley Austin LLP | New York City

Julie Hanlon Bolton, Esq. | Special Counsel, Associate Chief Counsel (Income Tax & Accounting) | Internal Revenue Service | Washington, D.C.

David S. Miller, Esq. | Proskauer Rose LLP | New York City

Krishna Vallabhaneni, Esq. | Acting Tax Legislative Counsel, Department of the Treasury | Washington, D.C.

Checkout

Lawyer Assistance Program 800.255.0569

NYSBA

Q. What is LAP?

A. The Lawyer Assistance Program is a program of the New York State Bar Association established to help attorneys, judges, and law students in New York State (NYSBA members and non-members) who are affected by alcoholism, drug abuse, gambling, depression, other mental health issues, or debilitating stress.

Q. What services does LAP provide?

A. Services are **free** and include:

- Early identification of impairment
- Intervention and motivation to seek help
- Assessment, evaluation and development of an appropriate treatment plan
- Referral to community resources, self-help groups, inpatient treatment, outpatient counseling, and rehabilitation services
- Referral to a trained peer assistant – attorneys who have faced their own difficulties and volunteer to assist a struggling colleague by providing support, understanding, guidance, and good listening
- Information and consultation for those (family, firm, and judges) concerned about an attorney
- Training programs on recognizing, preventing, and dealing with addiction, stress, depression, and other mental health issues

Q. Are LAP services confidential?

A. Absolutely, this wouldn't work any other way. In fact your confidentiality is guaranteed and protected under Section 499 of the Judiciary Law. Confidentiality is the hallmark of the program and the reason it has remained viable for almost 20 years.

Judiciary Law Section 499 Lawyer Assistance Committees Chapter 327 of the Laws of 1993

Confidential information privileged. The confidential relations and communications between a member or authorized agent of a lawyer assistance committee sponsored by a state or local bar association and any person, firm or corporation communicating with such a committee, its members or authorized agents shall be deemed to be privileged on the same basis as those provided by law between attorney and client. Such privileges may be waived only by the person, firm or corporation who has furnished information to the committee.

Q. How do I access LAP services?

A. LAP services are accessed voluntarily by calling **800.255.0569** or connecting to our website **www.nysba.org/lap**

Q. What can I expect when I contact LAP?

A. You can expect to speak to a Lawyer Assistance professional who has extensive experience with the issues and with the lawyer population. You can expect the undivided attention you deserve to share what's on your mind and to explore options for addressing your concerns. You will receive referrals, suggestions, and support. The LAP professional will ask your permission to check in with you in the weeks following your initial call to the LAP office.

Q. Can I expect resolution of my problem?

A. The LAP instills hope through the peer assistant volunteers, many of whom have triumphed over their own significant personal problems. Also there is evidence that appropriate treatment and support is effective in most cases of mental health problems. For example, a combination of medication and therapy effectively treats depression in 85% of the cases.

Personal Inventory

Personal problems such as alcoholism, substance abuse, depression and stress affect one's ability to practice law. Take time to review the following questions and consider whether you or a colleague would benefit from the available Lawyer Assistance Program services. If you answer "yes" to any of these questions, you may need help.

1. **Are my associates, clients or family saying that my behavior has changed or that I don't seem myself?**
2. **Is it difficult for me to maintain a routine and stay on top of responsibilities?**
3. **Have I experienced memory problems or an inability to concentrate?**
4. **Am I having difficulty managing emotions such as anger and sadness?**
5. **Have I missed appointments or appearances or failed to return phone calls? Am I keeping up with correspondence?**
6. **Have my sleeping and eating habits changed?**
7. **Am I experiencing a pattern of relationship problems with significant people in my life (spouse/parent, children, partners/associates)?**
8. **Does my family have a history of alcoholism, substance abuse or depression?**
9. **Do I drink or take drugs to deal with my problems?**
10. **In the last few months, have I had more drinks or drugs than I intended, or felt that I should cut back or quit, but could not?**
11. **Is gambling making me careless of my financial responsibilities?**
12. **Do I feel so stressed, burned out and depressed that I have thoughts of suicide?**

There Is Hope

CONTACT LAP TODAY FOR FREE CONFIDENTIAL ASSISTANCE AND SUPPORT

The sooner the better!

1.800.255.0569

NEW YORK STATE BAR ASSOCIATION

Join Our Section

☐ As a NYSBA member, **PLEASE BILL ME $25 for Tax Section dues.** (law student rate is $12.50)

☐ I wish to become a member of the NYSBA (please see Association membership dues categories) and the Tax Section. **PLEASE BILL ME for both.**

☐ I am a Section member — please consider me for appointment to committees marked.

Name ______________________________

Address ______________________________

____

City ____________ State _____ Zip ____________

The above address is my ☐ Home ☐ Office ☐ Both

Please supply us with an additional address.

Name ______________________________

Address ______________________________

City ____________ State _____ Zip ____________

Office phone (______) ______________________

Home phone (______) ______________________

Fax number (______) ______________________

E-mail address ______________________________

Date of birth ______ /______ /______

Law school ______________________________

Graduation date ____________

States and dates of admission to Bar: ____________________

Please return this application to:

MEMBER RESOURCE CENTER,

New York State Bar Association, One Elk Street, Albany NY 12207

Phone 800.582.2452/518.463.3200 • FAX 518.463.5993

E-mail mrc@nysba.org • www.nysba.org

Join a Tax Section Committee(s)

Please designate in order of choice (1, 2, 3) from the list below, a maximum of three committees in which you are interested. You are assured of at least one committee appointment. All appointments are made as space availability permits.

___ Bankruptcy and Operating Losses (TAX1100)
___ Compliance, Practice and Procedure (TAX1300)
___ Consolidated Returns (TAX1400)
___ Corporations (TAX1500)
___ Cross-Border Capital Markets (TAX4100)
___ Cross-Border M&A (TAX4500)
___ Diversity (TAX4300)
___ Employee Benefits (TAX2600)
___ Estates and Trusts (TAX1700)
___ Financial Instruments (TAX1800)
___ "Inbound" U.S. Activities of Foreign Taxpayers (TAX3700)
___ Individuals (TAX2100)
___ Investment Funds (TAX4200)
___ New York City Taxes (TAX2400)
___ New York State Taxes (TAX2500)
___ "Outbound" Foreign Activities of U.S. Taxpayers (TAX2000)
___ Partnerships (TAX2800)
___ Pass-Through Entities (TAX2900)
___ Real Property (TAX3100)
___ Reorganizations (TAX3200)
___ Securitizations and Structured Finance (TAX4000)
___ Spin Offs (TAX4600)
___ Tax Exempt Entities (TAX3500)
___ Treaties and Intergovernmental Agreements (TAX4700)

2019 ANNUAL MEMBERSHIP DUES

Class based on first year of admission to bar of any state.
Membership year runs January through December.

ACTIVE/ASSOCIATE IN-STATE ATTORNEY MEMBERSHIP	
Attorneys admitted 2011 and prior	$275
Attorneys admitted 2012-2013	185
Attorneys admitted 2014-2015	125
Attorneys admitted 2016 - 3.31.2018	60
ACTIVE/ASSOCIATE OUT-OF-STATE ATTORNEY MEMBERSHIP	
Attorneys admitted 2011 and prior	$180
Attorneys admitted 2012-2013	150
Attorneys admitted 2014-2015	120
Attorneys admitted 2016 - 3.31.2018	60
OTHER	
Sustaining Member	$400
Affiliate Member	185
Newly Admitted Member*	FREE

DEFINITIONS

Active In-State = Attorneys admitted in NYS, who work and/or reside in NYS
Associate In-State = Attorneys not admitted in NYS, who work and/or reside in NYS
Active Out-of-State = Attorneys admitted in NYS, who neither work nor reside in NYS
Associate Out-of-State = Attorneys not admitted in NYS, who neither work nor reside in NYS
Sustaining = Attorney members who voluntarily provide additional funds to further support the work of the Association
Affiliate = Person(s) holding a JD, not admitted to practice, who work for a law school or bar association
*Newly admitted = Attorneys admitted on or after April 1, 2018

NYSBA

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PASS-THROUGH AND GROUP CONCEPTS AFTER THE TAX CUTS AND JOBS ACT OF 2017

Presented By:

Stuart L. Rosow, Panel Chair
Proskauer Rose LLP
New York City

Andrew M. Herman, Esq.
Ernst & Young LLP
Washington, DC

Adam Kool, Esq.
Kirkland & Ellis LLP
New York City

Clifford M. Warren, Esq.
Senior Level Counsel, Associate Chief Counsel (Passthroughs)
Internal Revenue Service
Washington, DC

Section 163(j) and Partnerships

I. Section 163(j) and Partnerships

A. Section 163(j) provides that the limitations on the deduction for business interest expense is to be applied at the partnership level rather than at partner level.

1. Concept: All business interest expense should be subject to same limitations for deductions. Question is whether this is better achieved by applying the limitation at the partner or partnership level.

2. Imposing the limit at partnership level also imposes considerable complexity. Rules are need to integrate partnership level computing with the allocation of items of business interest income, business interest expense and other items of income or deduction that are taken into account in the computation of the of the limitation at the partnership level. In particular, rules are needed to allocate each of these various items to determine each partner's share of any deductible business interest expense, as well as certain "excess" items that are taken into account at the partner level, such as excess business interest income, excess taxable income and excess business interest expense which may be carried over to future years.

B. The statutory approach also produces some unexpected results and potential abuses.

1. Example 1: Partnership ABC has the partners A, B and C. For 2019 Partnership AB has 300 of adjusted taxable income ("ATI") and 100 of business interest expense. Because of the partnership level computation, all of the interest is deductible under section 163(j). Assume further that the business interest expense is allocated entirely to partner C, while all of the items comprising ATI are allocated equally to each of A&B.

2. Under Example 1, there is the somewhat surprising conclusion that C is entitled to deduct all of the business interest expense. This is the case not only if C has not business interest income or ATI from the partnership, but also no business interest income or ATI from any other businesses that C may conduct. While this is an extreme example, it illustrates at least some of the issues with the statutory approach.

II. Basic Rules

A. Section 163(j) requires that the partnership separately compute its ATI. For these purposes, the partnership is required to segregate its sources of all items of income and expense to determine the amounts that are considered from business activities and those items derived from exempt activities.

1. Under Treas. Reg. §1.163(j)-6(d), the partnership's ATI is computed without taking into account partner basis items and remedial items.

2. For these purposes, "partner basis" items include basis adjustments under Section 743(b) and allocations resulting from the application of Section 704(c)(1)(C)(i). Rather, these items are taken into account by the partner in computing its separate Section 163(j) limitations. Treas. Reg. §1.163(j)-6(e)(2).

3. A partnership's ATI also does not include any allocations made under the remedial method under Section 704 and Treas. Reg. §1.704-3(d). As with other partner items, these allocations are taken into account by the partner in computing its ATI.

4. A partnership's ATI however, includes items of income resulting from basis adjustment under Section 734(b).

B. Under Treas. Reg. §1.163(j)-6(e), a partner's separate ATI does not include any item taken into account in the computation of the partnership's ATI. Once interest is determined to be deductible at the partnership level it is not again subject to Section 163(j) testing at the partner level.

C. In addition to determining the amount of deductible interest, Treas. Reg. §1.163(j)-6 defines and provides rules for the determination of other items that are necessary for determination of the partnership level. Those include, the partnership's "excess business interest income," "excess business interest" and "excess taxable income."

1. Any excess business interest expense allocated to a partner is treated as business interest expense of the partner in a succeeding year. That excess business interest expense is then deductible by the partner in any future year in which that partner is allocated excess business interest income are excess taxable income.

2. The excess business interest expense in any year is not treated as a carryover of the partnership.

D. The proposed regulations also provide special rules concerning the computation of the partner's basis in its partnership interest and rules governing the treatment of dispositions of partnership interest.

1. A partner's basis in its partnership interest is reduced, but not below zero, by all interest expense allocated to the partner even if the interest is not deductible under section 163(j). Treas. Reg. §1.163(j)-6(h)(2). Note that the usual limitations under section 704(d) apply however. Treas. Reg. §1.163(j)-6(h)(1).

2. Under the regulations, a partner will increase its basis to the extent of the interest expense which has not been allowed upon a disposition of all of the partner's interest in the partnership. No such adjustment is made if the partner disposes of only a portion of its interest.

3. This rule leads to certain interesting results. Because the partner increases its basis by the amount of disallowed interest immediately before the disposition, it is likely that there will be an inside-outside basis disparity, with the partner's outside basis exceeding its share of inside basis. If the partner makes a nonrecognition transfer of its interest in the partnership, such as to a new partnership, the transferee will be entitled to an increase in inside basis under section 743(b). If the partnership holds depreciable property or inventory which has appreciated, the net effect of the transaction is to convert interest expense which has not been deducted into either depreciation or a reduction in income from the sale of inventory. If that is the case, is the limitation really achieving the Congressional goal?

III. Allocation of Partnership Items

A. Section 163(j) provides that deductible business will be allocated among the partners in accordance with an eleven step formula. The rules provide that deductible business interest (and other section 163(j) items will be considered allocated in accordance with the partnership's "nonseparately stated income" if and only if the eleven step formula is followed.

B. The formula is intended to serve the following goals, as set forth in the preamble to the proposed regulations.

1. Section 163(j) is applied at the partnership level.

2. A partnership cannot have both excess business taxable income (or excess business interest income) and excess business interest expense.

3. Parity must be maintained between the partnership's deductible business interest expense and other section 163(j) items so that the aggregate of each items determined at the partnership level corresponds to the allocations of such items for purposes of section 163(j).

4. If a partnership has both deductible business interest expense and excess business interest expense in a given year, a partner whose items of interest income or taxable income that were used to support the partnership's deduction should not be allocated excess business interest expense.

5. If a partnership has either excess taxable income or excess business interest income in a year, the allocation of those items should correspond to the allocations to the partners of the items comprising excess taxable income or excess business interest income.

C. The proposed rules use the following procedure to determine each partner's share of deductible business interest expense, excess business expense to be carried over, excess business interest income and excess taxable income that may be used by a partner to support deductions of business interest of the partner.

1. Under the eleven step process, the partnership first determines its Section 163(j) excess items and the amount of its deductible business interest expense.

2. Second, the partnership determines each partner's allocable share of items of income, gain, loss and deduction that are taken into account by the partnership in determining its Section 163(j) items. That determination is based upon the allocations under Section 704(b).

3. Steps three through five provide a method for determining each partner's share of the partnership's excess business interest income or excess business interest expense.

4. Step six specifies the method for determining each partner's share of the partnership's adjusted taxable income.

5. Steps 7 through 10 provide an intricate series of computations intended to determine each partner's capacity to absorb interest deductions based upon its share of the partnership's ATI.

6. Finally, in step eleven, the partnership's deductible business interest expense and excess Section 163(j) items (excess business interest income, excess taxable income and excess business interest expense) are allocated to the partners based upon the determinations made in the preceding steps.

7. These computations are then illustrated through a series of examples which, while very helpful, emphasize the complexity and intricacy of the computations required.

D. Almost all have agreed that the "eleven step process" works as a technical matter to produce a reasonable result. The issues are whether the complexity is warranted—or whether taxpayers should be required to use a spreadsheet program to compute their tax items—and whether there are simpler alternatives.

1. The eleven step formula imposes significant recordkeeping requirements. As an initial matter, the eleven step process exists solely for Section 163(j) purposes. Taxpayers must maintain a parallel set of books (and make parallel allocations simply to comply with Section 163(j)).

2. The process itself involves multiple different computations to be made for each partner, For example, the eleven step process requires that a partnership determine for each partner the following items: "allocable business income excess", and "allocable business income deficit". After these amounts are initially determined, the proposed regulations require a redetermination in accordance with a mathematical formula, resulting in each partner having a "final allocable business income excess" and "final allocable business income deficit". Similar determinations and redeterminations are also made with respect to a partner's "remaining

business interest expense" and "allocable ATI", as well as determinations of a partner's "ATI capacity excess", "ATI capacity deficit" and a computation of a partner's "priority amount".

3. Once all of these computations are made, the partners can then determine their share of deductible business interest expense and the other section 163(j) items.

4. A simplified alternative (among others) would be generally to allocate deductible business expense to each partner based upon the interest expense, ATI and business interest income allocated to each partner.

5. This could be accomplished as follows: for each partner that is allocated business interest expense, determine the portion of the interest expense allocated to such partner that would be considered deductible business interest expense taking into account only the business interest income and ATI allocated to such partner.

    i. If the aggregate amount determined for all partners is equal to, or less than, the amount of the partnership's deductible interest expense, then each partner would be allocated deductible business interest expense that each partner in the amount determined in the first step—in other words, the amount of interest expense would have been entitled to deduct under Section 163(j) if only partnership items of income and deduction are taken into account.

    ii. If the first step produced deductible interest in excess of the limitation determined at the partnership level, each partner's allocation of deductible business interest expense would equal the proportion of the partnership's total deductible business expense that the deductible amount determined in the first step for such partner constitutes of the deductible amount determined for all partners. Also, any deductible business interest expense as determined at the partnership level that is not allocated through the first step would then be allocated among the partners that have been allocated business interest deductions in proportion to the amount of interest expense of each partner remaining after the first step.

6. This approach can be illustrated by the following example. Consider first the facts of Example 14 of proposed regulations Section 1.163(j)-6(o). Partnership PRS had $140 of business interest expense, $200 of ATI and no business interest income. Accordingly, PRS has $60 of deductible business interest expense. PRS' items of ATI have been allocated such that A, B and C have income of $100, $100 and $400 respectively, while D has a loss of $400. PRS' business interest expense has been allocated $40 to B, $60 to C and $40 to D.

i. Under the suggested approach, PRS would first determine for each of B, C and D the amount of the business interest allocated to each partner that would be deductible under Section 163(j) taking into account solely the ATI and business interest income allocated to such partner. In this case, the entire $60 of interest expense allocated to C would have been deductible, $30 of the interest expense allocated to B would have been deductible and no amount of business interest expense allocable to D would have been deductible.

ii. The total amount of business interest expense determined in the first step (or $90) exceeds the total amount deductible under Section 163(j) applied at the partnership level (or $60). Under this approach the partnership would determine the proportion of the interest expense allocated to each partner that is determined to be deductible in the first step and allocate the total deduction in those proportions. Thus, C would be entitled to two-thirds of the $60 deduction (60/90) and B would be entitled to one-third (30/90) of the $60 deduction. D would not be entitled to any business interest deduction. Once the deductible business interest income is determined, the other Section 163(j) items can be computed.

IV. Tiered Partnerships

A. Among the issues for which Treasury and the IRS requested guidance is the treatment of tiered partnerships: in order words, should the statutory rule be applied at each partnership level or should it be applied by combining the tiers as is the traditional approach to tiered partnerships.

1. The issues can be illustrated by the following that are intended to illustrate the ability of taxpayers to exploit the computation of the interest limitation under Section 163(j) to increase their interest deduction.

2. The issues concern whether the statute mandates that each partnership be treated as a separate entity or whether there is regulatory flexibility to disregard separate tiers of partnerships. On its face, the statute appears to require each partnership to compute separately its deductible interest. However, there may be an abuse when the tiered partnership arrangement is used to reduce the overall tax burdens of the ultimate taxpayers, without affecting their overall economic results.

3. Example 1: Partnership A has two businesses. Business 1 has gross income of $600 and gross deductions (no depreciation or amortization) of $800. Business 2 has gross income of $1000 and gross deductions (no depreciation or amortization) of $700. Partnership A has debt of $2000 with interest deductions of $200.

i. Under these facts, Partnership A has the following results:

Gross Income:	$1600
Gross Deductions:	$1500
ATI	$ 100
Interest Allowed:	$ 30
Taxable Income:	$ 70

4. Example 2: Assume the same facts as Example 1 except that Partnership A transfers Business 2 to Partnership B in exchange for a 99% interest. The other partner, holding 1%, is a partner of Partnership A. With the lender's consent, Partnership B assumes debt of $1000 at the same interest rate and Partnership A guarantees the $1000 debt.

i. Under these facts, Partnerships A and B have the following results:
Partnership B:

Gross Income:	$1000
Gross Deductions:	$ 700
ATI	$ 300
Interest Allowed:	$ 100
Taxable Income:	$ 200

Partnership A

Business 1:

Gross Income	$ 600
Gross Deductions	$ 800
ATI	$(200)
Interest Deduction	$ 0
Taxable Income	$(200)
Share of Partnership 2	$ 198
Taxable Income	$ (2)

5. Simply by choosing to operate Business 2 through a lower tier partnership, Partnership A and its partners are able to reduce their overall taxable income by increasing the interest deduction. Economically, there is little or no difference between operating the business through one regarded entity rather than two. Indeed, to the extent that there are non-tax reasons for separating the operation of the two businesses, those can be satisfied by choosing a single member LLC as opposed to a tiered partnership structure.

6. One approach to limiting this situation would be to apply a rule disregarding tiered partnerships in situations in which there is substantial common control. For these purposes, the rule could apply if the same persons own (directly or indirectly) 80% or more of the interests in both

partnerships. The abuse is most likely to arise in this circumstance since the use of tiered partnerships in this instance is unlikely to change the partners' ultimate economic position.

7. It should be noted that this approach would be applicable not just for situations involving tiered partnerships, but would apply as well to tiered arrangements involving other entities. For example, the technique of separating out the business activities could be used by a corporation to increase its interest deduction by conducting a portion of its business through a partnership with an affiliated partner holding a small interest.

V. Section 706 and Section 163(j) Interaction

A. The following examples are intended to present certain issues concerning the application of Section 163(j) and its interaction with the rules of Section 706. The basic question that need to be addressed is the following: should the limits of Section 163(j) be applied to each separate segment of the year or should the computation be made for the partnership's entire year with an allocation of the interest amount to each of the separate periods?

B. Example 1: Assume Partnership ABC has three partners, A with a 50% interest, B with a 30% interest and C with a 20% interest. All items of income and deduction are shared in accordance with the partners' respective percentage interests. In the first segment of the year, ABC has gross income of 600, gross deductions of 700 and business interest expense of 100. At the end of the first segment, C sells its 20% interest to D. In the second segment, ABC has gross income of 900, gross deductions of 400 and no interest expense.

1. If the partnership's Section 163(j) limit is computed separately for each segment of the year, no interest would be deductible. There is negative ATI for the first segment (and no business interest income) and there is no business interest expense in the second segment. That result is likely unfair to A and B, although the unfairness can be partially mitigated by treating their share of the first segment's interest expense as excess business interest expense.

2. If the partnership's limitation is computed for the entire year, all of the interest is deductible business interest because the aggregate ATI of the partnership is 400. Under this approach, all of the interest expense in the first segment would be deductible business interest, with the result that C would be entitled to deduct the full amount of its interest, even though it had negative ATI and was not even a partner when the ATI was earned.

3. There is a further complication. Assume C has a taxable year that ends with the end of the first segment and ABC has the calendar year as its taxable year. If, for example, the first segment ended in February, C

would be required to file its tax return before the partnership had determined its ATI and deductible business expense for the year.

C. Example 2: Assume Partnership XYZ with three partners has the following ATI and business interest expense (and no business interest income). For the first segment, Partners X and Y are each allocated income and deductions resulting in a share of ATI equal to 200 and business interest expense of 75. Partner Z is allocated income and deductions resulting in a share of ATI equal to 100 and no business interest expense. Partner Z sells its interest to Partner D. In the second segment of the year, Partners X and Y are each allocated income and deductions resulting in a loss of 50 as well as business interest expense of 25. Partner D is allocated equal amounts of income and deductions resulting in a share of ATI of zero and interest expense of 25.

1. In this example, if the Section 163(j) limit is computed using the entire year, there is ATI of 400 and an interest limit of 120. If the eleven step formula is applied to the entire year, each of the partners will have an ATI deficit, with the result that a portion of Z's excess ATI being applied to allow all of the other partners, including D, to be allocated a portion of the partnership's deductible interest expense. This is the case, even though the partnership had a loss for the period in which D was a partner.

2. Applying the section 163(j) limit to the segments separately also yields an unsatisfactory result. The Section 163(j) limit determined for the first segment would be 150, with the result that all of the interest allocated to partners X and Y would be deductible interest. The first problem with this approach is that the amount of interest allowed exceeds the amount that would be allowable if the partnership computed the limit for the entire year. The second is that the approach does not take into account the losses allocated to X and Y in the second part of the year, even though they are continuing partners.

Section 864(c)(8) - Sales of Partnership Interests by Foreign Persons

I. Background.

A. Rev. Rul. 91-32, 1991-1 C.B. 107

1. In Rev. Rul. 91-32, IRS held that for a non-U.S. seller, gain from sale of an equity interest in a partnership is treated as effectively connected income that is taxable in the United States to the extent the gain is attributable to the partnership's assets that were used in a U.S. trade or business.

2. To reach this result, IRS applied an "aggregate" theory of partnerships, and effectively treated the non-U.S. seller as selling its attributable portion of the partnership's assets.

B. Grecian Magnesite Mining v. Comm'r, 149 T.C. 63 (2017)

1. In *Grecian Magnesite*, the Tax Court largely rejected the conclusion of Rev. Rul. 91-32, holding that Section 741 of the Code generally contemplated an "entity" theory of partnerships for purposes of determining the consequences of a sale of a partnership interest by a non-U.S. person.

2. Accordingly, the Tax Court found that gain on the sale of a partnership interest generally was not treated as effectively connected to the conduct of a U.S. trade or business on the facts of *Grecian Magnesite*, even if the partnership itself was engaged in a U.S. trade or business.

C. Section 864(c)(8)

1. Following the government's loss in *Grecian Magnesite*, Congress enacted Section 864(c)(8) in the 2017 tax reform package. Section 864(c)(8) largely codifies the holding of Rev. Rul. 91-32, treating gain from sale of an equity interest in a partnership as effectively connected income to the extent the gain is attributable to the partnership's assets that are used in a U.S. trade or business.

II. Selected Issues Under Section 864(c)(8).

A. Treatment of Nonrecognition Transactions.

1. Proposed regulations generally do not override nonrecognition provisions, although statute clearly extends regulatory authority if Treasury and IRS believed override was appropriate.[1]

2. However, preamble to proposed regulations notes that government is still considering additional guidance, particularly in the case of Section 731 distributions.

3. As illustrated through the following example, it is not entirely clear that all Section 731 transactions with base erosion potential could be attacked under either (i) the partnership anti-abuse regulations, or (ii) traditional judicial anti-abuse doctrines like step-transaction or economic substance.

i. Example. Foreign partner ("<u>FP</u>") and a U.S. person ("<u>USP</u>") hold interests partnership PRS. PRS is engaged in a United States trade or business and also holds assets that would produce foreign-source income if sold by PRS (the "<u>Non-USTB Assets</u>"). In a transaction qualifying as a nonrecognition transaction under Section 731 of the Code and with a specific intent to limit the

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[1] Code Section 864(c)(8)(E).

extent to which FP recognizes income effectively connected with a U.S. trade or business, PRS distributes the Non-USTB Assets to FP in complete redemption of its interest in PRS.

ii. In this example, application of partnership anti-abuse regulations may prove challenging absent additional abusive facts. Even though the Section 731 distribution may have been motivated by FP's goal of reducing income subject to federal income taxes, the result is generally consistent with Subchapter K's policy of allowing flexible entry into and exit from partnerships on a tax-deferred basis, and it does not appear that a specific statute outside of Subchapter K contemplates aggregate treatment in this fact pattern.

iii. Similarly, absent additional facts suggesting that the distribution described in the Example above was part of a plan or otherwise lacked economic substance, it is not clear that either step-transaction or economic substance doctrines would present a viable line of attack for characterizing the taxpayers' selected form in the example.

III. Attribution of Gain to U.S. Office**.**

A. Because Section 864(c)(8) contemplates that a foreign partner must recognize effectively connected income based on a deemed sale of partnership assets, it is necessary for purposes of the statute to determine what portion of a partnership's gain or loss on a deemed sale is treated as U.S. source.

B. Proposed regulations as written effectively assume that partnership business assets generally give rise to U.S.-source gain or loss, except to the extent (i) no income or gain previously produced by a given asset was taxable as effectively connected income of the partnership during the ten-year period ending on the date of the transfer, and (ii) such asset was not used, or held for use, in the conduct of a trade or business within the United States by the partnership during the ten-year period ending on the date of transfer.[2]

C. Proposed regulations requested comments regarding proposed rule, perhaps recognizing that it is likely that in many cases a deemed sale of partnership assets under Section 864(c)(8) will result in a greater amount of effectively connected income than an actual sale of partnership assets might generate.

D. Because a deemed sale in all cases requires some guiding principle that may or may not reflect the results of an actual deemed sale, there is unlikely to be a perfect approach to the deemed sale. However, alternative approaches to be considered may involve (1) specific rules to address assets that are particularly

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2 Prop. Reg. §§1.864(c)(8)-1(c)(2)(i) and 1.864(c)(8)-1(c)(2)(ii).

likely to be the subject of distortion (e.g., goodwill or certain inventory sales), and/or (2) deemed sales based on historic recognition of income or loss as between the partnership's U.S. and non-U.S. operations.

The GILTI/BEAT Breaking Point – Choosing Between CFC and Foreign Branch Structures

I. Background.

A. In General.

1. Following tax reform, U.S. taxpayers face an entirely new set of considerations when deciding whether to hold non-U.S. operations through one or more regarded "controlled foreign corporations" (as defined in Code Section 957(a)) ("CFCs") or whether to organize non-U.S. operations in branch form (such that all domestic and foreign operations are effectively grouped and treated as earned by a U.S. entity).

2. Holding foreign operations in CFCs generally permits taxpayers to take advantage of the GILTI regime, which results in an effective tax rate on non-U.S. income that can be as low as 10.5%. Foreign tax credits ("FTCs") are usable against GILTI income under Code Section 960(d), subject to an 80% cutback. No carryback or carryforward of GILTI FTCs is permitted under Code Section 904.

3. Even though income from non-U.S. branches is generally taxable at a 21% rate, foreign branches may still offer valuable benefits over the GILTI regime, including with respect to (i) the flow-through of foreign losses to the U.S. (subject to complex limitation), (ii) full use of FTC (i.e., no 80% cutback), (iii) ability to carryback or carryforward FTCs and (iv) general non-application of base-erosion and anti-abuse tax ("BEAT") on payments between home office and branch. These advantages become even more attractive when, as illustrated below, the application of FTC expense allocation rules and/or the application of BEAT result in a substantially higher effective tax rate on foreign income earned in the GILTI regime.

II. GILTI

A. Under new Code Section 951A, U.S. corporations are generally subject to a minimum tax on so-called "global low-taxed intangible income" ("GILTI") earned by their CFCs. GILTI is generally the taxable income of all of a taxpayer's CFCs in excess of a deemed return on tangible assets, with certain limited exclusions for specified types of income (e.g., "Subpart F" income).[3]

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[3] Code Section 951A(b).

B. Under Code Section 250, a taxpayer is generally permitted a deduction equal to 50% of its GILTI inclusion. Additionally, as discussed above, a taxpayer is also permitted an FTC of 80% of foreign taxes allocable to GILTI income under Code Section 960(d).

C. Accordingly, before taking into account FTC expense allocation rules (discussed below) or BEAT, GILTI regime currently results in effective tax rate on non-U.S. income of between 10.5% and 13.125% depending on availability of FTCs.

III. Foreign Tax Credit Allocation to GILTI

A. Proposed regulations under Section 904 confirm that certain expenses of U.S. taxpayers (e.g., interest expense) must be allocated to GILTI basket income.

B. The allocation of each dollar of expense to GILTI basket income effectively results in a limitation on GILTI FTCs, such that for each dollar of expense allocated to GILTI for which FTCs are otherwise available, the effective tax rate is increased by 21%.[4]

IV. BEAT

A. Code Section 59A imposes a minimum tax on large U.S. multinationals with substantial payments to foreign related persons (including foreign related persons who are CFCs). While the precise contours of BEAT are beyond the scope of this discussion, the central thrust of BEAT is to deny a deduction for certain payments made from a U.S. corporation to a related foreign person.

B. Importantly, BEAT may apply to payments from a domestic corporation to a wholly-owned CFC, even where the payment generates an inclusion at a 21% rate for the domestic corporation under Section 951 of the Code.

C. However, because payments between a domestic corporation's home office and its foreign branches are generally disregarded for U.S. federal income tax purposes, BEAT generally would not apply to such payments if non-U.S. operations are organized in branch form.

V. Branch Inflection Point.

A. As highlighted through the examples below, whether and to what extent a taxpayer may prefer a foreign branch to a regarded corporation subject to GILTI is a highly complex and individualized inquiry following tax reform, but there are certain cases where a branch may prove to be more attractive than a CFC, notwithstanding the 50% deduction permitted with respect to GILTI income.

B. Example 1: Basic Operation of GILTI

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[4] For an in-depth discussion of the reasons for this effective 21% increase in tax rate, see New York State Bar Tax Section Report No. 1394, p. 13 (May 4, 2018).

1. U.S. shareholder owns a single CFC with $1,000 of pre-tax tested GILTI income and no deemed return on tangible assets. CFC has paid $150 of foreign taxes, all of which are attributable to GILTI income. The GILTI inclusion on this fact pattern is $1,000 and the allowed FTC is 80% of $150, or $120.[5] Assuming the full Section 250 deduction of $500 is allowed, taxable income will be $500 and the tentative U.S. tax liability is $105 (i.e., $500 x 21%). If no expenses are allocated to GILTI income, the FTC will offset the U.S. tax in full for an aggregate tax liability of $150.

2. If U.S. shareholder held the operations of CFC through a foreign branch, U.S. shareholder would be subject to a 21% effective tax rate, with a tentative U.S. tax liability of $210 (i.e., $1,000 x 21%) and a credit of $150 for foreign taxes paid, for a total U.S. tax liability of $60 and an aggregate tax liability of $210.

C. Example 2: Operation of GILTI Regime with FTC Expense Allocation

1. Assume the same facts as in Example 1, but $300 of expenses are allocable to GILTI under the Section 904 rules. The FTC limit under Section 904(a) will be $42 (i.e., [$1000 income - $500 GILTI deduction – $300 interest expense] x 21%). Accordingly, of the $105 of tentative U.S. tax liability described in Example 1, $42 is offset by FTCs, with $63 of remaining U.S. tax liability. The aggregate tax liability with respect to the $1,000 of foreign income in this fact pattern is therefore $213 (i.e., $150 of foreign tax liability plus $63 of additional U.S. tax liability).

2. Notably, the aggregate tax liability of $213 with respect to the $1,000 of foreign income in this fact pattern would be no different if U.S. shareholder chose to organize the operations of CFC in a foreign branch. Because there is no GILTI deduction to take into account, the Section 904(a) limitation would be $147 (i.e., [$1000 income – $300 interest expense] x 21%). Accordingly, of the $210 of tentative U.S. tax liability, $147 is offset by FTCs, with the same $63 of remaining U.S. tax liability. The aggregate tax liability with respect to the $1,000 of foreign income in this fact pattern is therefore $213 (i.e., $150 of foreign tax liability plus $63 of foreign tax liability). Given the lack of a rate differential, the benefits of organizing in branch form (discussed above) may be highly attractive to U.S. taxpayer in this fact pattern.

D. Fact Pattern #3: Operation of GILTI Regime with BEAT Payments

1. Assume the same facts as in Example 1, but U.S. taxpayer makes $350 of payments that are subject to BEAT to the non-U.S. business. The BEAT payments are immediately taxable to U.S. taxpayer under Section 951, but the BEAT payments are not included in the taxable income of CFC under

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[5] As a technical matter, the GILTI inclusion is comprised of a

the laws of the jurisdiction in which CFC is organized. The results are the same as in Example 1, except that U.S. taxpayer's aggregate tax liability increases by $73.50 (i.e., $350 x 21%). Accordingly, U.S. taxpayer's aggregate U.S. tax liability is increased to $73.50 as a result of inclusions under Section 951, and U.S. taxpayer also pays $150 in foreign taxes, for an aggregate tax liability of $223.50.

2. In contrast, if U.S. taxpayer had organized the operations of CFC as a foreign branch, there would be no inclusion under Section 951 with respect to $350 of payments described above. Accordingly, U.S. shareholder would be subject to a 21% effective tax rate, resulting in a tentative U.S. tax liability of $210 (i.e., $1,000 x 21%), with a credit of $150 for foreign taxes paid for a total U.S. tax liability of $60 and an aggregate tax liability of $210. In this fact pattern, not only does the foreign branch offer a rate benefit as compared to the GILTI regime, but U.S. taxpayer can also take advantage of the other benefits of a foreign branch structure described above.

INTERNATIONAL COMITY AFTER THE TAX CUTS AND JOBS ACT OF 2017 (PART ONE)

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Report No. 1406
November 26, 2018

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1500 Pennsylvania Avenue, NW
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The Honorable Charles P. Rettig
Commissioner
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The Honorable William M. Paul
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Re: *Report No. 1406 – Report on Proposed GILTI Regulations*

Dear Messrs. Kautter, Rettig, and Paul:

I am pleased to submit Report No. 1406, commenting on the proposed regulations (the "**Proposed Regulations**") issued by the Internal Revenue Service and the Department of the Treasury (collectively, the "**Treasury**") under Sections 951, 951A, 1502 and 6038 to implement the so-called "GILTI" provisions of the Code that were added by the legislation informally known as the Tax Cuts and Jobs Act of 2017 (the "**Act**").

We commend the Treasury for its efforts in providing substantial and timely guidance on the GILTI rules. These rules constitute some of the most far-reaching changes made in many years to the U.S. international tax system. The Proposed Regulations clearly represent the results of an enormous effort on the part of the Treasury, and they provide very helpful guidance to taxpayers on certain aspects of the GILTI rules.

This Report supplements our prior report submitted on May 4, 2018, which discussed certain significant issues arising from the Act's addition of the GILTI provisions to the Code. The prior report is attached for your reference. In this Report, we make recommendations on issues presented by the Proposed Regulations, and also restate certain recommendations from the Prior Report that were not adopted in the Proposed Regulations. Many of our comments relate to the various basis adjustment rules in the Proposed Regulations. We are concerned about the enormous complexity created by those rules.

We appreciate your consideration of our recommendations. If you have any questions or comments regarding this Report, please feel free to contact us and we will be glad to assist in any way.

Respectfully submitted,

Karen G. Sowell

Karen G. Sowell
Chair

Enclosure

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NEW YORK STATE BAR ASSOCIATION TAX SECTION

REPORT ON PROPOSED GILTI REGULATIONS

November 26, 2018

Table of Contents

I. Introduction

This Report[1] comments on proposed regulations (the "**Proposed Regulations**")[2] issued by the Internal Revenue Service (the "**IRS**") and the Department of the Treasury (collectively with the IRS, the "**Treasury**") to implement the so-called "GILTI" provisions of the Code. These provisions were added by the legislation informally known as the Tax Cuts and Jobs Act of 2017 (the "**Act**").[3] The Proposed Regulations were issued under Sections 951, 951A, 1502 and 6038.[4]

This Report supplements our prior report (the "**Prior Report**")[5] submitted on May 4, 2018, which discussed certain significant issues arising from the Act's addition of the GILTI provisions to the Code. We have attached the Prior Report as an Appendix hereto for ease of reference. In this Report, we make recommendations on issues presented by the Proposed Regulations, and also restate certain recommendations from the Prior Report that were not adopted in the Proposed Regulations. However, given the limited period of time available to comment on the Proposed Regulations, this Report is necessarily limited to issues that we have identified so far and that we believe to be most important. It is not intended as a complete list of issues raised by the Proposed Regulations.

In general, the discussion in this Report follows the order in which issues are presented by the Proposed Regulations. However, we discuss in a separate section of this Report certain provisions of the Proposed Regulations that relate to tax basis. While those provisions appear in different portions of the Proposed Regulations, they are intended to create a unified set of rules and are best evaluated based on the overall results that they reach.

We commend the Treasury for its efforts in providing substantial and timely guidance on the GILTI rules. These rules constitute some of the most far-reaching

[1] The principal authors of this report are Michael Schler and Andrew Davis. Helpful comments were received from Kim Blanchard, Micah Bloomfield, Andrew Braiterman, Jonathan Brenner, Marty Collins, Peter Connors, Charles Cope, Marc Countryman, Tim Devetski, Andrew Dubroff, Pamela Lawrence Endreny, Phillip Gall, Larry Garrett, Micah Gibson, Kevin Glenn, Edward Gonzalez, Andrew Herman, Brian Krause, Andrew Needham, Elena Romanova, David Schnabel, Eric Sloan, Karen Gilbreath Sowell, Chaim Stern, Ted Stotzer, Linda Swartz, Shun Tosaka, Dana Trier, Gordon Warnke and Bob Wilkerson. This report reflects solely the views of the Tax Section of the New York State Bar Association (***"NYSBA"***) and not those of the NYSBA Executive Committee or the House of Delegates.

[2] REG-104390-18, Federal Register Vol. 83, No. 196, October 10, 2018 (the "**Federal Register GILTI**") at 51072-51111.

[3] The Act is formally known as "*An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018*", P.L. 115-97.

[4] Unless otherwise stated, all "Code" and "Section" references are to the Internal Revenue Code of 1986, as amended.

[5] NYSBA Tax Section Report No. 1394, *Report on the GILTI Provisions of the Code* (May 4, 2018).

changes made in many years to the U.S. international tax system. The Proposed Regulations clearly represent the results of an enormous effort on the part of the Treasury, and they provide very helpful guidance to taxpayers on certain aspects of the GILTI rules.

We understand that subsequent proposed regulations will address the calculation of the foreign tax credit ("**FTC**") allowed to a U.S. shareholder ("**U.S. shareholder**")[6] of a controlled foreign corporation ("**CFC**")[7] under the GILTI rules. We do not address those issues in this Report, but will do so in a subsequent report after those proposed regulations are issued.

II. Summary of Principal Recommendations and Comments[8]

<u>Part III: Non-Basis Issues</u>

A. Proposed Regulation Section 1.951-1: Amounts Included in Gross Income of U.S. Shareholders

1. This Proposed Regulation generally relates to the allocation of Subpart F income and tested income among classes of stock of a CFC, based on a Hypothetical Distribution of such income. The broad language of the Anti-Avoidance Rule in this regulation should be narrowed so that it only covers the reallocation of the reported amount of Subpart F income or tested income among the U.S. shareholders actually owning Section 958(a) stock in the CFC. In addition, examples should be provided and certain types of transactions should generally be permissible under the Rule. If, contrary to our recommendation, a narrow interpretation of the Rule is rejected, the Rule should be moved elsewhere in the regulation and its scope should be clarified. Part III.A.2(a).

2. The Anti-Avoidance Rule should not allow the IRS to change the current effects of transactions that occurred before the general effective date of the final regulation, or possibly, in the case of Subpart F, that occurred before the date the Proposed Regulations were published. Moreover, if contrary to our recommendation a broad interpretation of the Rule is adopted, this interpretation should not apply under either Subpart F or GILTI to transactions that occurred before the date of publication of the Proposed Regulations (or arguably the date that final regulations are issued). Part III.A.2(a).

[6] A U.S. shareholder of a foreign corporation is a U.S. person that actually or constructively owns 10% or more of the vote or value of the stock in the corporation. Section 951(b). *See also* Prop. Reg. § 1.951-1(g)(1).

[7] A foreign corporation is a CFC for a taxable year if U.S. shareholders in the aggregate actually or constructively own stock with more than 50% of the total vote or value of its shares on any day during the taxable year. Section 957(a).

[8] All terms used herein are as defined in the body of this Report.

3. Clarification should be provided for the rule that in the Hypothetical Distribution of earnings with respect to shares of a CFC, no amount is treated as distributed in redemption of stock. Example 4 in Proposed Regulation Section 1.951-1(e)(7), which illustrates that provision, should be revised. Part III.A.2(b).

4. In the Hypothetical Distribution, the rule for discounting amounts allocable to dividends in arrears on preferred stock should be clarified. Part III.A.2(c).

5. We have no objection to the rule that a CFC could potentially allocate Subpart F income to holders of preferred stock at the same time it allocates tested loss to holders of common stock. Part III.A.2(d).

B. Proposed Regulation Section 1.951A-1: General Provisions

6. We urge an amendment to the statute to take account of QBAI, interest income, and interest expense in CFCs with tested losses. Part III.B.2(a).

7. The Proposed Regulations allow all interest income that is tested income to offset interest expense that would otherwise reduce DTIR, although the statute only allows such offset for interest income that is attributable to such interest expense. If the Treasury intends to adopt this rule in final regulations, it should consider whether an amendment to the statute to confirm this result would be helpful. Part III.B.2(a).

8. The Proposed Regulations do not change the statutory rule that interest expense paid to the U.S. shareholder counts as interest expense and reduces NDTIR even though it is fully taxed to the U.S. shareholder. If the Treasury does not believe it has the authority to change this result by regulation, we urge a statutory amendment to change it. Part III.B.2(a).

9. The Proposed Regulations state that a U.S. shareholder must include CFC tested items in the U.S. shareholder's tax year that includes the last day of the CFC's taxable year on which the CFC is a CFC. We believe that this rule is inconsistent with the Code, which refers to the U.S. shareholder's tax year that includes the last day of the tax year of the CFC (regardless of the date on which it ceased to be a CFC). We believe the final regulations should be conformed to the rule in the Code. Part III.B.2(b).

10. We believe the methods of allocating QBAI and tested losses in the Proposed Regulations are reasonable. If no class of stock has liquidation value, we recommend first allocating tested loss to any shareholders that have guaranteed debt of the CFC, and then to the most senior class of common stock, unless another class of stock will in fact bear the economic loss. Also, QBAI should be allocated to participating

preferred stock by bifurcating the stock into nonparticipating preferred stock and common stock. Part III.B.2(c).

C. Proposed Regulation Section 1.951A-2: Tested Income and Tested Loss

11. If the Proposed Regulations intend to adopt purely U.S. tax principles for determining tested income and loss of a CFC, as is stated in the Preamble, the reference in the Proposed Regulations to Treasury Regulation Section 1.952-2 should be modified. Part III.C.2(a).

12. As we stated in our Prior Report, we strongly believe that net operating losses should be allowed as a carryforward either at the CFC or shareholder levels. In addition, assuming future regulations state that Section 163(j) applies to CFCs, regulations should confirm that interest deductions deferred under Section 163(j) are not subject to any restrictions on loss carryovers, since the deductions are deemed to arise in future years. Part III.C.2(a).

13. Regulations should clarify whether certain other deductions disallowed to a domestic corporation are allowed to a CFC for GILTI purposes, and provide as complete a list as possible as to any variances between income for CFC and GILTI purposes and income for a domestic corporation. Part III.C.2(a).

14. The Proposed Regulations disallow a deduction or loss attributable to a basis increase that arises from transfers between related CFCs in the transition period. If this position will be adopted in final regulations, we suggest a statutory amendment to confirm the authority of the Treasury to issue such regulations. Regulations should also confirm the mechanics of the application of the rule in several respects, including how it applies in calculating gain on the sale of an asset. Part III.C.2(b).

15. We agree with the rule in the Proposed Regulations that tested income is determined without regard to the application of Section 952(c), and the example illustrating that rule. However, due to the ambiguity in the statute, the Treasury should consider whether an amendment to the statute to confirm this result would be helpful. Part III.C.2(c).

16. Regulations should confirm that a royalty deemed paid under Section 367(d) from a CFC to its U.S. shareholder can be deductible from tested income, and not only from Subpart F income. Part III.C.2(d).

D. Proposed Regulation Section 1.951A-3: QBAI

17. In calculating the tax basis of QBAI property, we urge reconsideration of the retroactive application of the ADS depreciation rules to property placed in service before enactment of the Act. Part III.D.2(a).

18. Regulations should confirm that the use of ADS for GILTI purposes, for

either new or preexisting assets, is not a change in method of accounting, or if it is a change in method, global approval should be given for such a change. Part III.D.2(a).

19. We have no objection to the anti-abuse rule that disregards QBAI created by intra-group transfers during the transition period.

20. A separate anti-abuse rule excludes assets from QBAI if they are held "temporarily" by a CFC. We believe that there should be a presumption that the rule does not apply if assets are held for a stated period of time (such as 2 or 3 years). We do not believe a period of time based on a percentage of the depreciable life of the asset would be appropriate. Part III.D.2(b).

21. Another anti-abuse rule excludes assets from QBAI if they are held for no more than one year and reduce a GILTI inclusion. We believe this rule should be changed into a presumption that a holding period of no more than a year has a principal purpose of tax avoidance. We suggest several factors that should be strong factors in overcoming the presumption. In addition, we believe that holding periods of related CFCs in an asset should be aggregated if there is no reduction in the GILTI inclusion as a result of transfers of the asset among the CFCs. Moreover, a consolidated group should be treated as a single entity for purposes of these rules. Part III.D.2(b).

E. Proposed Regulation Section 1.951A-4: Tested Interest Income and Expense

22. The Proposed Regulations expand the statutory reference to interest income and expense to include interest equivalents. To avoid whipsaw against the government, the Code should be amended to adopt these rules or to confirm the authority of the Treasury to issue these regulations. Part III.E.

F. Proposed Regulation Section 1.951A-5: Partnerships

23. As a policy matter, we prefer a pure aggregate approach for applying the GILTI rules to domestic partnerships. If the Treasury desires to implement such an approach but believes it does not have authority to do so by regulations, we urge it to request a statutory amendment to adopt this approach or to authorize regulations to do so. If a pure aggregate approach is adopted, generous grandfathering provisions should apply to allow existing foreign corporations that are treated as CFCs under the existing rules to continue to be so treated. Part III.F.2(a).

24. We discuss a number of problems that we see under the Proposed Regulations Hybrid Approach, and we suggest some methods under that approach for determining tax basis in a partnership, and in CFCs owned by a partnership. Part III.F.2(b).

25. If the Proposed Regulations Hybrid Approach is adopted, and a partnership does not provide for pro rata ownership of partnership capital and profits, regulations should clarify the manner in which a partner is determined to be a U.S.

shareholder of a CFC owned by the partnership. At a minimum, partnership level determinations should be binding on the partner. Part III.F.2(b)(iv).

26. We agree with the Treasury that the Pure Entity Approach should not be adopted. Part III.F.2(d).

27. If the Pure Aggregate Approach is not adopted, regulations could adopt either the Proposed Regulations Hybrid Approach or the Prior Report Hybrid Approach (as suggested in the Prior Report). We do not take a position as to which of these two approaches is preferable. The Proposed Regulations Hybrid Approach will be simpler for many partners in U.S. shareholder partnerships, but will be less fair to many such partners than the Prior Report Hybrid Approach. The Proposed Regulations Hybrid Approach also introduces complexities at the partnership level that are not present in the Prior Report Hybrid Approach. Part III.F.2(e).

28. Whatever approach is adopted, it is essential that the same rules apply for both the Subpart F and GILTI regimes. Regulations should also clarify that the rules at issue apply solely for purpose of calculating Subpart F and GILTI inclusions. Part III.F.2(e).

G. Proposed Regulation Section 1.1502-51: Consolidated Section 951A

29. We strongly commend the Treasury for applying single entity principles for calculating the GILTI inclusions in a consolidated group. Part III.G.1.

30. Future regulations under Section 250 and the FTC should likewise apply single entity principles for GILTI purposes to a consolidated group. Part III.G.2(a).

31. We support the rule in the Proposed Regulations that tested losses of CFCs of all group members are allocated proportionately to tested income of CFCs of all group members, without regard to the location of the different CFCs within the group. Part III.G.2(b).

Part IV: Basis Issues

A. Introduction

32. While we accept the desire of the Treasury to prevent what may be viewed as loss duplication, we suggest several arguments that Congress rather than the Treasury should adopt or authorize basis adjustment rules. If basis regulations are to be adopted, we prefer either of the two approaches described in Part IV.G. We believe those

approaches are simpler than the approach in the Proposed Regulations and generally achieve the goals of the Proposed Regulations in preventing loss duplication. Part IV.A.

B. Proposed Regulation Section 1.951A-6: The CFC Basis Reduction Rule

33. The CFC basis reduction rule reduces the tax basis of a CFC immediately before its sale by the net used tested loss amount of the CFC. If this rule or a similar rule will be retained in the final regulations, we suggest that the Treasury request a statutory amendment to confirm its authority to issue regulations to modify the basis rules of Section 961. In addition, to support the validity of the regulations under the Administrative Procedure Act, the preamble to the final regulations should (i) further explain the nature of the double tax benefit from a tested loss that the rule is designed to prevent, and (ii) if applicable in the final regulations, explain why the rule applies to all used tested losses without regard to whether a double tax benefit from the tested loss is obtained by the U.S. shareholder. Part IV.B.2(b).

34. We believe the CFC basis reduction rule should not apply if the U.S. shareholder can show that the tested loss will not as a factual matter result in a double tax benefit. A recapture rule could apply if a second tax benefit in fact arises in the future. A simpler version of the rule would also be possible. Second, further consideration should be given to a rule allowing a taxpayer to elect to waive all or part of the use of a tested loss, in which case the waived loss would not create a used tested loss for purposes of the rule. Part IV.B.2(c).

35. We believe that in applying the CFC basis reduction rule, the method of netting used tested loss amounts with offset tested income amounts in the Proposed Regulations is appropriate. Part IV.B.3(a).

36. Clarification should be provided concerning several aspects of the CFC basis reduction rule following the sale of stock of the U.S. shareholder of the CFC. Part IV.B.3(b).

37. Clarification should be provided concerning the extent to which the basis in the stock of a CFC is treated as reduced before its sale for purposes of allocating the interest expense of the U.S. shareholder to the CFC, for purposes of the NUBIG and NUBIL rules of Section 382, and for purposes of the basis reduction rule in Section 108(b). Part IV.B.3(c)(i)-(iii).

38. We do not believe the CFC basis reduction rule should be extended to a non-corporate shareholder of a CFC. Part IV.B.3(d).

39. The definition of "disposition", which triggers the CFC basis reduction rule, should include a Section 165(g) worthless stock deduction. We discuss, but do not take a position on, whether Sections 301(c)(2), 301(c)(3), and 1059 should apply to

distributions from a CFC by reference to the reduced basis of the CFC stock that would arise upon sale of the CFC. Part IV.B.3(e).

40. Regulations should clarify the effect of the CFC basis reduction rule in cases where there is a tax free transfer of the CFC but the rule will no longer apply by its terms, for example if the CFC is no longer a CFC after the transfer. Part IV.B.3(f).

41. Regulations should clarify the application of the CFC basis reduction rule in the case of certain Section 381 transactions. Part IV.B.3(g).

42. Regulations should confirm certain aspects of a rule that specially allocates Subpart F income that arises as a result of the CFC basis reduction rule when one CFC sells the stock of another CFC. Part IV.B.3(h).

43. Regulations should clarify the application of the CFC basis reduction rule when a domestic partnership sells stock of a CFC or a partner sells its interest in a domestic partnership holding a CFC. Part IV.B.3(i).

44. Regulations should provide relief from estimated tax penalties for taxes due as a result of the CFC basis reduction rule, for sales of CFCs prior to 30 days after finalization of the regulations. Part IV.B.3(j).

C. Proposed Regulation Section 1.1502-51: Basis Reduction for CFC Stock Held in a Group

45. Regulations should clarify whether the CFC basis reduction rule continues to apply to a member of a group that owns a CFC subject to that rule, after the member leaves the group and sells the CFC thereafter. We believe that the rule should continue to apply, and that the basis reduction should tier up in the new group (to match the increased gain resulting from the sale of the CFC in the new group). Part IV.C.2(b).

46. Regulations should clarify the results when stock of a CFC is sold from one member of the group to another member. Part IV.C.2(c).

47. The Proposed Regulations contain a special rule for consolidated groups that modifies the special allocation of Subpart F income resulting from the application of the CFC basis reduction rule when one CFC sells the stock of another CFC. We believe the special rule should be either eliminated or substantially revised. Part IV.C.2(d).

D. Proposed Regulation Section 1.1502-32: Upper Tier Basis Adjustments

48. We support the approach of the Proposed Regulations to immediately reduce the basis of the stock of a member holding stock in a CFC by the net used tested

loss amount in the CFC. Part IV.D.2(a). However, any exceptions that are added to the CFC basis reduction rule should also be incorporated into this rule. Part IV.D.2(b).

49. The Proposed Regulations offset the basis reduction in member stock if the CFC with the net used tested loss amount also has an offset tested income amount in a different year. We believe the Proposed Regulations should be revised to prevent duplication of the basis increase, once for the offset tested income amount and again for the dividend of the same amount, if the CFC pays a dividend eligible for Section 245A out of the offset tested income. Part IV.D.2(c).

50. We support the fact that a basis reduction in stock of a CFC under the CFC basis reduction rule is only offset by an offset tested income amount of the same CFC in a different year, as opposed to being offset by offset tested income of other CFCs owned by the same U.S. shareholder. Part IV.D.2(d).

51. The Proposed Regulations provide for a basis increase in member stock just before the member's sale of a CFC, to the extent the CFC has offset tested income and could have paid a dividend eligible for Section 245A. Regulations should clarify that this rule does not apply to the member if it joins a new group and then sells the CFC. Part IV.D.2(e).

52. Regulations should clarify the application of the consolidated return basis adjustment rules to stock of a member when the member is sold in the middle of the year. Part IV.D.2(f).

53. Regulations should illustrate the fact that the increase in basis in stock of a member for notional Section 245A dividends can not only reduce the taxable gain on the sale of the stock of the member, but also create or increase a tax loss, Part IV.D.2(g), and avoid the Section 961(d) loss disallowance rule, Part IV.D.2(h). In addition, regulations should clarify the exception to the basis increase rule for dividends that would not be eligible for Section 245A or would be subject to Section 1059, when the hypothetical dividend would be from a second tier CFC. Part IV.D.2(i). Finally, the regulation should be clarified to cover the case where the CFC in question has PTI. Part IV.D.2(j).

54. Regulations should confirm that a reduction in basis in a CFC under the CFC basis reduction rule does not tier up within a group (since there has already been a basis reduction in stock in the member). Part IV.D.2(k).

55. Regulations should clarify whether the reduction in a member's basis in the stock of another member on account of the latter's net used tested loss amount of a CFC reduces the e&p of the former member. Correspondingly, if no such reduction in e&p arises, regulations should confirm that there is no increase in the former member's

e&p on the disposition of the CFC as a result of the CFC basis reduction rule. Part IV.D.2(l).

56. Regulations should provide that in applying the loss duplication rules of -36(d) on the sale of stock of a member holding a CFC, the member's basis in the stock of the CFC should take account of the basis reduction that would arise on a sale of the CFC, and the selling shareholder's basis in the member stock should take account of the basis increase in member stock that would arise on the sale of the CFC. Part IV.D.2(n).

57. Likewise, in applying the loss disallowance rule of -36(c), the member's basis in a CFC should take account of the basis reduction that would arise on a sale of the CFC. Part IV.D.2(o).

58. Regulations should confirm that the attribute redetermination rules of the consolidated return regulations apply to the basis adjustment rules in the Proposed Regulations. Part IV.D.2(p).

59. We believe that a modification should be made to the Section 958 basis allocation rules in an internal spin-off to reflect the CFC basis reduction rule when the distributing or controlled corporation holds stock in a CFC with a net used tested loss amount. Part IV.D.2(q).

60. Final regulations should provide that, possibly subject to certain exceptions, there is no gain recognition when a member of a group is distributed in an external spin-off, and the gain would be triggered as the result of an ELA created by the upper tier basis reduction rule in -32. In addition, regulations should provide a rule for the case where boot to the distributing parent corporation exceeds the reduced, but not the unreduced, basis of the parent in the distributed corporation. Part IV.D.2(r).

E. Basis Issues in Intra-Group Reorganizations

61. The rule in -51 for nonrecognition transactions involving CFC stock among group members should be clarified to avoid a double basis reduction when there is an asset reorganization and one of the assets of the target corporation is CFC stock. Regulations should also clarify the effect of a tested loss in the year of the nonrecognition transaction. Part IV.E.2.

62. Revised Example 4 in -13(f)(7) should be further revised to prevent a double basis reduction from arising from an offset tested loss, as appears to occur in the example as written. Part IV.E.3.

F. General Basis Issues Under the Proposed Regulations

63. Regulations should determine the extent to which all shares of a CFC owned by a single U.S. shareholder are aggregated and treated as a single share, or else treated as separate shares with their own net used tested loss amounts and net offset

tested income amounts. We believe that all shares of a single class held by a single U.S. shareholder should be aggregated, with an anti-abuse rule for transactions in shares undertaken with a principal purpose of tax avoidance. We do not believe common stock and preferred stock held by a U.S. shareholder should be aggregated. Part IV.F.1.

64. The rules for basis adjustments in the Proposed Regulations are enormously complicated, and we acknowledge that some of our suggestions to make the rules work better as a technical matter and to grant taxpayer relief will make them even more complicated. We express our concern about the complexity of the rules, both in the corporate nonconsolidated and consolidated return contexts, and in the partnership context. Many taxpayers will have to deal with enormous complexity in making the necessary calculations, and the results will be difficult if not impossible for IRS revenue agents to audit. Part IV.F.2.

65. Consideration should be given to a broader reevaluation of the -32 basis adjustment rules to account for the fact that dividends from CFCs may now be eligible for Section 245A and will nevertheless give rise to a basis increase in the stock of the member receiving the dividend. Part IV.F.3.

G. Our Preferred Approaches to Avoid Loss Duplication

66. We believe that either of our two alternative approaches to basis reduction would be preferable to the approach in the Proposed Regulations. Under our preferred approach, a CFC with offset tested income would have its e&p reduced by the amount of its offset tested income, a CFC with used tested loss would have its e&p increased by such amount, and basis would shift from the stock of the tested loss CFC to the basis of the tested income CFC to the extent of the lesser of the existing basis of the tested loss CFC or the amount of the used tested loss. Alternatively, the e&p adjustments could be made without the basis shifts. Although these rules might require legislation and would raise their own complexities, we believe they would be simpler to administer than the existing proposed rules and would generally achieve the goals of the Proposed Regulations in preventing loss duplication. Part IV.G.

III. General Discussion and Recommendations

A. Proposed Regulation Section 1.951-1: Amounts Included in Gross Income of U.S. Shareholders

1. *Background*

Proposed Regulation Section 1.951-1(e) contains rules for determining a U.S. shareholder's pro rata share of a CFC's Subpart F income for a taxable year. These rules, subject to certain modifications, also govern the allocation of a CFC's tested income, tested loss, qualified business asset investment ("**QBAI**"), tested interest expense and tested interest income (each, a "**CFC tested item**"), all of which are components of the GILTI calculation.[9]

The Proposed Regulations require the allocation of Subpart F income among shareholders of a CFC based on how the CFC would distribute its current earnings and profits ("**e&p**") in a hypothetical distribution to its shareholders on the last day of the CFC's taxable year on which it is a CFC (the "**Hypothetical Distribution**").[10] In effect, each U.S. shareholder's percentage share of the CFC's Subpart F income is equal to the percentage of the CFC's current e&p that would be allocable to that U.S. shareholder in the Hypothetical Distribution. Current e&p for purposes of this calculation is the greater of (x) current e&p as determined under Section 964 and (y) the CFC's Subpart F income, increased by its tested losses (if any), plus the CFC's tested income.[11]

For purposes of the Hypothetical Distribution, distributions within each class of stock are assumed to be made pro rata with respect to each share of stock in that class.[12] Distributions between classes of stock are generally based on the "distribution rights of each class of stock on the hypothetical distribution date . . . taking into account all facts and circumstances related to the economic rights and interest" in current e&p of that class.[13] Certain legal rights, however, are limited or disregarded in calculating the Hypothetical Distribution, including (i) rights to redemption, (ii) dividends that accrue at less than the applicable federal rate ("**AFR**") and (iii) other restrictions and limitations on distributions.[14]

Finally, Proposed Regulation Section 1.951-1(e)(6) contains a broad anti-abuse rule (the "**Anti-Avoidance Rule**") that is headed "Transactions and arrangements with a principal of reducing pro rata shares."

2. *Comments*

(a) *The Anti-Avoidance Rule*

The Anti-Avoidance Rule states the following:

[9] Prop Reg. § 1.951A-1(d)(1).

[10] Prop Reg. § 1.951-1(e)(1)(i).

[11] Prop Reg. § 1.951-1(e)(1)(ii). References to e&p in this Report take these adjustments into account.

[12] Prop Reg. § 1.951-1(e)(2)-(3).

[13] Prop Reg. § 1.951-1(e)(3).

[14] *See* Prop Reg. § 1.951-1(e)(4)(i) (rights to redemption); Prop Reg. § 1.951-1(e)(4)(ii) (preferred stock with dividends accruing at less than AFR); Prop Reg. § 1.951-1(e)(5) (other restrictions and limitations on distributions).

> For purposes of this paragraph (e), any transaction or arrangement that is part of a plan a principal purpose of which is avoidance of Federal income taxation, including, but not limited to, a transaction or arrangement to reduce a United States shareholder's pro rata share of the subpart F income of a controlled foreign corporation, which transaction or arrangement would avoid Federal income taxation without regard to this paragraph (e)(6), is disregarded in determining such United States shareholder's pro rata share of the subpart F income of the corporation.[15]

The rule also applies for purposes of allocating CFC tested items under Proposed Regulation Section 1.951A-1(d), including allocations with respect to QBAI. There is no significant discussion of the rule in the preamble to the Proposed Regulations (the "**Preamble**"), and no example of the application or nonapplication of the rule in the Proposed Regulations.

The location of the Anti-Avoidance Rule in the Proposed Regulations, as well as the heading of the section,[16] suggests that it is intended to be limited to transactions or arrangements that distort allocations of a fixed amount of Subpart F income (or a CFC tested item) among CFC shareholders. Under this construction, the IRS's sole remedy for a breach of the rule would be to reallocate reported income among shareholders to eliminate the distortion created by the relevant transaction or arrangement. In other words, the IRS would not be able to challenge the aggregate amount of Subpart F income (or CFC tested item), but only the manner in which such amount is allocated. Similarly, under this interpretation, the rule would be limited to reallocations of income of the CFC among the *actual* Section 958(a) U.S. shareholders of the CFC. In particular, the rule would not allow the IRS to allege that a transfer of CFC stock by a U.S. shareholder to a related or unrelated third party had a principal purpose of the avoidance of tax, with the result that the income of the CFC should be allocated to the former shareholder (possibly forever). This interpretation of the rule is consistent with the heading of the rule quoted above, and the passing mention of the rule in the Preamble. We believe this is the appropriate scope of the rule.

However, the plain language of the Anti-Avoidance Rule arguably extends the rule much farther. The rule would disregard "any transaction or arrangement that is part of a plan a principal purpose of which is avoidance of Federal income taxation" in calculating a U.S. shareholder's share of a CFC's Subpart F income (or CFC tested item). This language can be interpreted to extend beyond transactions that affect the sharing of items among shareholders, to transactions that reduce the total amount of income that would be allocable by the CFC or that shift income allocations to new shareholders. For instance, the rule could apply to the purchase (rather than lease) of QBAI property by a

[15] Prop Reg. § 1.951-1(e)(6).

[16] *Cf*. Section 7806(b) (no inference to be drawn from the location of any section within the Code or descriptive matter relating thereto).

single CFC, or alternatively a CFC raising funds by a borrowing rather than by an equity contribution from its shareholders. In both cases, the result could be a reduction in the GILTI inclusion of the shareholders and thus "the avoidance of Federal income taxation" by the shareholders.

This broad construction of the rule makes it, in effect, a general anti-abuse rule for the entire Subpart F and GILTI regimes. Any transaction that had the effect of reducing a U.S. shareholder's Subpart F income or GILTI inclusion would be at risk, even if it would satisfy the economic substance doctrine[17] and other statutory and common law doctrines.

We believe that this interpretation is far too broad, and that Proposed Regulation Section 1.951-1(e)(6) should be limited to the potential reallocation of the reported amount of Subpart F income or tested income among the U.S. shareholders actually owning Section 958(a) stock in the CFC. If the IRS wishes to challenge the amount of reported income, it should be required to apply other rules, including the economic substance doctrine or other anti-abuse doctrines. Likewise, a transfer of CFC stock is already subject to the usual rules of tax ownership, and the results of the transfer are already subject to those other doctrines.

We acknowledge that the Treasury might have concerns about transfers of ownership, particularly among related parties, for the purpose of avoiding Subpart F or GILTI inclusions. Moreover, our proposed interpretation would preclude the Proposed Regulations from applying to such actions as the conversion of common stock of a CFC into convertible debt for purposes of avoiding GILTI inclusions. However, transfers of ownership among related parties (and conversions of equity into convertible debt) are accepted throughout the Code unless a specific statutory or common law anti-avoidance doctrine applies. We do not believe a special, broader anti-abuse rule should apply solely to transfers of equity in a CFC for purposes of allocating CFC income under the Subpart F and GILTI regimes.

If the narrow interpretation of the rule is intended, Proposed Regulation Section 1.951-1(e)(6) should be clarified accordingly. Examples should also be provided to illustrate transactions that would and would not be disregarded under the rule. In particular, we believe that if some shareholders of a CFC are issued common stock and others are issued preferred stock, absent unusual circumstances and assuming material economic difference between the two classes, the resulting allocations of income to the two classes should be respected even if there was a partial tax motivation for issuance of the two classes.[18]

[17] *See* Section 7701(o).

[18] Likewise, we do not believe the Proposed Regulations should apply to mid-year sales of CFC stock with an alleged principal purpose of avoiding tax on the seller's share of Subpart F or tested income for the year of sale. *See* Prior Report at 50-58. This is a mechanical problem that should be fixed, if desired by the Treasury, by a specific regulation or statutory change applicable to all taxpayers, rather than by an anti-

If, contrary to our recommendation, this narrow scope of the Anti-Avoidance Rule is rejected by the Treasury, and the broader interpretation is adopted, the rule should be moved to a separate section of the final regulations, and its scope should be clarified.

Finally, the Proposed Regulations would have the final regulation apply on January 1, 2018, for calendar year taxpayers.[19] Regardless of the ultimate scope of the final regulation, this rule should be clarified to state whether a transaction occurring before the effective date can potentially be a tax avoidance transaction that is disregarded in a taxable year to which the regulation applies. If so, a transaction that occurred decades ago with a purpose of avoiding Subpart F income (and that heretofore was considered to be effective in doing so) could be disregarded at all times in the future. We do not believe this degree of retroactivity is reasonable (or likely intended).

Thus, even if the narrow interpretation of the regulation is adopted, we believe the final regulation should not apply to transactions occurring before the general effective date of the final regulation. In fact, this issue should not arise to a material degree under GILTI, because there could not have been an intent to avoid the GILTI regime much before the date of enactment of the Act. As to the application of the narrow rule to Subpart F, the regulation could apply to transactions before the date of publication of the Proposed Regulations only if the regulation qualified under Section 7805(b)(3) as a regulation to prevent abuse. However, few if any Treasury Regulations have been issued in reliance on this provision, and we question whether this regulation is critical enough to justify its application to transactions before the date the Proposed Regulations were published.

Moreover, if the broader interpretation of the Proposed Regulations is adopted, the result will be rules that taxpayers could not reasonably have predicted from the language of the Act. We acknowledge that Section 7805(b)(2) authorizes regulations under the Act to be retroactive to the date of enactment if they are issued within 18 months of enactment, and as noted above Section 7805(b)(3) authorizes retroactive regulations to prevent abuse. However, taxpayers who believed that they had satisfied the existing anti-abuse rules at the time of their transaction should not retroactively be potentially subject to a new, much broader, anti-abuse rule. As a result, if the broader interpretation of the Proposed Regulations is adopted, we do not believe it should apply to transactions that occurred before the date of publication of the Proposed Regulations. Moreover, given the novelty and uncertainty concerning such a broad interpretation, arguably it should not apply to transactions occurring before the date the regulations are finalized.

abuse rule that depends on the motive for a sale. *See, e.g.*, Section 1377(a)(1) (taxing a shareholder of an S corporation on its pro rata share of income of the S corporation for its entire taxable year, without regard to ownership of the stock on any particular day during the year).

[19] Prop. Reg. § 1.951-1(i).

(b) *Hypothetical Redeeming Distributions*

Proposed Regulation Section 1.951-1(e)(4)(i) states that, in the Hypothetical Distribution, no amount of current e&p shall be treated as being distributed in redemption of stock (whether or not such a distribution would be treated as a dividend under Section 302(d)), in liquidation, or as a return of capital. This rule limits the general rule of paragraph (e)(3), which requires the taxpayer to take into account all facts and circumstances in determining how the Hypothetical Distribution would be allocated between classes of stock. The following example (Example 4 in Proposed Regulation Section 1.951-1(e)(7)) applies this provision:

> **Example 1.** *Hypothetical redeeming distributions.* FC1 has outstanding 40 shares of common stock and 10 shares of 4% nonparticipating, voting preferred stock with a par value of $50x per share. Pursuant to the terms of the preferred stock, FC1 has the right to redeem at any time, in whole or in part, the preferred stock. FC2 owns all of the preferred shares. USP1, wholly owned by FC2, owns all of the common shares. For Year 1, FC1 has $100x of e&p and $100x of Subpart F income within the meaning of Section 952. In Year 1, FC1 distributes as a dividend $20x to FC2 with respect to FC2's preferred shares.
>
> **Analysis.** If FC1 were treated as having redeemed any preferred shares, the redemption would be treated as a distribution to which Section 301 applies under Section 302(d) due to FC2's constructive ownership of the common shares. However, under paragraph (e)(4)(i) of this section, no amount of e&p is distributed in the Hypothetical Distribution to the preferred shareholders on the date of the Hypothetical Distribution as a result of FC1's right to redeem, in whole or in part, the preferred shares. FC1's redemption rights with respect to the preferred shares cannot affect the distribution of current e&p in the Hypothetical Distribution to FC1's shareholders. As a result, the amount of FC1's current e&p distributed in the Hypothetical Distribution with respect to FC2's preferred shares is $20x and with respect to USP1's common shares is $80x. Accordingly, under paragraph (e)(1) of this section, USP1's pro rata share of FC1's Subpart F income is $80x for Year 1.

Presumably, paragraph (e)(4)(i) is intended to preclude FC1 from allocating any e&p to FC2's preferred shares in the Hypothetical Distribution based on their redemption right. Under the facts of the example, allocating Subpart F income with respect to the preferred stock's redemption right would allow such income to escape U.S. taxation.

We find Proposed Regulation Section 1.951-1(e)(4) and the accompanying example puzzling. As an initial matter, the Hypothetical Distribution involves a distribution of current e&p, which is specially defined as the greater of normal e&p or Subpart F income plus tested income. Given this definition, it is difficult to see how any such distribution (other than a distribution in redemption of stock) could be a return of capital.

Furthermore, to the extent paragraph (e)(4)(i) is intended to limit the broad scope of paragraph (e)(3), the example's facts are not relevant to that provision. The example states that a distribution in redemption would be treated as a dividend for tax purposes under Section 302(d). Yet nowhere in paragraph (e)(1) or (e)(3) are the tax consequences of a distribution treated as relevant under the Hypothetical Distribution. Similarly, the example states that $20x is actually distributed as a dividend to FC2 even though (e)(1) provides that the Hypothetical Distribution does not take into account actual distributions during the year. This is again not relevant to the issue of whether the redemption right has consequences for purposes of the Hypothetical Distribution.

The example may have been intended to illustrate the different point, stated in paragraph (e)(4)(i), that allocations under the Hypothetical Distribution are to be made without regard to the fact that (i) if such a distribution was actually made, the CFC would have chosen to (or been required to) use part of the cash to redeem some of its stock, and (ii) such a redemption of stock might have been a dividend for tax purposes. We believe the example would better illustrate the concerns of (e)(4)(i) if it involved either this fact pattern or an actual redemption of stock.

(c) *Preferred Stock with Low Dividend Rate*

Proposed Regulation Section 1.951-1(e)(4)(ii) provides a special rule applicable to CFCs with a class of redeemable preferred stock with cumulative dividend rights and dividend arrearages that do not compound at least annually "at a rate that equals or exceeds the applicable Federal rate" under Section 1274(d)(1). For such a class of preferred stock, the amount of the CFC's current e&p distributed to it in the Hypothetical Distribution may not exceed the amount of dividends actually paid during the taxable year with respect to that class of stock, plus the current present value of the unpaid current dividends of that class. Paragraph (e)(4)(ii) specifies that, for purposes of determining this present value, the currently unpaid dividends should be discounted to the current time by the AFR "that applies on the date the stock is issued", assuming the dividends are paid at the mandatory redemption date.

The beginning of paragraph (e)(4)(ii) is unclear as to which AFR governs for purposes of triggering the requirement to discount future dividends. We suggest clarifying, consistent with the remainder of the provision, that the relevant AFR is the "AFR that applies on the date the stock is issued for the term from such issue date to the mandatory redemption date." While the use of the current AFR would be more economically correct, it would make no sense to initially test the need to discount future payments at a different rate than the rate actually used to discount those payments if the requirement to discount is triggered.

(d) *Allocations of Subpart F Income and Tested Loss*

Under the Proposed Regulations, Subpart F income is allocated independently of tested income/loss in the Hypothetical Distribution. As a result, a CFC could potentially allocate Subpart F income to preferred shareholders while allocating tested loss to common shareholders.

Consider the following example (based on Example 7 in Proposed Regulation Section 1.951-1(e)(7)):

> **Example 2.** *Allocations of Subpart F income and tested loss*. Assume that USP1 owns all the common stock of FC1, and USP2 owns all the preferred stock with an annual accrual of dividends of $1,200 and no dividend arrearages. For Year 1, FC1 has $8,000 of e&p, $10,000 of Subpart F income, and $2,000 of tested loss. FC1's current e&p is $10,000, the greater of the e&p of FC1 determined under Section 964 ($8,000) or the sum of its Subpart F income and tested income ($10,000). Accordingly, for Year 1, FC1 allocates USP1 $8,800 of Subpart F income and USP2 $1,200 of Subpart F income. Under Proposed Regulation Section 1.951A-1(d)(4)(i), FC1's $2,000 tested loss is allocated to USP1's common shares to the extent they have positive value.

Under Section 951(c)(2)(B)(ii), the Subpart F income must be taxable to FC1's shareholders notwithstanding the tested loss. Logically, this income should be allocated to USP2, the preferred stockholder, up to its preference. The question then is whether the tested loss should simply be allocated to USP1, the common stockholder, or instead be allocated to USP2 to the extent of its Subpart F income and then to USP1.

We have no objection to the approach in the Proposed Regulations. Arguably, it is less economically correct than first allocating tested losses to USP2 to match its Subpart F income. Indeed, on different numbers, FC1 could allocate $1,200 of Subpart F income to preferred stockholders and $1,200 of tested loss to common holders, even though it has no net e&p. But the approach adopted by the Proposed Regulations is simpler, and preferred stockholders would generally not expect to be allocated tested losses from a CFC until theirs is the only capital remaining. Moreover, there is currently no provision in the Proposed Regulations that would ensure that, if the rules first allocated tested loss to USP2 to the extent of its Subpart F allocations, there would be a corresponding "catch up" allocation of tested income in future periods to USP2 to reflect FC1's actual payment of a dividend to USP2. Thus, absent further changes in the regulations, an alternative approach could result in USP2 receiving no net income allocation even though it received a $1,200 dividend in year 1.

B. Proposed Regulation Section 1.951A-1: General Provisions

1. *Background*

Proposed Regulation Section 1.951A-1 sets out general provisions governing the calculation of a U.S. shareholder's yearly GILTI inclusion (the "**GILTI inclusion amount**").[20] A "**CFC inclusion year**" is any taxable year of a foreign corporation at any time during which it is a CFC, and the "**CFC inclusion date**" is the last day of a CFC inclusion year on which the foreign corporation is a CFC. The GILTI inclusion amount is included in the gross income of the shareholder in the shareholder's "**U.S. shareholder inclusion year**," which is the taxable year of the U.S. shareholder that includes the CFC inclusion date.

The GILTI inclusion amount, with respect to a U.S. shareholder for a U.S. shareholder inclusion year, is the excess (if any) of its "net CFC tested income" for the year, over its "**net deemed tangible income return**" (or "**NDTIR**") for the year. A U.S. shareholder's "**net CFC tested income**" is the excess, if any, of (x) the aggregate of such U.S. shareholder's pro rata share of the tested income of each of its CFCs with tested income for the year ("**tested income CFCs**"), over (y) the aggregate of such U.S. shareholder's pro rata share of the tested loss of each of its CFCs with a tested loss for the year ("**tested loss CFCs**").[21]

"**NDTIR**" is the excess, if any, of the U.S. shareholder's "**deemed tangible income return**" ("**DTIR**"), or 10% of the aggregate of such U.S. shareholder's pro rata share of QBAI of each tested income CFC for the year, over the U.S. shareholder's "**specified interest expense**" for the year. Specified interest expense is defined as the excess, if any, of the U.S. shareholder's pro rata share of the tested interest expense of each of its CFCs, over such U.S. shareholder's pro rata share of the tested interest income of each of its CFCs.

Paragraph (d) provides that, subject to certain exclusions, CFC tested items will be allocable to shareholders consistent with the rules applicable to Subpart F income.[22]

2. *Comments*

(a) *Interest Expense and Interest Income*

[20] Prop Reg. § 1.951A-1(c)(1).

[21] Prop Reg. § 1.951A-1(c)(2).

[22] Prop Reg. § 1.951A-1(d)(1). Specific rules apply for allocations of the various CFC tested items. *See* Prop Reg. § 1.951A-1(d)(2) (tested income); Prop Reg. § 1.951A-1(d)(3) (QBAI); Prop Reg. § 1.951A-1(d)(4) (tested loss); Prop Reg. § 1.951A-1(d)(5) (tested interest expense); Prop Reg. § 1.951A-1(d)(6) (tested interest income).

We note first that the interest expense of tested loss CFCs is included in the calculation of specified interest expense and therefore reduces NDTIR, even though the QBAI of tested loss CFCs is disregarded in calculating NDTIR. This result is especially burdensome and unfair to taxpayers when the tested loss CFC has both specified interest expense and QBAI. In that case, the interest expense reduces the benefit of QBAI in tested income CFCs and the taxpayer gets no benefit for the QBAI in the tested loss CFC. However, as discussed in the Prior Report,[23] this result is consistent with the statute and the conference agreement. The Preamble confirms that the adoption of this approach in the Proposed Regulations is intentional.[24] Nevertheless, given the unfairness of the rule, if the Treasury does not feel it can change this result by regulations, we urge it to request an amendment to the statute to take account of both QBAI and interest income and expense in tested loss CFCs.[25]

Second, Section 951A(b)(2)(B) reduces DTIR of a U.S. shareholder by interest expense that reduces tested income (or increases tested loss) of the shareholder, except to the extent interest income "attributable" to that expense is included in tested income of the U.S. shareholder. At a minimum, this means that if a CFC pays interest to anyone, the interest expense would generally be specified interest that reduces NDTIR, but if the interest is paid to a CFC that has the same shareholder, so that it increases the tested income from that CFC allocated to the same shareholder, then the interest expense is not specified interest and does not reduce the shareholder's NDTIR. This rule makes sense because there is no net tax benefit to the shareholder from the interest expense so there is no logical reason to reduce the shareholder's NDTIR by the expense.

However, Proposed Regulation Section 1.951A-1(c)(3)(iii) is more favorable to taxpayers. It provides that specified interest expense is reduced by *all* interest income included in the tested income of the U.S. shareholder (subject to certain exceptions), even if earned from unrelated parties. In particular, there is no requirement of any connection between the interest expense and interest income in order for the exclusion from specified interest expense to apply. Accordingly, if a U.S. shareholder has a CFC that pays $100x of interest to a third party, and another CFC that receives $100x of interest from a different third party that is included in tested income, the shareholder will have $0 of specified interest expense, even if the interest income is plainly not related in any way to the interest expense.

This result arguably makes sense as a policy matter. It appears that the purpose of the rule for specified interest expense is that debt-financed assets should not count as QBAI, with "first dollars" of debt being allocated to QBAI. Since money is fungible, it

[23] *See* Prior Report at 62.

[24] *See* Federal Register GILTI at 51078-79.

[25] Merely disregarding interest expense in tested loss CFCs would allow tested loss CFCs to borrow and cause the proceeds to be used to purchase QBAI in tested income CFCs, with no reduction in DTIR for the interest expense on the borrowing.

can be argued that the appropriate measure of debt-financing for QBAI would be the net debt of all the shareholder's CFCs, or net interest expense of those CFCs, rather than gross interest expense paid to unrelated parties. (On the other hand, it can also be argued that a CFC by CFC approach, except for debt between CFCs, as provided in the statute also makes sense.) The Preamble further justifies the result in the Proposed Regulations on the ground that a requirement to trace interest income to interest expense would be administratively burdensome, especially if different CFCs are held by different U.S. shareholders.[26]

Nevertheless, it is not the most natural reading of the statute to say that all interest income is "attributable to" all interest expense. If that was the intent, the statute normally would have been written differently. Therefore, if the Treasury intends to adopt this rule in final regulations, it should consider whether an amendment to the statute to confirm this result would be helpful.[27]

Third, we have considered the treatment under the Proposed Regulations of interest expense paid by a CFC to its U.S. shareholder. Consider the following example:

> **Example 3.** *Interest on debt to U.S. shareholder.* USP owns all the stock of CFC1. At the beginning of Year 1, USP loans $100 to CFC1 at an interest rate of 10%. In Year 1, assume CFC1 has $100 of gross tested income, $90 of DTIR, and $10 of interest expense on the loan from USP. USP will have net CFC tested income of $90 and NDTIR of $80, resulting in a GILTI inclusion amount of $10. USP will also have $10 of interest income attributable to the loan.

The interest expense paid by CFC1 to USP reduces DTIR, even though USP includes it in its gross income. Both the narrow and the broad versions of the rule in the preceding section prevents a reduction in DTIR when the interest expense gives rise to interest income that is included in tested income of another CFC of the shareholder.

Here, the interest expense gives rise to interest income that is directly taxed to the U.S. shareholder at a 21% rate rather than the 10.5% rate for tested income of another CFC, with the deduction being at the 10.5% rate in either case. Nevertheless, the relief granted from reduction in NDTIR when the interest is paid to a sister CFC does not apply when the interest is paid to USP. The result is an additional GILTI inclusion equal to the amount of interest expense. The same results would apply if the interest income were paid to a sister CFC that reported the interest income as Subpart F income, with the U.S. shareholder paying tax on that income at a 21% rate, since the exclusion from reduction in NDTIR only applies to interest income included in tested income under GILTI.

[26] Federal Register GILTI at 51078.

[27] While the proposed rule is generally pro-taxpayer, it could adversely affect a taxpayer if a higher GILTI inclusion would be sheltered by FTCs and yet would result in a higher tax basis in the CFC.

These results are not logical. The statute clearly contemplates that interest paid by a CFC to a sister CFC and taxed as tested income to the U.S. shareholder does not reduce NDTIR. Given that rule, there is no good reason for interest expense to reduce NDTIR if it is paid directly by the CFC to the U.S. shareholder and taxed at regular rates, or paid to a sister CFC and taxed as Subpart F income to the U.S. shareholder at regular rates. While we understand the constraints of the statute, the Treasury took a liberal interpretation of the statute in the related interpretation discussed above. If the Treasury does not believe it has the authority to adopt these positions by regulation, we urge a statutory amendment to avoid a reduction in NDTIR for interest expense of a CFC when the related interest income is included in the income of the U.S. shareholder (directly or as Subpart F income) at regular tax rates. We note that in the case of interest paid directly to the U.S. shareholder by a CFC (the fact pattern that will arise in the great majority of cases), the tracing of interest income and expense should be relatively simple.

(b) *Taxable Year of GILTI Inclusion*

As described above, a U.S. shareholder must include CFC tested items for a given CFC inclusion year in the U.S. shareholder inclusion year that includes the CFC inclusion date, which is the last date during the CFC inclusion year that the foreign corporation is a CFC.[28] Consider the following example:

> **Example 4.** *Timing of GILTI inclusion.* USP, a calendar-year taxpayer, owns all of the stock of CFC1, a June 30 taxpayer. On December 31, 2018, USP sells all the stock (or 51% of the stock) of CFC1 to FC, an unrelated foreign corporation, at which point CFC1 ceases to be a CFC. The CFC inclusion year is the CFC tax year ending on June 30, 2019, and the CFC inclusion date is December 31, 2018. Thus, USP must include its share of the CFC tested items of CFC1 for the 2019 CFC inclusion year of CFC1 on its 2018 tax return.

As an initial matter, we note that this timing rule is inconsistent with Section 951A(e)(1), which states that the pro rata share of tested income is taken into account "in the taxable year of the United States shareholder in which or with which the taxable year of the controlled corporation ends." This reference is to the taxable year of the U.S. shareholder that includes the last day of the CFC inclusion year, not the year that includes the CFC inclusion date as in the Proposed Regulations. Moreover, the statute here is the same as has long been applicable to Subpart F income under Section 951(a)(1) and Treasury Regulation Section 1.951-1(a)(2).[29] The Preamble contains no explanation for the Proposed Regulations' divergence from the statute on this point.

[28] Prop Reg. §§ 1.951A-1(b), (e)(4).

[29] The same rule applies to the inclusion of income by a shareholder of a "qualified electing fund" under the PFIC rules. Section 1293(a)(2).

On the facts of Example 4, the statute would require USP to reflect the CFC tested items of CFC1 on its 2019 tax return, not its 2018 tax return as in the Proposed Regulations. Consider an even more extreme example:

> **Example 5.** *Close of CFC inclusion year after filing date.* USP, a calendar-year taxpayer, owns all of the stock of CFC1, a November 30 taxpayer. USP sells the stock of CFC1 to FC, an unrelated foreign corporation, on December 31, 2018, at which point CFC1 ceases to be a CFC. The CFC inclusion date is December 31, 2018, and USP must include its share of the CFC tested items of CFC1 for CFC1's year ending November 30, 2019, on USP's 2018 tax return.

Under these facts, the Proposed Regulations would require USP to file its 2018 tax return taking into account the CFC tested items of CFC1 for CFC1's taxable year ending November 30, 2019, even though that date is after the due date for USP's 2018 tax return.

We urge that final regulations adopt a rule that the "CFC inclusion date" is the last day of the CFC inclusion year, rather than the last date in the CFC inclusion year that the foreign corporation is a CFC. Such a rule is necessary for the regulations to be consistent with the language of the GILTI provisions of the Code as well as with the preexisting Subpart F rules, which are not changed by the Act or the Proposed Regulations. If a CFC has both Subpart F income and tested income in the same taxable year of the CFC, it would not be logical for the Subpart F income and tested income to be included in different taxable years of the U.S. shareholder.

Practical reasons also support this conclusion. The determination of a U.S. shareholder's GILTI inclusion amount depends on the tested income, tested loss, interest income, interest expense and QBAI of the CFC for the entire CFC inclusion year. These items are not known or even knowable on the CFC inclusion date (as it is defined in the Proposed Regulations), because they depend on events that occur through the end of the CFC inclusion year. It is not logical to require a U.S. shareholder to report income on a tax return for a taxable period that ends before the amount of income allocable to the taxable period can be determined. It is also difficult to see the policy justification for this result, since the "all events' test" is not satisfied until all the CFC tested items are determinable on the last day of the CFC inclusion year.

Moreover, a U.S. shareholder may not even know until the end of the CFC inclusion year whether it was a U.S. shareholder on the CFC inclusion date. Consider the following example:

> **Example 6.** *Inability to determine U.S. shareholder status as of CFC inclusion date.* Assume the same facts as Example 4, but that FC sells the stock of CFC1 to USP2, an unrelated U.S. corporation, on June 29, 2019. Under the Proposed Regulations, the CFC inclusion date is now June 30, 2019. Thus, USP2 must include its share of the CFC tested items of CFC1

> on its 2019 tax return, rather than USP including its share of those items on its 2018 tax return.

In fact, absent a narrowing of the current ownership attribution rules, this same result would arise if FC retained the stock of CFC1, did not have a U.S. subsidiary on December 31, 2018, and first formed a U.S. subsidiary on June 29, 2019. At that point, because of constructive ownership of 100% of CFC1 by the new U.S. subsidiary,[30] CFC1 would again become a CFC and the CFC inclusion date would be June 30, 2019. Here, USP is relieved of any obligation to report its share of tested income of CFC1 even though there is no U.S. shareholder with Section 958(a) ownership on the CFC inclusion date to report such income.

Accordingly, even an all-knowing USP will not be able to know for sure whether it was a U.S. shareholder of CFC1 on the CFC inclusion date until the last day of the taxable year of CFC1. USP must "wait and see" until the end of the CFC inclusion year to determine not only the components of its GILTI inclusion amount, but also whether it needs to perform any calculation in the first place.

We note that the pro rata share of the tested income of a CFC for a CFC inclusion year to be allocated to a U.S. shareholder is based on the U.S. shareholder's stock ownership on the CFC inclusion date.[31] However, while this rule is necessary to determine the *pro rata amount* to be allocated to the U.S. shareholder that has sold its stock on that date, this is not relevant for determining the *timing* of the inclusion to the U.S. shareholder.

In addition, the Proposed Regulations should be clarified in one respect. Proposed Regulation Section 1.951A-1(c)(2) defines net CFC tested income as the aggregate of the U.S. shareholder's pro rata share of the tested income of each tested income CFC "for the year." The only year that is referred to in this subsection is the "U.S. shareholder inclusion year." However, tested income is a CFC-level concept, and the reference should be to the CFC inclusion year that includes the CFC inclusion date that is within such U.S. shareholder inclusion year. Similar ambiguities exist in paragraphs (c)(3)(ii) and (iii).

(c) *Allocations of QBAI and Tested Loss*

The Preamble requests comments on "proposed approaches for determining a U.S. shareholder's pro rata share of a CFC's QBAI and tested loss, including how (or

[30] Sections 958(b), 318(a)(3)(C).

[31] Prop. Reg. § 1.951A-1(d)(1). The same rule applies under Subpart F, see Section 951(a)(2)(A).

whether) to allocate tested loss of a CFC when no class of CFC stock has positive liquidation value."[32] We offer several comments on this topic.

First, Proposed Regulation Section 1.951A-1(d)(3) currently allocates QBAI of a tested income CFC in proportion to the allocation of tested income until the amount of QBAI is equal to ten times tested income (i.e., the point where DTIR attributable to the tested income fully offsets the CFC's tested income). Any remaining QBAI ("**excess QBAI**") is allocated solely to common shares (and not to preferred shares). In effect, this rule ensures that preferred shareholders do not receive QBAI that can be used to shelter tested income allocated to them from other CFCs.

We believe this method of allocation is reasonable. Preferred shareholders have a debt-like claim on the CFC and should not receive tax benefits that could, in effect, create a negative tax rate on their fixed allocation of income from a CFC.

Note, however, that this rule can sometimes create extreme results. Consider the following example:

> **Example 7.** *Excess QBAI.* USP1 owns all the common stock of CFC1, and USP2 owns all the preferred stock with a par value of $10,000 and a dividend of 10%. In year 1, CFC1 has $100 of current e&p and tested income, and $10,000 of QBAI. All $100 of CFC1's current e&p is distributed on the preferred shares in the Hypothetical Distribution, so USP2 is allocated all $100 of CFC1's tested income. Under paragraph (d)(3), CFC1 allocates to USP2 the first $1000 of QBAI; the remaining $9000 of QBAI is allocated to USP1.

Given CFC1's small amount of tested income, it allocates the vast majority of its QBAI to USP1, the holder of its common stock. This disproportionate allocation will partially be reversed in future years to the extent there is sufficient tested income in those years, since that tested income will be allocated to the arrearages on the preferred stock in the Hypothetical Distribution[33] and will bring with it a proportionate share of QBAI for those years. In this sense, the Proposed Regulations pair QBAI and tested income allocations to preferred stock as much as possible, without creating an excess allocation of QBAI in Year 1 that may or may not be used. Moreover, absent a cap on the amount of QBAI allocated to preferred stock, it would be necessary to adopt an offsetting reduction in the QBAI allocated to preferred holders in a later year, to ensure such holders do not doubly benefit when there is tested income that will permit QBAI to be used.

[32] Federal Register GILTI at 51074.

[33] Under Prop. Reg. § 1.951-1(e)(4)(iii), such catch-up allocations of tested income only arise to the extent a dividend arrearage exceeds accumulated e&p of the CFC on the date the preferred stock was issued (or December 31, 1962, if later).

Second, we believe that the allocation method for tested losses in Proposed Regulation Section 1.951A-1(d)(4)(i)(C) is also logical. A CFC's tested losses are allocated based on a Hypothetical Distribution of e&p equal to the amount of tested loss but, subject to two exceptions, only to the common shareholders. When the common stock has no liquidation value, paragraph -1(d)(4)(iii) allocates tested loss to classes of stock with liquidation value, the most junior first. In addition, paragraph (d)(4)(ii) allocates tested loss to preferred shares to the extent the tested loss reduces the e&p accumulated since the issuance of those preferred shares to an amount below the amount necessary to satisfy any accrued but unpaid dividends with respect to such preferred shares.

These results seem appropriate since they reflect the economic burden borne by the different classes of stock as a result of the tested loss.

Third, if no class of stock has positive liquidation value, the loss will likely be borne by creditors. We recommend first allocating tested loss to any shareholders that have guaranteed the debt. Then, it seems most logical to allocate any remaining tested loss to the most senior class of common stock, since that class has the most to lose from the equity becoming more and more negative (except for preferred stock, but it does not seem logical to allocate losses to them in excess of their liquidation right and accrued dividends). An exception should be made if it can be demonstrated that another class of stock will in fact bear the economic loss.

Fourth, the Proposed Regulations should be revised to provide a rule for the allocation of QBAI with respect to convertible preferred stock or participating preferred stock. This is stock that has a fixed dividend and minimum liquidation value, but participates in increases in value above a stated floor in a manner comparable to common stock. Logically, this stock should be bifurcated into preferred stock (to the extent of the fixed dividend and liquidation right) and common stock (to the extent that the participation right is "in the money"), and QBAI should be allocated to each piece separately. For example, the 10x limit should apply to the fixed portion of the preferred stock, and the excess QBAI should be allocated to both the regular common stock and the participating portion of the preferred stock.

C. Proposed Regulation Section 1.951A-2: Tested Income and Tested Loss

1. *Background*

Proposed Regulation Section 1.951A-2 contains rules relating to the determination of tested income and tested loss of a CFC. Paragraph (b)(1) defines "**tested income**" as a CFC's gross tested income (as defined below) for a CFC inclusion year, over allowable deductions (including taxes) that are properly allocable to the CFC's gross tested income for that CFC inclusion year. Paragraph (b)(2) defines "**tested loss**" as the reverse of tested income (i.e., such allowable deductions over gross tested income).

Consistent with Section 951A(c)(2)(A), paragraph (c) defines "**gross tested income**" as the gross income of the CFC for the CFC inclusion year without regard to certain items, including (i) effectively connected income, (ii) Subpart F income, (iii) income that would be Subpart F income but is excluded under the "high tax" exception of Section 954(b)(4) and Treasury Regulation Section 1.954-1(d), (iv) dividends received by the CFC from related parties and (v) foreign oil and gas extraction income (as defined under Section 907(c)(1)).

Tested income and tested loss are calculated in a manner consistent with Treasury Regulation Section 1.952-2, which governs the calculation of a CFC's Subpart F income.[34]

2. *Comments*

(a) *Application of Treasury Regulation Section 1.952-2*

The Treasury has requested comments on the proposed application of rules under Treasury Regulation Section 1.952-2 for purposes of determining Subpart F income, tested income and tested loss.[35]

As noted in the Preamble, Treasury Regulation Section 1.952-2 generally requires that tested income or tested loss of a CFC be determined by treating the CFC as a domestic corporation taxable under Section 11 and by applying the principles of Section 61 and the regulations thereunder.[36] That being said, as discussed in the Prior Report, Treasury Regulation Section 1.952-2 effectively adopts GAAP principles unless those principles would have a "material effect" as compared to the calculation under U.S. tax principles.[37] If the intent of the Proposed Regulations is to adopt pure U.S. tax principles, the reference to Treasury Regulation Section 1.952-2 should be modified.

The Treasury has also requested comments on other approaches for determining tested income or tested loss, including whether additional modifications should be made to Treasury Regulation Section 1.952-2 for purposes of calculating GILTI. We offer two possible modifications.

First, Treasury Regulation Section 1.952-2(c)(5)(ii) states that net operating loss ("**NOL**") carryforwards are not taken into account for purposes of calculating Subpart F

[34] Prop. Reg. § 1.951A-2(c)(2).

[35] In particular, the Preamble requests comments on whether a CFC should be entitled to the deduction under Section 245A for purposes of calculating tested income. Federal Register GILTI at 51075. This is discussed in NYSBA Tax Section Report No. 1404, *Report on Section 245A* (October 25, 2018), at 17-26 ("**Section 245A Report**").

[36] Treas. Reg. § 1.952-2(a).

[37] Treas. Reg. §§ 1.952-2(b)(1), (c)(2); Prior Report at 28.

income. By application of this regulation to GILTI, NOL carryforwards cannot be taken into account in calculating tested income, so no NOL carryforwards are allowed at all under GILTI. As discussed in the Prior Report, this rule might make sense under Subpart F, which is limited to e&p and reduces Subpart F income by qualified deficits,[38] but we do not believe it is the proper rule under GILTI, which has neither such concept.

The Prior Report discussed the allowance of NOL carryforwards at either the CFC or U.S. shareholder level, and recommended allowing carryforwards at the U.S. shareholder level.[39] The failure to allow carryforwards, at least at the CFC level, is clearly not required by the Code. It also is quite unfair. If a U.S. shareholder has a single CFC with a tested loss in Year 1 and equal tested income in Year 2, the shareholder has no economic gain over the period. Yet absent the allowance of carryforwards, the shareholder owes tax on 100% of the tested income in Year 2 without credit in any year for the tested loss.

The failure to allow carryforwards is also inconsistent with the idea that the GILTI provisions effectively create a worldwide tax system with foreign income being taxed at a lower rate than the U.S. rate. Such a system presupposes that major deductions that would be allowed to a U.S. corporation would be allowed to a CFC. As a result, we continue to strongly believe that carryforwards of losses should be permitted at either the U.S. shareholder level or the CFC level.

We continue to prefer a carryforward of NOLs at the U.S. shareholder level, as recommended in the Prior Report. We acknowledge, however, as we did in the Prior Report, that there is less statutory authority for this approach than for allowing carryforwards at the CFC level. As a result, if the Treasury does not feel it has authority to allow NOL carryforwards at the U.S. shareholder level, we recommend allowing carryforwards at the CFC level, notwithstanding the complexities discussed in the Prior Report. We readily acknowledge that this will cause additional complexity under the basis adjustment rules of Proposed Regulation Section 1.951A-6(e) and the consolidated return basis adjustment rules under Proposed Regulation Section 1.1502-32. However, we do not believe that the complexities of basis calculations justify the disallowance of loss carryforwards and the resulting taxation of noneconomic profits.

In any event, assuming future regulations state that Section 163(j) applies to CFCs, regulations should also confirm that interest disallowed under Section 163(j) is not subject to any restrictions on loss carryovers. The statute treats such interest as incurred in the following year, and in the following year it is not an NOL deduction under Section

[38] *See* Prior Report at 35.

[39] *See* Prior Report at 33-44.

172. Additional issues arise under Section 163(j) that are beyond the scope of the Proposed Regulations but should be covered in subsequent regulations.[40]

Second, because the GILTI inclusion amount is based on tested income (and is not limited to e&p), it is likely that Congress intended that some deductions that are disallowed for U.S. income tax purposes (but reduce e&p) would also be disallowed for purposes of calculating tested income. This would logically be the case for items like fines and penalties, which should be disallowed for a CFC just as they would be for a U.S. corporation.

That being said, there are other deductions that are disallowed to a U.S. corporation for which it is less clear, as a matter of policy, whether the disallowance should also apply to a CFC. In particular, consideration should be given as to whether it is appropriate to disallow deductions for compensation paid by a CFC that would be disallowed to a domestic corporation under Section 162(m)[41] or Section 280G.[42] The final regulations should contain as complete a list as possible of any variances intended from taxable income of a domestic corporation.

(b) *Disqualified Basis from Transition Period Transfers*

The GILTI rules become effective for a CFC for the first taxable year of the CFC beginning after December 31, 2017. As a result, for a CFC with a fiscal year tax year, the rules do not apply to the period from January 1, 2018, to the end of the first tax year that ends in 2018 (the "**transition period**"). This potentially allows taxpayers to create gain in a CFC during the transition period that will not result in tested income, with the resulting benefit of loss or deduction in related CFCs that will reduce GILTI inclusions in periods when the GILTI rules are effective.

To deal with this possibility, Proposed Regulation Section 1.951A-2(c)(5) disallows a deduction or loss attributable to "**disqualified basis**", which is basis resulting from the transfer between two related CFCs of certain depreciable or amortizable property ("**specified property**") during the transition period. This exclusion does not

[40] For example, a mismatch of tested income and tested deduction will arise (at least temporarily) if a CFC pays interest to a related CFC and the interest deduction is disallowed under Section 163(j), although the payor CFC might be entitled to the deduction in future years. A similar mismatch would arise if the interest was paid to a U.S. shareholder. On the other hand, if the interest is included in income of the payee CFC and the deduction is disallowed under Section 163(j), query whether the U.S. shareholder should have an increase in specified interest income, which could allow an increase in NDTIR.

[41] Section 162(m) disallows deductions in excess of $1 million for compensation paid to "covered employees" of a publicly traded corporation or, after the enactment of the Act, a foreign private issuer.

[42] Section 280G disallows deductions for "excess parachute payments" made to "disqualified individuals" under Section 280G(c), with "disqualified individuals" defined to include the highest 1% paid individuals (up to 250) of the taxpayer.

apply to the extent the selling CFC had effectively connected income on the transfer, or the U.S. shareholder recognized Subpart F income as a result of the transfer.

This provision is notable in a number of respects. First, motive is not relevant—the deduction and loss are disallowed if they arise from any property transfers that create disqualified basis. Second, the rule applies to all depreciable or amortizable property, not just tangible property that is QBAI. Thus, the rule is materially broader than the comparable provision under Proposed Regulation Section 1.951A-3(h)(2), discussed in Part III.D.2(b), which is applicable to QBAI arising from similar transfers of certain depreciable property. Third, the basis of the relevant assets is respected for all other purposes of the Code.

We acknowledge the argument that as a matter of policy, a transfer between related parties during the transition period should not produce a costless step up in tax basis for GILTI purposes. That being said, the provision has no specific statutory basis in the GILTI provisions of the Act. The Preamble cites only Section 7805(a) and the Conference Report to the Act[43] as authority.[44] The Conference Report states that the conferees intended that "non-economic transactions intended to affect tax attributes" such as tested income and tested loss should be disregarded.[45]

However, the language in the Conference Report is not supported by any specific grant of authority in the Code, and the Proposed Regulations cover more transactions than the "non-economic transactions" referred to in the Conference Report. As a result, if the Treasury intends to continue to take this position, we suggest that it request a statutory amendment to confirm its authority to adopt this position.

The final regulations should also clarify the mechanics of the application of paragraph (c)(5). Under that paragraph, if an asset has both disqualified basis and non-disqualified basis, the deduction or loss is treated as allocated proportionately between disqualified and non-disqualified basis.[46] Disqualified basis is reduced or eliminated in the same manner. Consider the following situation:

> **Example 8.** *Amortization of disqualified basis.* CFC1 has an intangible asset with a basis of $150 and sells it to CFC2 for $300 during the transition period. Assume that CFC2 is required to amortize the $300

[43] H. Rep. 115-466 (2017) (the "**Conference Report**").

[44] Federal Register GILTI at 51075-76. The Preamble cites this authority by cross reference to the analogous QBAI rules.

[45] Conference Report at 645.

[46] Prop. Reg. § 1.951A-2(c)(5)(i).

> basis over a new 15-year holding period, or $20 per year. The disqualified basis is the $150 basis step up, which is half of the asset's total basis.

In the first year, half of the $20 annual amortization deduction is disallowed, and the disqualified basis is reduced to $140. Accordingly, we believe that, after Year 1, the asset should have a total basis of $280 for purposes of this rule (the cost minus the entire amortization deduction of $20) with a disqualified basis of $140. Under this approach, half of each remaining year's amortization deduction will be attributable to disqualified basis, and so annual amortization of $10 will be allowed.

This approach should be confirmed. The alternative would be to have the adjusted basis of the asset for purposes of the rule be reduced only by the deduction allowed in calculating tested income. For example, the adjusted basis would be $290 after the first year, $280 after the second year, and so on. This approach would be complex and illogical, since it would increase the ratio of disqualified basis to total basis over time and change the allowed amortization deduction each year.

Next, consider the application of the rule upon the sale of an asset:

> **Example 9.** *Disqualified basis upon sale.* Assume the same facts as Example 8. After five years, total amortization of $50 (rather than $100) has been allowed, and CFC2 will hold the asset with a total adjusted basis of $200, $100 of which is disqualified basis using the assumed rule above. The asset is sold at that time to a third party.

Since the loss attributable to disqualified basis is disregarded for determining tested loss, the remaining tax basis for calculating tested loss is $100. However, paragraph (c)(5) states that the deduction attributable to disqualified basis is disregarded for determining both tested income and tested loss. Regulations should confirm that this means that for purposes of calculating tested income on a sale of the asset, the prior deductions attributable to disqualified basis (which were in fact disallowed) must likewise be disregarded.

In the example, this rule would mean that the amount of disqualified deductions ($50) must be added back to the existing basis ($200) before calculating gain. In effect, this is the original cost basis of $300, minus the $50x of deduction allowed in the calculation of taxable income. The result is a regular tax basis of $200, a basis of $100 for determining tested loss on a sale, and a basis of $250 for determining tested gain on the sale. Therefore, if the sale to the third party was for $250, there would be no gain.

This is the only logical approach. If the basis for gain was lower, the U.S. shareholder in Example 9 would have more overall tested income following a sale of the asset (from disallowed deductions plus the inclusion of offsetting tested income) than if no transaction in the transition period had been done in the first place. In the absence of such a transaction, the initial basis of $150 would have been reduced by $50 of deductions, and on a later sale to a third party for $250, there would have been $150 of gain, or $100 of net taxable income. In the actual transaction, the sale to CFC2 for $300 gave rise to $150 of gain followed by $50 of deductions, or $100 of net taxable income so far, and the results of a sale to a third party for $250 are the same only if no additional gain is recognized on that sale.

(c) *Application of Section 952(c)*

Proposed Regulation Section 1.952-2(c)(4) provides that tested income and deductions allocable to tested income are determined without regard to the application of Section 952(c). Section 952(c)(1)(A) provides that Subpart F income for a year is limited to current e&p for the year, and Section 952(c)(2) provides that if the (c)(1)(A) limitation applies for a year, then the excess of e&p in a future year over Subpart F income in the future year is recharacterized as Subpart F income in the future year. In effect, this is a "catch-up" provision for Subpart F when the e&p limitation initially applies.[47]

Under Section 951A(c)(2), tested income does not include "any gross income taken into account in determining the Subpart F income of the corporation." Arguably, therefore, if a CFC has income that is not Subpart F income for the year because of the e&p limitation under Section 952(c)(1)(A), it might be treated as tested income for the year, notwithstanding the catch up provision in Section 952(c)(2). The Proposed Regulations resolve this ambiguity by in effect stating that if an item would be Subpart F income without regard to the e&p limit, it remains potential Subpart F income in a future year with e&p under Section 952(c)(2), rather than becoming tested income in the current year because it is not currently Subpart F income.

The Proposed Regulations illustrate the rule with an example. In year 1, the CFC has $100 of what would be Subpart F income (referred to herein as "**notional Subpart F income**"), and a non-Subpart F loss that reduces e&p to $0. In year 2, the CFC has $100 of tested income and $100 of e&p. The example states that there is no Subpart F income in year 1 because of the e&p limitation in Section 952(c)(1)(A). In year 2, there is $100 of Subpart F income under Section 952(c)(2) because of the e&p in year 2, and there is also $100 of tested income.

We agree with the conclusion in the example that the notional Subpart F income in year 1 should be excluded from tested income notwithstanding the fact that Section 952(c)(1)(A) also excludes it from Subpart F income in year 1. Absent such a rule, every item of Subpart F income that was in excess of e&p would become tested income for the year. This would leave no room for the application of Section 952(c)(2) in future years, which we do not believe should be read out of the Code. As a statutory matter, this conclusion is based on the fact that Section 951A(c)(2)(A)(i)(II) excludes from gross tested income any gross income taken into account in determining Subpart F income, and

[47] Section 952(c)(2) is needed, and the issue in this section arises, because, unlike the rule in Section 951A(c)(2)(B)(ii) that tested losses do not reduce e&p for Subpart F purposes, there is no such rule for other non-Subpart F expenses and deductions that reduce e&p. An alternative solution that would require legislation would be a rule that created a separate tracking of e&p solely for Subpart F purposes.

Section 952(c)(2) takes the year 1 Subpart F income into account in year 2 (as discussed below).

We also agree with the result in the example that there is $100 of Subpart F income in year 2. Under Section 952(c)(2), there is $100 of e&p in excess of Subpart F income in year 2, so $100 of e&p in year 2 is recharacterized as Subpart F income.

Finally, we agree with the result in the example that there should also be $100 of tested income in year 2. It can be argued that as a policy matter, there should not be an inclusion of $100 of tested income in year 2 because this would result in a total inclusion of $200 of income in year 2 as a result of a single item of $100 of tested income in year 2. Arguably this result would be surprising and unfair to taxpayers.

However, failure to include the $100 of tested income in year 2 would result in that income being permanently exempt from tax. Such a result would in effect allow the non-tested, nondeductible expense in year 1 to offset the tested income in year 2, which is inconsistent with the rule that only losses allocable to gross tested income can reduce tested income. Such a result would also have elements of randomness (and provide an opportunity for tax planning), since the tested income would clearly be included in year 2 if the nondeductible expense had occurred in year 2 rather than year 1.

As a matter of statutory construction, the conclusion in the Proposed Regulations is not entirely clear. Section 951A(c)(2)(A)(i)(II) excludes from gross tested income any gross income taken into account in determining Subpart F income. Therefore, since Section 952(c)(2) converts the year 2 e&p into Subpart F income, and the e&p arises from the tested income, arguably the tested income is “taken into account” in determining the year 2 Subpart F income, and so Section 951A(c)(2)(A)(i)(II) prevents the income from being tested income at the same time.

On the other hand, it can be argued that Section 951A(c)(2)(A)(i)(II) should not be interpreted to prevent the inclusion. That provision is intended merely to give a priority to Subpart F income over tested income, not to exclude any items of income from taxation altogether. Likewise, Section 951A(c)(2)(A)(i)(II) was likely not intended to apply twice in this manner, (1) first in year 1 to treat the notional Subpart F income as not being tested income because is “taken into account” in year 2 under Section 952(c)(2), and (2) again in year 2 to treat the actual tested income as not being tested income because that income is also “taken into account” in that year by Section 952(c)(2).

Moreover, as a technical matter, Section 951A(c)(2)(A)(i)(II) only applies to the tested income in year 2 if that income is “gross income taken account in determining Subpart F income” in year 2. Subpart F income is determined in year 2 solely on the basis of Section 952(c)(2), which looks solely to the e&p in year 2. Even if the same underlying operating income gives rise to both tested income and e&p in year 2, either tested income or e&p can exist without the other. As a result, the tested income should not be said to be “taken into account” in year 2 under Section 952(c)(2).

Finally, when the tested income and e&p in year 2 arise from different sources, clearly Section 952(c)(2) does not take the tested income into account in year 2, so Section 951A(c)(2)(A)(i)(II) does not prevent the tested income from being included in income. This means that under the view that there is no inclusion of $100 of tested income in year 2 in the example in the Proposed Regulations, tracing of tested income and e&p would be required to determine the applicability of Section 951A(c)(2)(A)(i)(II) to the tested income in year 2. This level of complexity is not apparent on the face of the statute and was likely not intended.

As a result, we believe the position of the Proposed Regulations is at least a reasonable interpretation of the Code. However, because of the ambiguity in the statute, if the Treasury wishes to adopt this position in final regulations, it should consider whether an amendment to the statute to confirm this result would be helpful.

(d) *Deemed Royalties under Section 367(d)*

The Proposed Regulations should be clarified to confirm that deemed royalties under Section 367(d) can be deducted from tested income. These deemed royalties arise when a U.S. person transfers certain intangible property to a transferee foreign corporation in a transaction subject to Section 351 or Section 361. In effect, the U.S. transferor is treated as selling the intangible property for a deemed royalty, which is characterized as ordinary income over its useful life.

Treasury Regulation Section 1.367(d)-1T(c)(2)(ii) provides that the transferee foreign corporation may treat this as an expense against "gross income subject to Subpart F, in accordance with the provisions of Treasury Regulation Sections 1.954-1(c) and 1.861-8." It further provides that "[n]o other special adjustments to earnings and profits, basis, or gross income" shall be permitted because of the deemed royalty. The concern is that tested income might not be considered gross income subject to Subpart F, and that the deemed royalty could only be used to reduce Subpart F income.

On the one hand, Section 951A is part of Subpart F of the Code (which runs from Section 951 to Section 965). Thus, as a technical matter, even though GILTI inclusions are not "Subpart F income" under Section 952(a), they are "subject to Subpart F" and, therefore, deemed royalties can be allocated against tested income. Proposed Regulation Section 1.951A-2(c)(3) might also allow the allocation of Section 367(d) deductions because those may be allocated "under the principles" of Section 954(b)(5).

On the other hand, Treasury Regulation Sections 1.954-1(c) and 1.861-8, referred to in the Section 367(d) regulation quoted above, specifically deal with Subpart F income. This could be read to prohibit the allocation of deemed royalty expense to tested income (which is not Subpart F income), although this argument is weakened by the fact that GILTI income did not exist at the time those regulations were adopted. If this interpretation applies, the deemed royalty income could be taxed as an income inclusion to the U.S. shareholder without an offsetting deduction against tested income. This would be neither fair to the taxpayer nor consistent with the intent of Section 367(d).

D. Proposed Regulation Section 1.951A-3: QBAI

1. *Background*

Proposed Regulation Section 1.951A-3 contains rules for calculating the QBAI of a CFC. Consistent with Section 951A(d)(1), for a tested income CFC, QBAI is defined as the average of the CFC's aggregate adjusted bases as of the close of each quarter of all "specified tangible property" that is used in a trade or business of the CFC and is depreciable under Section 167.[48] "**Specified tangible property**" is defined as tangible property (generally, property depreciable under Section 167(a)) used in the production of gross tested income. A tested loss CFC is deemed to have no QBAI.

The basis of specified tangible property is determined using the alternative depreciation system of Section 168(g) ("**ADS**").[49] This applies to all specified tangible property, even if it was placed into service before enactment of the Act. The definition is not affected by future changes in law unless the law specifically and directly amends the definition of QBAI.

Proposed Regulation Section 1.951A-3(f) contains special rules for calculating QBAI for short taxable years. Proposed Regulation Section 1.951A-3(h) sets out two anti-abuse rules for transfers of specified tangible property that produce additional QBAI.

2. *Comments*

(a) *Application of Alternative Depreciation System*

We are concerned about the complexity created by applying ADS to all specified tangible property placed in service before enactment of the Act. While CFCs may already use the ADS system to determine depreciation on much of their specified tangible property, the Preamble acknowledges that this will not always be the case. Therefore, taxpayers will be required to recalculate the basis of all non-ADS specified tangible property at the effective date of the GILTI rules as if they were already being depreciated under ADS, solely for purposes of calculating QBAI.

Tested income and loss, meanwhile, will be determined for GILTI purposes based on the actual tax basis of the assets, so a single asset might have two different tax bases for purposes of the GILTI rules. In fact, they may have a third basis for purposes of calculating e&p and therefore Subpart F income of the CFC. Of course, these rules apply to assets newly placed in service, but it is much easier to apply rules prospectively to new assets than retroactively to preexisting assets.

[48] Prop. Reg. § 1.951A-3(c)(1).

[49] Prop. Reg. § 1.951A-3(e).

Moreover, Section 250(b)(2)(B) incorporates the GILTI basis calculation for purposes of calculating the foreign-derived intangible income ("**FDII**") deduction of a U.S. corporation. Thus, absent a modification in the FDII regulations, the rule in the Proposed Regulations will require retroactive application of ADS to all domestic tangible assets of every U.S. corporation claiming a FDII deduction. This will be even more burdensome unless the taxpayer has available a comprehensive record of when assets are placed in service, etc., and access to a computer system that allows a hypothetical calculation of past depreciation on such assets to be done quickly.

We do not believe that these results are compelled by Section 951A(d)(3), which states that the calculation of the basis of specified tangible property will disregard changes in law enacted after the Act. This does not require that ADS be applied retroactively to assets placed into service before enactment of the Act. The Preamble states that this approach is necessary to avoid distortion of QBAI to the U.S. shareholder,[50] but we are not aware of how distortion could arise for previously acquired property. We urge reconsideration of the retroactive application of ADS to property placed in service before enactment of the Act.

In addition, regulations should confirm that the use of ADS by the U.S. shareholder in calculating its DTIR from QBAI of its CFCs, for either new or preexisting assets, is not a change in the shareholder's method of accounting. Alternatively, if such use is a change in method of accounting, global approval under Section 446(e) should be given for this change by all taxpayers. The concern is that if ADS was not used previously by the U.S. shareholder, the shareholder is using ADS for the first time in calculating an "item" (i.e., DTIR) in the shareholder's taxable income, and this could be viewed as a change in method of accounting.[51]

(b) *Anti-Abuse Rules*

Proposed Regulation Section 1.951A-3(h) contains two broad anti-abuse rules that, if triggered, require a tested income CFC to disregard some or all of the basis of its specified tangible property in calculating its QBAI. Both of these rules are arguably supported by Section 951A(d)(4), which allows the Secretary to issue regulations or guidance to prevent the avoidance of the purposes of the QBAI rules, including (x) with respect to property transferred or held "temporarily" and (y) where the avoidance of the QBAI rules is "a factor in the transfer or holding of such property."

[50] Federal Register GILTI at 51076.

[51] Rev. Proc. 2015-13, Section 2.02, provides that "[a] change in method of accounting occurs when the method of accounting to be used by the taxpayer for an item (or that would be used if the taxpayer had the item in the year of change) in computing its taxable income for the year of change is different than the taxpayer's established method of accounting used (or that would have been used if the taxpayer had the item in the immediately preceding year) to compute the taxpayer's taxable income for the immediately preceding taxable year."

First, Proposed Regulation Section 1.951A-3(h)(2) reflects the fact that a sale of depreciable tangible property during the transition period can not only create a tax-free step up in asset basis for purposes of calculating tested income (as described above), but can also result in an increase in tax basis in such assets for QBAI purposes. Thus, paragraph (h)(2) excludes from QBAI all of a CFC's basis in specified tangible property created by a taxable transfer of specified tangible property between related CFCs during the transition period. This rule, however, does not apply to the extent that a selling CFC has effectively connected income on the sale, or a U.S. shareholder of the selling CFC reports gain on the sale as Subpart F income.

This rule is a per se rule, in that a good business purpose does not allow the creation of QBAI as a result of a transfer during the transition period. By contrast, the Conference Report to the Act states the intent of the conferees that the transactions to be disregarded are "non-economic transactions intended to affect tax attributes of CFCs and their U.S. shareholders....to minimize tax under this provision." Nevertheless, the Proposed Regulations are authorized by Section 951A(d)(4) if the Treasury could reasonably conclude that these restrictions are appropriate to prevent the avoidance of the purposes of the QBAI rules.[52] Accordingly, we have no objection to this rule.

Second, under Proposed Regulation Section 1.951A-3(h)(1) (the "**Temporary Ownership Rule**"), specified tangible property is disregarded for purposes of calculating QBAI if a tested income CFC acquires such property "with a principal purpose of reducing the GILTI inclusion amount" of a U.S. shareholder, and the tested income CFC holds the property "temporarily." Furthermore, any specified tangible property that is held for less than twelve months is automatically treated as being held "temporarily" and "with a principal purpose of" reducing the GILTI inclusion amount of any U.S. shareholder, if such property actually reduces any such GILTI inclusion amount (the "**One-Year Rule**"). Neither the Temporary Ownership Rule nor the One-Year Rule is limited to transfers within the transition period.

In general, we believe the Temporary Ownership Rule is consistent with Section 951A(d)(4), which grants authority for regulations that target property held temporarily for purposes of avoiding the QBAI rules. However, the Temporary Ownership Rule provides no limit on how long an ownership period can be and still be considered "temporary." Rather, the only reference point is the existence of the One-Year Rule, which suggests that a holding period of more than one year can be temporary, since otherwise the basic Temporary Ownership Rule would be superfluous. Indeed, the acquisition of an asset for any specified intended period, e.g., five or ten years, could be considered temporary.

Given that there is similar uncertainty with the "a principal purpose" standard that is a prerequisite for the Temporary Ownership Rule, we urge the Treasury to adopt a presumption that, if specified tangible property is held by a CFC for more than a

[52] Conference Report at 645.

specified period of time, the Temporary Ownership Rule will not apply. The specified period would logically be a fixed period of time (e.g., 2 or 3 years). We considered the possibility of a period of time based on a percentage (such as 25% or 33%) of the depreciable life of the asset, but we do not think that the depreciable life of an asset is related to the question of whether use of the asset is "temporary."

We also believe the One-Year Rule should be substantially narrowed. Any holding of specified tangible property for less than twelve months will result in the entirety of its basis being lost for QBAI purposes. This rule will apply even if there is a good business purpose, and no tax avoidance purpose, for the acquisition and disposition of the property. This result does not seem correct as a policy matter, or consistent with Section 951A(d)(4), which authorizes regulations to prevent the avoidance of the purposes of the QBAI rules.

There are many ways that an asset could be held for less than one year that are not inconsistent with the purposes of the QBAI rules. Consider the following examples:

> **Example 10.** *One-Year Rule.* CFC1 has specified tangible property that it purchased on January 1, 2019. On November 30, 2019, CFC1 sells the specified tangible property after deciding that the asset (or the entire related business) is not working out. The specified tangible property does not count towards CFC1's QBAI calculation. The same result would arise even if CFC1 replaced the sold property with other specified tangible property with the same or a higher tax basis, and the aggregate holding period of both properties was more than a year.
>
> **Example 11.** *One-Year Rule applies to seller of CFC because of post-sale disposition of CFC assets.* CFC1 has specified tangible property that it purchased on January 1, 2019. On November 30, 2019, USP1, CFC1's sole shareholder, sells its stock in CFC1 to a non-U.S. person, and CFC1 ceases to be a CFC. The purchaser causes CFC1 to sell the specified tangible property on December 15, 2019. USP1 has the GILTI inclusion for 2019, but the specified tangible property does not count towards CFC1's QBAI calculation for USP1.
>
> **Example 12.** *One-Year Rule applies to buyer of CFC because of post-sale disposition of CFC assets.* Same as Example 11, except USP1 sells the stock of CFC1 to a U.S. purchaser USP2 and CFC1 remains a CFC for all of 2019. USP2 has the GILTI inclusion for 2019. The GILTI inclusion disregards the QBAI attributable to the specified tangible property, since that property was held for less than one year, even though it was acquired prior to USP2's acquisition of CFC1.
>
> **Example 13.** *One-Year Rule applies to seller of entity because of Section 338(g) election.* CFC1 has specified tangible property that it purchased on January 1, 2019. On November 30, 2019, CFC1's sole shareholder USP1

> sells the stock of CFC1 to USP2, and USP2 makes a Section 338(g) election with respect to the sale. The specified tangible property does not count towards CFC1's QBAI calculation for USP1.
>
> **Example 14.** *One-Year Rule applies to buyer of entity after Section 338(g) election.* On January 1, 2019, USP1, CFC1's sole shareholder, sells its stock in CFC1 to USP2. USP2 makes a Section 338(g) election with respect to the sale. USP2 disposes of certain unwanted assets of the business (including certain specified tangible property) on December 15, 2019. The specified tangible property does not count towards USP2's QBAI calculation. If a Section 338(g) election had not been made, the one-year holding period might have been met for many of these assets.

These examples demonstrate that the One-Year Rule can create perverse results and uneconomic incentives. In some cases, U.S. shareholders will have an incentive to cause related CFCs to hold their assets beyond the one-year period to ensure QBAI is not lost, even if the shareholder desires to sell those assets for good business reasons. Moreover, the outcome under the One-Year Rule can depend upon the actions of an unrelated buyer or seller of the stock of a CFC for which the U.S. shareholder may not have knowledge or control. The outcome can also depend upon whether a sale of stock of a CFC is accompanied by a Section 338(g) election, which bears no logical connection to whether basis in an asset should count as QBAI.

Consequently, we urge that the One-Year Rule be converted from an automatic rule into a presumption that specified tangible property held for less than 12 months is held temporarily and for a principal purpose of reducing a U.S. shareholder's GILTI inclusion amounts. The taxpayer should be entitled to rebut this presumption by showing that the acquisition and/or disposition of the specified tangible property was motivated by a good business purpose.

In addition, a strong factor in overcoming the presumption should be that an asset used in the business is not acquired in contemplation of a subsequent disposition within one year, and the ultimate disposition occurs in a transaction with an unrelated third party or as part of a disposition of an entire going concern. Another strong factor should be that an asset disposed of within a year is replaced by an asset with a similar use and having a tax basis at least as high as the basis of the original asset, and the aggregate holding period is more than a year.

In addition, regulations should provide that the rule is applied by tacking the holding periods of related CFCs, as long as any transfers between the CFCs do not result in a reduction in the GILTI inclusion amount of the U.S. shareholder. For example:

> **Example 15**. *No decrease in GILTI inclusion amount from related-party transfer of specified tangible property*. USP owns CFC1, which purchases specified tangible property on January 1, 2019. On September 30, 2019, CFC1 either (1) transfers the property to its wholly owned subsidiary

> CFC2 in a Section 351 transaction, or (2) sells the property to a related CFC2 wholly owned by USP for an amount less than or equal to its QBAI tax basis on that date. CFC2 holds the property for a period beyond January 1, 2020.

The One-Year Rule literally applies in these cases, since CFC1 has held the property for less than a year and the ownership of the property by CFC1 has reduced the GILTI inclusion of USP for 2019. However, the One-Year Rule would not have applied if CFC1 had held the property for the entire year, and we are assuming that USP has obtained no benefit from the transfer of the property among the CFCs. As a result, there is no reason for the One-Year Rule to apply to CFC1. (We note that the Temporary Ownership Rule would likely not apply to these facts because that rule requires a purpose of reducing USP's GILTI inclusion amount.)

If the One-Year Rule were applied by automatically tacking the holding period of related CFCs, that would allow groups to move QBAI among CFCs from year to year to obtain the maximum benefit of QBAI (e.g., by moving specified tangible property out of tested loss CFCs). Our proposed rule is intended to prevent such tax planning by allowing tacking of holding periods only if there is no reduction in GILTI inclusion arising from the transfers between related CFCs.

Similarly, in tacking the holding periods of related CFCs, and in determining whether there is a reduction in the GILTI inclusion amount of a U.S. shareholder, the regulations should treat a consolidated group as a single entity. As discussed in Part III.G.1, Proposed Regulation Section 1.1502-51 adopts this principle, and that principle should apply here as well.

E. Proposed Regulation Section 1.951A-4: Tested Interest Income and Expense

Proposed Regulation Section 1.951A-4 provides rules for determining tested interest expense and tested interest income of a CFC. "Interest expense" is defined broadly to include any expense or loss treated as interest under the Code, in addition to any other expense or loss incurred in one or more related transactions in which "the use of funds is secured for a period of time," if such expense or loss is "predominantly incurred in consideration for the time value of money."[53] "Interest income" has a comparably broad definition that picks up interest and interest equivalents.[54]

However, Section 951A(b)(2)(B) refers only to interest income and interest expense, not to interest equivalents. If the Treasury intends to adopt the position of the Proposed Regulations, we believe it should request an amendment to the statute to include interest equivalents, or to authorize regulations to include interest equivalents, for

[53] Prop. Reg. § 1.951A-4(b)(1)(ii).

[54] Prop. Reg. § 1.951A-4(b)(2)(ii).

this purpose.[55] Since the regulations cover both interest income and interest expense, there is a particular risk of whipsaw to the government unless the validity of the regulations is clear.

F. Proposed Regulation Section 1.951A-5: Partnerships

1. *Alternative Approaches to CFCs Held by Partnerships*

Proposed Regulation Section 1.951A-5 provides rules for determining the GILTI inclusion amount for partners of a domestic partnership, where the partnership itself is a U.S. shareholder of a CFC (a "**U.S. shareholder partnership**" and such a CFC, a "**partnership CFC**"). Any particular partner of a U.S. shareholder partnership may itself be a U.S. shareholder with respect to any particular partnership CFC (a "**U.S. shareholder partner**") or may not itself be a U.S. shareholder with respect to any particular partnership CFC (a **non-U.S. shareholder partner**").

Before discussing the Proposed Regulations in detail, we describe four possible ways that the GILTI rules could be applied to a partnership CFC. We start with the approach that treats the partnership most as an entity, and gradually move to the approach that treats the partnership most as an aggregate of its partners.

(a) *The Pure Entity Approach*

Under a pure entity approach (the "**Pure Entity Approach**"), a U.S. shareholder partnership would calculate a single GILTI inclusion amount with respect to its entire ownership interest in all partnership CFCs, and then allocate to each partner its distributive share of that GILTI inclusion amount. The CFC tested items that make up the partner's share of the partnership GILTI inclusion amount cannot be aggregated with any items of the partner attributable to CFCs it holds outside of the partnership ("**non-partnership CFCs**"), regardless of whether the partner is itself a U.S. shareholder of the partnership CFCs or non-partnership CFCs.

(b) *The Proposed Regulations Hybrid Approach*

The Proposed Regulations do not adopt a pure aggregate or pure entity approach for all partners of a U.S. shareholder partnership. Rather, they adopt a hybrid approach (the "**Proposed Regulations Hybrid Approach**") under which aggregate principles apply to U.S. shareholder partners of a partnership CFC, and entity principles apply to non-U.S. shareholder partners of a partnership CFC.[56]

[55] *See* NYSBA Tax Section Report No. 1393, *Report on Section 163(j)* (March 28, 2018), at 13 (discussing the authority for proposed regulations that take the same position for purposes of Section 163(j)).

[56] Prop. Reg. § 1.951A-5(c).

More specifically, if any partners of the U.S. shareholder partnership are non-U.S. shareholder partners for all the partnership CFCs, the U.S. shareholder partnership calculates a single GILTI inclusion amount with respect to all the partnership CFCs. The partnership then allocates to each such partner that partner's distributive share of the partnership's GILTI inclusion amount. As in the Pure Entity Approach, these partners cannot aggregate the CFC tested items—e.g., tested income or NDTIR—from the partnership with other CFC tested items (notably including tested loss) that they have based on their ownership of non-partnership CFCs.

By contrast, if a partner of a U.S. shareholder partnership is a U.S. shareholder partner with respect to a particular partnership CFC, the U.S. shareholder partner treats the U.S. shareholder partnership as a foreign partnership with respect to that CFC. The U.S. shareholder partner is then deemed to directly hold its indirect interest in the particular partnership CFC under Section 958(a). The U.S. shareholder partner includes its distributive share of CFC tested items of the particular CFC on its partner-level calculation of its GILTI inclusion amount. That calculation includes the U.S. shareholder's non-partnership CFCs, so that the shareholder can aggregate, say, tested losses from the partnership CFC with tested income from a non-partnership CFC.

If a partner of a U.S. shareholder partnership is a U.S. shareholder partner with respect to some, but not all, of the partnership CFCs, the U.S. shareholder partnership must recalculate its own GILTI inclusion amount for that partner. That calculation takes into account the CFC tested items only for those CFCs with respect to which the partner is a non-U.S. shareholder partner. The partner takes into account the CFC tested items from the CFCs for which it is a U.S. shareholder partner, and its share of the partnership level GILTI inclusion that only takes into account the CFCs for which it is a non-U.S. shareholder partner.

(c) *The Prior Report Hybrid Approach*

In the Prior Report, we suggested an alternative hybrid approach (the "**Prior Report Hybrid Approach**"). First, the domestic partnership is treated as an entity for purposes of determining whether its foreign corporate subsidiaries qualify as CFCs and, therefore, whether CFC tested items should be taken into account by its partners.[57] Then, aggregate principles apply to treat these CFC tested items as included in the partner-level calculation of the GILTI inclusion amount for each partner, regardless of whether a partner is itself a U.S. shareholder. This approach allows all partners to aggregate CFC tested items of partnership CFCs with CFC tested items of non-partnership CFCs.[58]

[57] Prior Report at 91.

[58] As discussed in the Prior Report at 86-87, we would also allow a corporation that is not a U.S. shareholder of a CFC to claim FTCs and Section 250 deductions with respect to tested income of the CFC passed through from the partnership. Both are available to a domestic corporation without a requirement

(d) *The Pure Aggregate Approach*

Under a pure aggregate approach (the "**Pure Aggregate Approach**"), all partners look through the domestic partnership in determining whether they are U.S. shareholders of a partnership CFC, in the same manner that they would look through a foreign partnership. The status of a domestic partnership as a U.S. shareholder is irrelevant. If they are themselves U.S. shareholders, partners are treated as in the Proposed Regulations Hybrid Approach and the Prior Report Hybrid Approach. If they are not themselves U.S. shareholders, they do not include in their calculation of the GILTI inclusion amount any CFC tested items from the partnership CFCs.

(e) *Summary of Approaches*

The four approaches described above can be illustrated in the following example:

> **Example 16.** *Outcomes under different partnership approaches.* PRS is a U.S. shareholder partnership that wholly owns one partnership CFC, CFC1. CFC1 has tested income of $100 and no other CFC tested items. PRS has two domestic partners, X Corp (a 95% partner) and Y Corp (a 5% partner). The outcome of each of the four approaches is summarized in the following chart:

	X Corp.	Y Corp.
Pure Entity Approach	$95 GILTI inclusion amount	$5 GILTI inclusion amount
Proposed Regulations Hybrid Approach	$95 tested income	$5 GILTI inclusion amount
Prior Report Hybrid Approach	$95 tested income	$5 tested income
Pure Aggregate Approach	$95 tested income	no income inclusion

The Preamble asks for comments on whether approaches other than the Proposed Regulations Hybrid Approach, including the Pure Entity Approach and the Pure Aggregate Approach, would more appropriately harmonize the provisions of the GILTI regime, particularly in light of the compliance and administrative burdens of the various approaches.[59]

that the corporation be a U.S. shareholder, and, in any event, the only reason the corporation has a GILTI inclusion from the partnership is because the partnership is a U.S. shareholder.

[59] Federal Register GILTI at 51080.

2. *Discussion of Alternative Approaches*

(a) *Pure Aggregate Approach*

As a policy matter, we reiterate our preference for the Pure Aggregate Approach as stated in a 2007 report.[60] We believe that approach better carries out the purposes of the GILTI and Subpart F rules, since the purposes of those rules are unrelated to the question of whether stock in a foreign corporation is owned by a U.S. or a foreign partnership. We therefore believe that no GILTI calculation should be made at the partnership level, and a domestic partnership owning stock in a foreign corporation should be looked through (just as is a foreign partnership) in determining whether a foreign corporation is a CFC and in testing for a partner's status as a U.S. shareholder of a CFC.

The current tax regime, under which the status of a foreign corporation as a CFC can be elective depending on whether the corporation is held through a domestic or foreign partnership, is difficult to justify on policy grounds. The current rules also encourage nonproductive tax planning to avoid CFC status, or to avoid CFC inclusions by U.S. persons that are not themselves U.S. shareholders of a CFC, by causing a foreign corporation to be held by a foreign rather than domestic partnership.

We acknowledge that the Pure Aggregate Approach is inconsistent with Treasury Regulation Section 1.701-2(f), Example 3, adopted almost 25 years ago, which treats a U.S. partnership as a U.S. shareholder of a CFC regardless of the nature of its partners. It may also be inconsistent with Section 7701(a)(30), which states that a U.S. person includes a domestic partnership. In fact, taxpayers often rely on the example in the Section 701 regulations to treat a CFC owned by a U.S. shareholder partnership as a CFC rather than a PFIC, and the IRS has issued private letter rulings confirming this position.[61]

Moreover, the drafters of Section 951A presumably were aware of this background when they determined that inclusions under Section 951A are to be treated in the same manner as Subpart F inclusions. There is no indication that Congress intended either to adopt a rule for partnership shareholders of CFCs under GILTI that was different than the rule under Subpart F, or to change the rules applicable to both GILTI and Subpart F. Indeed, it would be even more inconsistent with the structure of Sections 951 and 951A, or with the statutory definition of CFC and U.S. shareholder and their use throughout the Code, if a particular foreign corporation could be a CFC for Subpart F purposes and not for GILTI purposes. Perhaps for these reasons, the Preamble rejects the

[60] NYSBA Tax Section Report No. 1124, *Report on Differences between Domestic and Foreign Partnerships* (January 3, 2007), at 11 (the **"2007 Report"**).

[61] *See, e.g,* PLR 201106003 (Feb. 11, 2011); PLR 200943004 (Oct. 23, 2009).

Pure Aggregate Approach on the basis that such a result is "not clearly contemplated in [S]ection 951A or its legislative history and is inconsistent with [S]ection 951."[62]

However, Section 951A places significantly more weight than before on the characterization of domestic partnerships as U.S. shareholders of CFCs. In particular, (1) gross tested income is significantly more expansive than Subpart F income, (2) calculating the GILTI inclusion amount is significantly more complicated than calculating a Subpart F inclusion, and (3) in the context of GILTI, a significant portion of the calculations are done at the U.S. shareholder level.

Likewise, from the point of view of a non-U.S. shareholder partner of a U.S. shareholder partnership, the amount at stake in applying entity rather than aggregate principles is far higher than before, since all tested income rather than only Subpart F income is now taxable to a U.S. shareholder. The stakes are particularly high for an individual and possibly corporate non-U.S. shareholder partner that would not be entitled to a Section 250 deduction under an entity or hybrid approach to partnerships. We therefore believe that this is an appropriate time for the issue to be reconsidered.

The authority for a reconsideration of this issue by regulations would include the fact that general entity/aggregate principles have applied to partnerships at least since the enactment of the Internal Revenue Code of 1954 and are reflected in the legislative history thereof.[63] These principles are now codified in Treasury Regulation Section 1.701-2, which states that entity or aggregate principles should apply based on the purpose of the applicable rule.

For example, in 2007, the Treasury adopted Treasury Regulation Section 1.871-14(g)(3) under the portfolio interest rules. This regulation applies aggregate principles to look through a domestic or foreign partnership to determine if a non-U.S. partner is a 10% shareholder of a U.S. corporation owned by the partnership. A 10% shareholder of the U.S. corporation is ineligible for the portfolio interest exception to withholding tax on interest paid by the corporation.

Although that regulation did not change a long-established rule to the contrary, the greatly increased significance of the entity/aggregate issue in light of the enactment of GILTI seems to provide a "new" occasion to reconsider the issue. Finally, when Congress indicated that it was treating GILTI inclusions in the same way as Subpart F

[62] Federal Register GILTI at 51079. In the 2007 Report, we also stated that we believed that adoption of the Pure Aggregate Approach would require a legislative change. 2007 Report at 10.

[63] "Both the House provisions and the Senate amendment provide for the use of the 'entity' approach in the treatment of the transactions between a partner and a partnership which are described above. No inference is intended, however, that a partnership is to be considered as a separate entity for the purpose of applying other provisions of the internal revenue laws if the concept of the partnership as a collection of individuals is more appropriate for such provisions." H.R. Conf. Rep. No. 2543, 83rd Cong., 2d Sess. 59 (1954).

income, there is no indication that it was focusing on the existing noneconomic rule for domestic partnerships.

Moreover, even aside from general entity/aggregate principles, Section 7701(a)(4) states that the term "domestic", when applied to a partnership, means a partnership created or organized under the laws of the United States or a state thereof, "*unless . . . the Secretary provides otherwise by regulations*" (emphasis added). This exception has not been interpreted by the Treasury to be limited to recharacterization of domestic partnerships for all purposes of the Code. Rather, it was recently relied upon by the Treasury in adopting temporary regulations to require an otherwise domestic partnership to be treated as a foreign partnership for purposes of a particular Code provision.[64]

Likewise, Notice 2010-41, Section 4.01, relies on Section 7701(a)(4) to state that regulations will be issued to treat certain domestic partnerships owned by foreign corporations as foreign partnerships solely for purposes of certain Subpart F inclusion provisions of the Code. In fact, the Proposed Regulations themselves implement this rule for purposes of Subpart F, and expand it to GILTI.[65] The Preamble states that this rule is based on Notice 2010-41,[66] which as noted above is itself based on Section 7701(a)(4).[67]

Therefore, the Treasury already believes that at least in some circumstances, including circumstances involving Subpart F and GILTI, it is appropriate to issue regulations under Section 7701(a)(4) treating a domestic partnership as foreign. While the application of Section 7701(a)(4) has been limited so far to much narrower fact patterns, arguably the same authority could be used to treat a domestic partnership as foreign for purposes of determining the existence of a CFC and of a U.S. shareholder of a CFC for purposes of the Subpart F and GILTI provisions of the Code.

Nevertheless, if the Treasury desires to implement the Pure Aggregate Approach but believe that it does not have the authority to do so by regulations, we urge it to request a statutory amendment to adopt this approach or to authorize regulations that would do so.

However, as noted above, taxpayers now often rely on the existing rule for domestic partnerships in order to treat a foreign corporation owned by a domestic partnership as a CFC rather than a PFIC. It would be unfair to such taxpayers to change

[64] Treas. Reg. § 1.721(c)-6T(b)(4) treats a domestic partnership as foreign solely for purposes of certain partnership reporting provisions. T.D. 9814, Jan. 23, 2017; Section X(a) of its preamble explains that this provision is based on Section 7701(a)(4).

[65] Prop. Reg. § 1.951-1(h).

[66] Federal Register GILTI at 51082.

[67] Separate proposed regulations would adopt the same rule for purposes of Section 965. *See* Prop. Reg. § 1.965-1(e).

suddenly the rule for existing foreign corporations treated as CFCs, so that the CFCs would become PFICs. As a result, if future legislation or regulations adopt the Pure Aggregate Approach, we believe that generous grandfather provisions should apply to allow existing foreign corporations that are held by domestic partnerships and treated as CFCs under the existing rules to continue to be so treated, either permanently or at least for an extended period of time such as 10 years. Domestic partnerships holding grandfathered CFCs (not discussed further herein) would need to be subject to one of the approaches other than the Pure Aggregate Approach during the grandfather period. In any event, a regulation issued in reliance on Section 7701(a)(4) could only apply to partnerships organized after the regulation was proposed.[68]

(b) *Proposed Regulations Hybrid Approach*

If the Pure Aggregate Approach is not adopted, then non-U.S. shareholder partners of a Partnership CFC will be taxed, in one way or another, on their share of GILTI income from the CFC. In any particular U.S. shareholder partnership, there might be a large number of these partners, each owning a small percentage of the U.S. shareholder partnership. The Prior Report Hybrid Approach (discussed below) will require these partners to make their own GILTI calculations, even if they own no interests in any CFC except through the partnership. The major advantage of the Proposed Regulations Hybrid Approach, as compared to the Prior Report Hybrid Approach, is that these calculations are all done by the U.S. shareholder partnership, and a simple GILTI inclusion number is passed through to the non-U.S. shareholder partners.

We do not minimize the administrative benefit provided by this aspect of the Proposed Regulations. However, we see a number of problems with the Proposed Regulations Hybrid Approach.

(i) *Lack of Ability to Offset at the Partner Level*

A partner that is a non-U.S. shareholder partner of one or more partnership CFCs must include in income its share of the partnership GILTI inclusion amount for those CFCs, even if the partner has unused tested losses or excess NDTIR from non-partnership CFCs. The non-U.S. shareholder partner of one or more partnership CFCs will also lose the opportunity to use tested losses or NDTIR from those CFCs against tested income from non-partnership CFCs. This inability to offset will also exist for partnership CFCs held through different domestic partnerships. These results are unfair and uneconomic to the non-U.S. shareholder partners. They will also be greatly exacerbated if tested losses cannot be carried over, at either the shareholder or CFC level.

[68] Section 7701(a)(4) was amended by P.L. 105-34 to allow regulations to change the status of domestic partnerships, but Section 1151(b) of that Public Law states that regulations under that provision can only apply to partnerships organized after the date determined under Section 7805(b) without regard to (b)(2).

(ii) *Procedural Complexity*

The Proposed Regulations Hybrid Approach requires a U.S. shareholder partnership to determine whether each of its partners is a U.S. shareholder partner or a non-U.S. shareholder partner for each partnership CFC. In many cases, this will require the U.S. shareholder partnership to determine whether and to what extent each of its partners has separately held interests in each partnership CFC—directly and through attribution—and how these amounts change over time. The partnership needs to know the information in order to calculate the partnership level GILTI inclusion amount for each of its partners. Many partners will not be willing to give this information to their partnerships and should not be required to do so.

One way of addressing this problem would be to permit a partner that is U.S. shareholder partner of a partnership CFC, but whose interest in such CFC held through the partnership would not itself make it a U.S. shareholder partner of the CFC, to disregard its separately held ownership in the partnership CFC. This would allow such U.S. shareholder partner to accept its share of the partnership's GILTI inclusion amount (instead of its share of the partnership's CFC tested items). However, this could lead to tax planning opportunities, since segregation of partnership-level CFC tested items can be more favorable to the partner than an aggregate approach.

This problem could also be avoided if the U.S. shareholder partnership did not make its own calculation of a GILTI inclusion amount, but rather was required to pass through, to all its partners, the component parts of its partnership-level GILTI inclusion amount calculation. Each partner would be required to make its own *partnership-level* calculation of the GILTI inclusion amount, excluding those partnership CFCs for which it is itself a U.S. shareholder, and incorporate the remaining partnership CFCs into its *partner-level* calculation of the GILTI inclusion amount. This would reach the same dollar result as the Proposed Regulations, but the calculations would always be done at the partner level. However, if this were the end result, we see no reason to adopt this general approach instead of the Prior Report Hybrid Approach, discussed in Part III.F.2(c).

(iii) *Computational Complexity*

The Proposed Regulations Hybrid Approach can also create enormous computational complexity. Any U.S. shareholder partnership could have numerous partnership CFCs, and its partners could themselves be U.S. shareholders for any combination of those CFCs. As a result, a separate, personalized partnership-level calculation of GILTI inclusion for each partner would be required, taking into account only the partnership CFCs for which the partner is a non-U.S. shareholder. The number of required calculations could be very high, and these calculations could produce results for particular partners that are higher or lower than the baseline partnership-level GILTI inclusion amount.

Consider a simple example:

> **Example 17.** *Possible calculations of partnership GILTI inclusion amount.* PRS is a U.S. shareholder partnership that owns 50% of each of two partnership CFCs, CFC1 and CFC2. The partnership's share of CFC1's tested income is $50, and the partnership's share of CFC2's tested income is $100; there are no other CFC tested items. The partnership has a partnership level GILTI inclusion of $150. However, any particular partner might be required to report its pro rata share of a partnership GILTI inclusion of $0 (if it is a U.S. shareholder partner of both CFCs), $50 (if it is a U.S. shareholder partner of CFC2 only), $100 (if it is a U.S. shareholder partner of CFC1 only), or $150 (if it is not a U.S. shareholder partner of either CFC). Note also that if CFC1 instead had a tested loss of $100, the partnership level GILTI inclusion from CFC1 alone would be $0, but the partnership level tested income and tested loss calculation for individual partners for CFC1 alone could range from $100 of tested loss to $100 of tested income.

Indeed, if there are *n* partnership CFCs, there are (2^n – 1) possible partnership-level calculations of GILTI inclusion amounts for individual partners. This number reflects every potential combination of partnership CFCs for which one or more partners is a U.S. shareholder and the other partners are not.[69] The possible number of computations increases quickly with the number of partnerships CFCs—there are 31 potential calculations with five partnership CFCs, and 1,023 calculations with 10 CFCs. While the need for such a large number of calculations would likely rarely arise in practice, and the total number of calculations would never exceed the number of partners, the mere possibility of this need raises serious questions about the administrability of the general approach.

The Proposed Regulations also do not discuss the consequences for a partner of a U.S. shareholder partnership whose status shifts from being a U.S. shareholder partner of a CFC to being a non-U.S. shareholder partner of a CFC, or vice versa. This could arise either from a purchase or sale by the partner itself of equity in the partnership or of stock in a partnership CFC, or by the purchase or sale by the partnership of stock in a partnership CFC. This change in status would mean shifting from entity to aggregate treatment, or vice versa. It seems that a fairly complex set of rules would be needed, since CFC attributes that had been "locked up" within the partnership (e.g., net used tested loss amounts in a CFC) would now become partner attributes, or vice versa. The methodology for calculating basis in the partnership, and in the CFC, would also change.

(iv) *Allocation Issues*

In order to apply the Proposed Regulations Hybrid Approach, the U.S. shareholder partnership must first determine which of its partners are U.S. shareholder

[69] These numbers do not include the computation for the case where no partner of the partnership is a U.S. shareholder of any partnership CFC.

partners of each partnership CFC. As discussed in the 2007 Report,[70] it is unclear how this determination should be made in the absence of pro rata ownership of capital and profits over the life of the partnership. At a minimum, the U.S. shareholder partnership's determination of a partner's indirect ownership of a CFC should be binding on its partners to ensure that the government is not whipsawed. In addition, it would be helpful if regulations addressed whether this determination should be made based on each year's rights to capital or earnings, or based on projected future rights as determined either initially or as adjusted over time.[71]

In addition, if a partner is a non-U.S. shareholder partner of one or more partnership CFCs, it must report its share of the partnership level GILTI inclusion calculated on its behalf. In the absence of pro rata ownership of partnership capital and profits, potentially this inclusion item could be allocated in the same manner that an increase in the Section 704(b) book value of the stock of the CFC (equal to the amount of the partnership-level GILTI inclusion) would be allocated upon a revaluation of partnership assets.

However, this could be quite complex, because the partnership-level GILTI inclusion for different partners can be different because the inclusion for each partner only takes account of the partnership CFCs for which the particular partner is not a U.S. shareholder. It is also unclear how overall partnership priority allocations can be taken into account in allocating the partnership level GILTI inclusion when there may be a different total partnership level GILTI inclusion to be allocated to different partners, and when U.S. shareholder partners of particular CFCs are reporting partnership income from those CFCs on a basis that is completely different than non-U.S. shareholder partners.

(v) *Interaction with Partnership Audit Rules*

Layered on top of these enormously complicated rules are the partnership audit rules enacted as part of the Bipartisan Budget Act of 2015.[72] Many of these computations—including the individualized calculations of the partnership's GILTI inclusion amount and basis adjustments—would be partnership items subject to audit at the partnership level. It would be enormously difficult for the IRS audit division to deal

[70] 2007 Report at 8.

[71] There are also significant questions about how to measure a partner's rights to partnership capital and profits for purposes of these rules. For instance, in determining a partner's right to partnership capital, should the partnership use Section 704(b) capital, or capital upon a hypothetical liquidation at fair market value? Similarly, would a partner's right to partnership profits be based on allocations of Section 704(b) income or taxable income, and how would chargebacks of losses be taken into account? We note that, because similar issues present themselves any time stock is held through a partnership, any resolution for purposes of the GILTI rules could have broader implications throughout the Code.

[72] *See* Sections 6221-6241.

with these items, especially with respect to those determinations that are partly made at the partnership level and partly at the partner level.

For example, if a partner is a U.S. shareholder of a partnership CFC, and the items of the CFC passing through from the partnership to the partner are considered subject to partnership level audit, then some of the numbers going into the U.S. shareholder's calculation of a single GILTI inclusion amount will be subject to audit of the partnership under the partnership audit rules. Yet the items passing to the shareholder from CFCs held directly by the shareholder (or through other partnerships) will be subject to an entirely separate audit. Regulations should maximize the scope of items that will be subject to partnership-level audit, to prevent the need for multiple audits of individual partners to the extent possible.

(vi) *Incentive for Foreign Partnerships*

The Proposed Regulations Hybrid Approach can be avoided if a partnership that will hold CFCs is formed as a foreign partnership, or if an existing domestic partnership is redomiciled as a foreign partnership. The complexity of the Proposed Regulations Hybrid Approach may increase the incentives to use foreign rather than domestic partnerships. This will have the additional consequence of eliminating current GILTI inclusions for non-U.S. shareholders of partnership CFCs, since the foreign partnership will not itself be a U.S. shareholder of a CFC.

(vii) *Tax Basis*

The treatment of tax basis under the Proposed Regulations Hybrid Approach will be enormously complex. We believe the complexity will be greater than under the Prior Report Hybrid Approach because of the mixture of calculations required by the Proposed Regulations Hybrid Approach at both the partnership and partner levels. These calculations affect both the basis of each partner in its partnership interest and the partnership's basis in each CFC with respect to each partner.

If a partner is a non-U.S. shareholder partner of one or more partnership CFCs, the partner should clearly increase its outside tax basis in the U.S. shareholder partnership by the amount of any partnership level GILTI inclusion amount allocated to it. Similarly, since entity principles apply, under Section 961(a), the partnership's inside basis in the partnership CFCs should be increased to the extent of any GILTI inclusion amount determined at the partnership level and allocated to such partners under Proposed Regulation Section 1.951A-6(b)(2). Moreover, as discussed in Part IV.B.3(i), the partnership should disregard the CFC basis adjustment rule under Proposed Regulation Section 1.951A-6(e) in determining its gain or loss allocable to such partners on a sale of a CFC, because these partners will not be entitled to a Section 245A deduction on distributions from the CFC.

The treatment of U.S. shareholder partners is even more complex. Suppose the U.S. shareholder partnership allocates tested income to a U.S. shareholder partner and the partner does not have tested loss or NDTIR to offset that amount. The resulting GILTI inclusion amount should be treated comparably to a Subpart F inclusion of the partnership that is allocated to the U.S. shareholder partner, and therefore increase the partner's outside basis in its partnership interest. This should be the case even though the allocation is not an allocation of partnership income.

Suppose, instead, that the U.S. shareholder partner has tested income from the partnership that is fully offset by tested losses or NDTIR allocated to it from a non-partnership CFC. Arguably, the U.S. shareholder partner should get outside-basis credit for the tested income, provided that such partner could claim a deduction under Section 245A if the CFC paid a dividend to the partnership and Section 1059 would not apply to the dividend. Such a rule is similar to "Rule 3" discussed in Part IV.D.1 in the consolidated return context, and would preserve the benefit to the partner of the exempt income from the CFC if the partner sells the partnership interest. This rule would also avoid the need for "self-help" (through payment of a dividend from a CFC to the partnership) to achieve the same basis increase in the partnership interest by having the CFC make a tax-free distribution to the partnership.

On the other hand, such outside-basis credit in the partnership interest seems peculiar when no taxable income is passed through from the partnership. In that connection, it is not clear why a loss should be allowed to the extent it arises from the increase in tax basis. Such a result would be inconsistent with Section 1248, which recharacterizes gain to the extent of untaxed e&p but, if the gain is less than the amount of untaxed e&p, does not allow the creation of untaxed gain and a deductible loss.

Instead of such a basis increase, another approach would be to have the partner's sale of the partnership interest give rise to Section 1248 gain, and for the Section 751 amount relating to Section 1248 to be eligible for dividend treatment under Section 245A. This approach seems more appropriate than a basis increase for untaxed income. It puts the partner in a position similar to the position of holding the stock in the CFC directly, and either selling the stock or contributing it to the partnership after taking into account the CFC tested items of the CFC.

The authorities do not support the treatment of the Section 751 amount in this situation as a dividend.[73] However, those authorities arose before the enactment of Section 1248(j), which clearly contemplates that gain on sale of the stock of a CFC that is attributable to untaxed earnings of the CFC should be eligible for Section 245A. We urge

[73] Gain on the sale of stock of a foreign corporation that is subject to Section 1248 is treated as an unrealized receivable under Section 751(c), so that gain realized on the sale of a domestic partnership interest, to extent attributable to such stock (a "Section 751(c) amount"), has been treated by the Treasury as ordinary income but not as a dividend. *See* T.D. 9345, Federal Register Vol. 72, No. 145, July 30, 2007, 41442-41450 at 41443; T.D. 9644, Federal Register Vol. 78, No. 231, Dec. 2, 2013, 72394-72449 at 72419-20. The correctness of this view under current law is beyond the scope of this Report.

that regulations treat the Section 751 amount arising under Section 1248 as a dividend eligible for Section 245A.[74]

Suppose next that the U.S. shareholder partner has a net used tested loss amount (defined below) in a partnership CFC at the time the partner sells its partnership interest. As discussed in Part IV.B.3(i), under Proposed Regulation Section 1.951A-6(e), a U.S. shareholder directly owning stock of a CFC in this circumstance would reduce its basis in the CFC immediately before the sale of the stock by such amount. Logically the partner should reduce its basis in the partnership interest by this amount immediately before selling the interest, or else a U.S. shareholder of a CFC could routinely avoid the tax cost of that regulation by holding a CFC through a partnership.

Such a basis reduction in the partnership interest is analogous to Rule 1 (discussed in Part IV.D.1) in the consolidated return context, which requires an immediate basis reduction in the stock of a member of a consolidated group to reflect the net used tested loss amount of a CFC held by the member. The basis reduction is also analogous to Proposed Regulation Section 1.951A-6(e)(1)(iii), which requires a reduction in the basis of the equity in a foreign entity (other than a CFC), when the foreign entity holds stock in a CFC with a net used tested loss amount and the U.S. shareholder of the CFC sells the equity in the foreign entity.

A technical way to reach this result would be to require the partnership to reduce its basis in the CFC, with respect to a selling partner, by the partner's net used tested loss amount in the CFC, and then to treat the basis reduction as a noncapital, nondeductible expense of the partnership under Section 705(a)(2)(B) allocable to the selling partner. This would reduce the selling partner's basis in the partnership interest accordingly.

Turn now to the calculation of the U.S. shareholder partnership's basis in partnership CFCs. Pure entity principles cannot apply, since they would create enormous disparities depending on whether a U.S. shareholder partner held its interest directly or through a partnership.

> **Example 18.** *Partnership's inside basis in tested income CFC.* PRS is a U.S. shareholder partnership that wholly owns one partnership CFC, CFC1. PRS has one 50% corporate partner, USP1, and ten 5% partners. USP1 separately owns 100% of CFC2. In Year 1, CFC1 has tested

[74] Other issues will also arise if the partner that is a U.S. shareholder of the CFC receives untaxed tested income through the partnership. For example, rules would be needed for the treatment of capital accounts and Section 704(b) book value of the stock in the CFC. This would be particularly complicated if some partners were U.S. shareholders of a particular CFC and other partners were not, and because the same income of a partnership CFC might be taxable tested income to some U.S. shareholder partners and offset tested income to other U.S. shareholder partners. These rules would be far more complicated than today's rules for CFCs owned through a domestic or foreign partnership, because the Subpart F rules do not involve the aggregation of CFCs at either the partnership or partner levels.

income of $100x and CFC2 has tested loss of $50; neither has any other CFC tested items.

Under the Proposed Regulations, PRS's own GILTI inclusion amount is $100, of which $50 is allocated to the non-U.S. shareholder partners. Separately, USP1 is allocated $50 of tested income, which is fully offset by the tested loss of separately-owned CFC2. If pure entity principles applied, PRS's basis in CFC1 would increase by $100. However, if USP1 directly held its indirect interest in CFC1, there would be no basis increase, so the aggregate basis increase in CFC1 would be $50.

The disparity in basis results is even greater if the partnership CFC has a tested loss.

Example 19. *Partnership's inside basis in tested loss CFC stock.* Assume the same facts as Example 18, but that, in Year 1, CFC1 has tested loss of $100 and CFC2 has tested income of $50. After Year 1, PRS sells CFC1 to a third party.

Under pure entity principles, the sale of CFC1 would not trigger any downward basis adjustment under Proposed Regulation Section 1.951A-6(e), since CFC1's tested loss did not offset the tested income of any partnership CFCs. However, from the perspective of USP1, USP1's $50 share of the tested loss of CFC1 was used to offset $50 of tested income from CFC2, and so its allocable share of basis in CFC1 should be reduced by $50. It is therefore necessary to separately compute the basis of USP1 in CFC1 to give effect to the aggregate treatment accorded to USP1 under Proposed Regulation Section 1.951A-5(c).

As a result, it seems necessary for a U.S. shareholder partnership to be treated as having a separate basis in each partnership CFC with respect to each partner, as follows:

1. For CFCs for which a particular partner is a non-U.S. shareholder partner, the partnership's basis in each such CFC with respect to such partner is determined based on the personalized partnership-level GILTI inclusion amount calculated for that partner.

2. For each CFC for which a particular partner is a U.S. shareholder partner, the partnership's basis for such partner in each such CFC is determined as if such partner owned the CFC directly.

3. To the extent a particular U.S. shareholder partner is treated as having a net used tested loss amount in a partnership CFC, the partnership must be treated as having reduced its basis in the CFC with respect to such partner by such amount immediately before a disposition of the CFC. The U.S. shareholder partner would have to tell the partnership whether it had used a tested loss of the partnership CFC against its own tested income.

Under these rules, even if none of the partners is a U.S. shareholder with respect to a particular CFC, the partnership could have different bases in the CFC stock with respect to different partners, because of the potential status of those partners as U.S. shareholders of other partnership CFCs. The reason is that the individualized partnership-level GILTI calculations to different partners might make different use of the tested income and tested loss of the particular CFC. Moreover, a U.S. shareholder partnership will frequently not know its basis in some or all of its partnership CFCs with respect to some or all of its partners. The separate basis for each partner will depend on (i) whether the partner is a U.S. shareholder partner of the particular CFC, (ii) if so, whether it is able to utilize the tested losses of the partnership CFC in the calculation of its own GILTI inclusion amounts, and (iii) if not, whether or not it is a U.S. shareholder in other partnership CFCs.

Separate bases will create considerable complexity. If a purchaser buys a partnership interest without a Section 754 election being in effect, does the purchaser succeed to the basis that the selling partner had in each of the partnership CFCs? If a partnership distributes stock in a partnership CFC to a partner in a nonliquidating distribution, what does it mean for Section 732 to give the partner a carryover tax basis in the distributed property?

These rules will also increase the complexity of applying Sections 734 and 743 to partnership CFCs. For example, if Section 754 applies to a partner's purchase of its partnership interest, normally the partner would be treated as having a basis in the stock of each partnership CFC equal to the portion of the purchase price allocated to that stock. Logically this rule should apply even to a partnership CFC for which the particular partner is a non-U.S. shareholder, even though the partnership computes a GILTI inclusion for that partner with respect to that CFC at the partnership level.

However, as discussed in the preceding paragraph, the partnership may have a different tax basis in each CFC with respect to each partner, and this basis will need to be taken into account in determining the amount of the Section 754 step up for the particular CFC for the particular partner. This determination will be particularly complicated where a U.S. shareholder partner sells some or all of its partnership interest to a non-U.S. shareholder partner and, as a result, transforms the (now former) non-U.S. shareholder partner into a U.S. shareholder of a partnership CFC. Finally, it is also not clear how Section 734 can be applied to a distribution of a CFC to a partner, when the partnership may have a different basis in that CFC with respect to each partner.

Implementing these rules would be extremely complicated, although some of these issues might come up today with CFCs held through a foreign partnership. The partnership would calculate the basis of each partnership CFC for each non-U.S. shareholder partner of the CFC. This calculation would require a separate running determination of the various partnership GILTI inclusion amounts for each such partner. (Fortunately, there would be no need for the partnership to track used tested losses and offset tested income of a CFC for these calculations, assuming as we discuss elsewhere that those concepts are not applicable to partners of a partnership that are not themselves

U.S. shareholders of the CFC.) The calculation of basis of a partnership CFC for U.S. shareholder partners of the CFC would have to be done by the partners rather than the partnership, because the basis depends upon tested income, tested loss and NDTIR of other CFCs owned by the partner.

(c) *Prior Report Hybrid Approach*

The Preamble rejects the Prior Report Hybrid Approach because it might "be interpreted by taxpayers to exempt small partners of a domestic partnership from the GILTI regime entirely."[75] We do not understand this reasoning. Regulations adopting such an approach could explicitly state that partners of a U.S. shareholder partnership are required to report their share of CFC tested items regardless of their percentage ownership of the partnership.

Rather, we view the trade-offs between the Prior Report Hybrid Approach and the Proposed Regulations Hybrid Approach to be the following. The Prior Report Hybrid Approach has the major benefit of allowing non-U.S. shareholder partners of a U.S. shareholder partnership to aggregate the CFC tested items arising from partnership CFCs with other CFC tested items arising from non-partnership CFCs. This approach does not materially increase the complexity to them of GILTI tax reporting, since they are already making a GILTI calculation based on the CFC tested items of their non-partnership CFCs. Adding additional CFCs to the calculation does not materially increase the complexity of the calculation.

However, this benefit under the Prior Report Hybrid Approach to non-U.S. shareholder partners that own non-partnership CFCs is offset by the increased complexity of tax filing obligations under that approach to non-U.S. shareholder partners that do not own any non-partnership CFCs. Those partners are not obtaining any economic benefit under the Prior Report Hybrid Approach, yet under that approach they must calculate their own GILTI inclusions based on the CFC tested items of the partnership CFCs, rather than receiving a simple pass-through allocation of a partnership GILTI inclusion.

On an overall basis, we view the Proposed Regulations Hybrid Approach as being more complex than the Prior Report Hybrid Approach. This is largely, as discussed above, because of the complexity of the GILTI calculations and basis calculations that might be required under that approach. While we do not believe that the Prior Report Hybrid Approach could be characterized as simple, we believe that on an overall basis, it is significantly less complex than the Proposed Regulations Hybrid Approach.

We also believe that the Prior Report Hybrid Approach could be made less burdensome to small partners of U.S. shareholder partnerships. For example, regulations might permit partners to irrevocably elect into the Pure Entity Approach, subject to an anti-abuse rule, if they own less than a de minimis share of the partnership (e.g., 2%).

[75] Federal Register GILTI at 51079.

This would permit small partners avoid individualized calculations of the GILTI inclusion amount and outside basis. Given a small de minimis threshold and an anti-abuse rule, the potential for abuse (and the potential revenue loss to the fisc even in nonabusive situations) seems limited, even if the election were allowed on a partnership-by-partnership basis.

(d) *Pure Entity Approach*

The Pure Entity Approach is by far the simplest. However, it is clearly rejected in the Preamble,[76] and, we believe, for good reasons. The Preamble recognizes that fragmenting the ownership of U.S. shareholder partners in partnership CFCs can significantly change results under Section 951A, which presents an "inappropriate planning opportunity as well as trap for the unwary."[77] We agree that the Pure Entity Approach is unfair to U.S. shareholder partners because it does not allow aggregation with CFC tested items from outside the partnership. We rejected this approach in the Prior Report and we continue to agree that it should not be adopted.

We acknowledge that this approach would be similar to the existing treatment of Subpart F income under Section 951. However, Subpart F does not involve the blending of CFC-level items such as tested income and loss, NDTIR, and specified interest income and expense at the shareholder level, so that approach under Subpart F does not create the discontinuities that it would create for GILTI.

(e) *Conclusions*

As a policy matter, we support the Pure Aggregate Approach. If this approach is not adopted, we do not take a position between the Proposed Regulations Hybrid Approach and the Prior Report Hybrid Approach. While the reporting obligations under the former approach will be simpler for many partners in U.S. shareholder partnerships, that approach will also be less fair to many such partners that own interests in CFCs through more than one partnership, or both through partnerships and directly. The Proposed Regulations Hybrid Approach also introduces complexities at the partnership level that are not present in the Prior Report Hybrid Approach. We do not support the Pure Entity Approach.

Finally, whichever approach is adopted, it is essential that the same rules apply for both Subpart F and GILTI. Moreover, under any approach, final regulations should clarify that the partnership rules are unchanged except for the purposes of calculating Subpart F income and GILTI inclusions. For example, all items that are ordinarily determined at the partnership level, such as deductions of the partnership, should be determined on an entity basis, just as today.

[76] Federal Register GILTI at 51079.

[77] *Id.*

G. Proposed Regulation Section 1.1502-51: Consolidated Section 951A

This section of the Report discusses aspects of the -51 regulation that do not relate to tax basis. Tax basis issues are discussed in Part IV.

1. *Background*

The Proposed Regulations determine how GILTI inclusions are calculated by members of a consolidated group. In general, the aggregate of the GILTI inclusions by group members will be the same as if the group was a single corporation. We strongly commend the Treasury for adopting this approach. The Prior Report discussed the potential disadvantages to taxpayers, and the possibility for taxpayers to engage in nonproductive tax planning, in the absence of such single entity treatment for a consolidated group.[78] We urge that no changes be made in the final regulations that will weaken this single entity treatment.

The following terminology will be used in this section and the remainder of the Report:

(a) P is the parent of a consolidated group.

(b) M is a member of the group. If more than one member is involved, they will be referred to as M1, M2, etc. For simplicity, unless otherwise indicated, any M is a first tier wholly owned subsidiary of P.

Each member of the group is allocated the tested income arising from the stock it owns in CFCs with positive tested income (a tested income CFC). All tested losses from CFCs with tested losses (a tested loss CFC), NDTIR from tested income CFCs, and specified interest are aggregated, and then reattributed back to the members with tested income in proportion to that tested income. Each member then calculates its own GILTI inclusion.[79]

> **Example 20**. *Allocation of tested loss in a group*. M1 owns CFC1 with \$100 of tested income and CFC2 with \$100 of tested loss. M2 owns CFC3 with \$100 of tested income. M1 and M2 each retains its gross tested income of \$100. However, the tested loss of CFC2 is allocated 50% to M1 and 50% to M2, even though M1 owns 100% of CFC2. As a result, M1 and M2 each has a GILTI inclusion of \$50. The same would be true if CFC2 was instead a subsidiary of CFC1, or CFC1 was instead a subsidiary of CFC2, or if CFC2 was instead owned by M2.

[78] Prior Report at 17-27.

[79] Prop. Reg. § 1.1502-51(b).

As discussed in Part IV, the CFC basis reduction rule applies to reduce the tax basis of the stock of the CFC in the hands of a member, upon the member's disposition of the stock, by the member's net used tested loss amount in the stock.[80] However, for a CFC owned by any group member, used tested losses and offset tested income are calculated and apportioned on a group-wide basis taking account of the reallocation of tested losses.[81] In Example 20, CFC1 and CFC3 each has offset tested income of $50, and CFC2 has a used tested loss of $100.

2. *Comments*

(a) *Foreign Tax Credits and Section 250*

It is critical that the single entity treatment arising under the Proposed Regulations also apply to foreign tax credits and the Section 250 deduction. It is important, therefore, that future regulations allow a group to have an FTC based on the overall tested income of tested income CFCs of the group, the overall tested loss of tested loss CFCs, the overall foreign taxes paid by tested income CFCs, and an overall inclusion percentage for the group under Section 960(d)(2).

In addition, the Section 250 deduction is limited to 50% of the taxable income of the U.S. corporation with the GILTI inclusion. Regulations under Section 250 should allow the Section 250 deduction on the basis of the taxable income and GILTI inclusion of the group as a whole. Logically that deduction would be allocated to members in the same manner as tested losses, etc. are allocated, so that even a member with no separate taxable income can be allocated a Section 250 deduction.

For example, suppose M1 has a CFC with tested income of $100, M1 has an unrelated loss of $100, the group as a whole has taxable income of $100 before any Section 250 deduction (i.e., other members of the group have $100 of unrelated income), and there are no other CFCs. M1 has a GILTI inclusion of $100. The Section 250 deduction should be $50 based on the $100 of taxable income of the group as a whole, even though M1 has no taxable income of its own. Likewise, the deduction of $50 should be allocated to M1, leaving M1 with a separate company loss of $50. This does not violate the rule in Section 172(d)(9) that a Section 250 deduction cannot create a net operating loss, since no net operating loss is being created for the group as a whole or is being carried to a different year.

(b) *Allocation of Tested Losses*

We have considered whether, as a policy matter, tested losses of a CFC owned by a member M should instead be allocated first to M to the extent M has tested income from other CFCs, with any excess tested loss of M's CFCs allocated proportionately to

[80] Prop. Reg. § 1.1502-51(c)(1).

[81] Prop. Reg. §§ 1.1502-51(c)(2), (c)(3).

other members with tested income (the "**priority allocation rule**"). In Example 20, the question is whether the tested loss of CFC2 should instead be allocated entirely to M1, so that M1 has no GILTI inclusion and M2 has a $100 GILTI inclusion.

The priority allocation rule allocates to each member an amount of GILTI inclusion that better reflects the economic results to the members. On the other hand, the rule in the Proposed Regulations (the "**pro rata allocation rule**") prevents the location in the group of a tested loss CFC from affecting the amount of GILTI inclusion to any member, or the amount of used tested loss and offset tested income for any CFC.[82] The pro rata allocation rule therefore reduces the benefit of, and need for, uneconomic tax planning and is more consistent with single entity treatment of a consolidated group.

The priority allocation rule would also require reconsideration of the allocation of QBAI. In Example 20, suppose M1 has $1000 of QBAI. Under a single entity approach there is $100 of net tested income and $1000 of QBAI giving rise to $100 of NDTIR, so there is no GILTI inclusion. Under the pro rata allocation rule in the Proposed Regulations, the NDTIR is allocated in proportion to gross tested income, i.e., $50 to M1 and $50 to M2, so there is still no GILTI inclusion.

However, under the priority allocation rule, it would not be possible to allocate QBAI or NDTIR in proportion to tested income of tested income CFCs and still achieve the same result as if the group was a single entity. In Example 20, since M1 has no *net* tested income, any allocation of QBAI to M1 would "waste" the QBAI and the total GILTI inclusion would exceed the inclusion under single entity principles and the Proposed Regulations.

Rather, to achieve the single entity result under the priority allocation method, QBAI would have to be allocated among members in proportion to the net tested income of each member. The same would be true for specified interest expense, which reduces NDTIR. These group-wide allocations, without priority to the member generating the QBAI or specified interest expense, are inconsistent in principle with allocating tested losses of a member's CFC first to the tested income of the same member. Likewise, to achieve the equivalent of single entity treatment under the priority allocation rule, foreign tax credits would still have to be determined on a group wide basis with a single inclusion percentage for the group, without priority to the member generating the credits.

The priority allocation rule is also more economically correct, and fairer, to minority owners of members of a group, assuming the group has a typical tax sharing agreement among members. In Example 20, a minority shareholder in M1 would have an economic detriment from the tax liability allocable to M1 notwithstanding M1's lack of

[82] Under the priority allocation rule, any particular CFC might have a different used tested loss or offset tested income than under the pro rata rule. In Example 22, CFC1 would have $100 of offset tested income and CFC3 would have no offset tested income. The allocation of used tested losses could also differ under the two methods if tested losses exceeded tested income, and some members had both tested income and tested loss CFCs.

net income from CFC1 and CFC2. Likewise, a minority shareholder in M2 would get an economic windfall from the reduced tax liability on M2 arising as a result of a tested loss in a subsidiary of M1. However, similar uneconomic results could arise to minority shareholders even under the priority allocation rule, e.g., if one member has a CFC subsidiary with tested income, and another member has a CFC subsidiary with a tested loss.

The solution to this problem under the approach of either the Proposed Regulations or the priority allocation rule would be a revised tax sharing agreement among members. The revised agreement would provide that a member receiving the benefit of a tested loss from another member's CFC would reimburse that member for the resulting tax benefit, just as it would typically reimburse another member for the use of the member's NOL.

Finally, the priority allocation rule is more economically correct for purposes of the SRLY rules, since it better reflects the economic income of each member of the group. If a member has a SRLY loss carryover to a taxable year, the pro rata allocation rule may permit too much, or too little, of the SRLY loss to be absorbed in the taxable year as compared to the economically correct amount.

Taking these factors into account, we believe that on balance the pro rata allocation approach of the Proposed Regulations is the better approach, and we support it. We also note that in a consolidated group with wholly owned subsidiaries, it appears to us that the location of GILTI inclusions is only relevant for SRLY and basis purposes. The Proposed Regulations make enormous efforts to deal with the basis consequences arising from the pro rata approach. With the modifications we suggest in Part IV, we believe that the Proposed Regulations would adequately deal with basis issues arising from the pro rata allocation method. As a result, we do not believe that the economic distortions caused by the pro rata allocation method are a sufficient reason to reject it.

IV. Adjustments to Tax Basis

A. Introduction

As discussed in more detail in this Part, the Proposed Regulations create a detailed and complex set of rules that require, in some circumstances, (1) a reduction in the basis of the stock of a CFC immediately before the stock in the CFC is sold, (2) if the stock in the CFC is owned by a member M of a consolidated group, with P owing M, a reduction in P's basis in M at the time the CFC has a tested loss, even before the stock in the member or the CFC is sold and before M reduces its basis in the stock of the CFC, and (3) an increase in P's basis in M either on a current basis when the CFC has tested income, or in other cases immediately before the stock in the CFC is sold.

Because of timing differences between item (1) and item (2), these rules create disparities between the inside asset basis and outside stock basis in M, and these disparities raise additional complexities. Yet more complexity arises because item (3) provides a basis increase in M stock when there is not an equivalent basis increase in the CFC stock.

The theory behind the Proposed Regulations is that if a corporation is a U.S. shareholder of two CFCs, one with tested income and the other with tested loss, the tested loss can potentially give rise to a double tax benefit to the shareholder. First, the tested loss offsets the tested income, thereby reducing the GILTI inclusion of the shareholder and allowing the CFC with tested income to pay a tax-free dividend to the shareholder. Second, the tested loss will generally correspond to an economic loss in the stock of the CFC with the tested loss, and allow that stock to be sold with a tax loss.

We accept the general desire of the Treasury to prevent what may be viewed as loss duplication, although we suggest certain changes to the Proposed Regulations below. More fundamentally, however, we believe there are at least three arguments for excluding all of these nonstatutory basis adjustments from final regulations.

First, as discussed below, it is by no means clear that the Code and the applicable case law authorize regulations to adjust the tax basis of stock in a CFC in this manner. Moreover, while Section 1502 no doubt authorizes the consolidated return basis adjustments, those adjustments would be illogical and create inconsistencies in the absence of the underlying basis adjustments in the stock of the CFC.

Second, even if a court would say that the adjustments to CFC stock basis are valid, there is no express authority in the Code for regulations to adjust tax basis of stock in a CFC in this manner, nor any statutory guidance as to how basis should be adjusted. There are several choices that can be made to adjust basis and/or e&p at the CFC level, including the method in the Proposed Regulations and other alternatives we discuss below. All of the choices are inherently overinclusive and underinclusive. Arguably these policy decisions should be made by Congress rather than by the Treasury.

Finally, the issue of loss duplication from tested losses is but one version of a broader set of fact patterns involving the recognition of loss on the sale of stock of a foreign corporation. All of these fact patterns arise because in many cases, the Code now allows for the tax-free return under Section 245A of untaxed profits of a foreign corporation, at the same time a loss on the sale of stock of a foreign corporation is allowed subject to Section 961(d).[83] None of these other fact patterns are subject to special rules under either the Code or the Proposed Regulations.

For example, if a U.S. corporation is a 10% shareholder of a foreign corporation that is not a CFC, the shareholder is not subject to a GILTI inclusion but can withdraw its share of the profits tax free under Section 245A. If the shareholder happens to own stock in another foreign corporation with an equal amount of allocable loss, the shareholder can

[83] Section 961(d) effectively disallows a loss to the extent of distributed earnings that were eligible for Section 245A.

sell the stock in that corporation at a loss. This combination of tax-free income and recognized loss is in substance the same result that the Proposed Regulations are trying to prevent in the GILTI context. Similarly, if a U.S. shareholder owns a CFC with a tested loss, the stock can be sold at a loss, while if the CFC has tested income that is sheltered by NDTIR, the corresponding gain is tax-free to the extent of e&p. The Code makes no attempt to eliminate this lack of symmetry. To be sure, in none of these cases is the shareholder using a loss in one CFC to shelter income in another CFC that would otherwise be taxable to the shareholder, and so arguably the considerations are different.

Arguably Congress rather than Treasury regulations should determine the extent to which basis adjustments are appropriate to change the results in these different fact patterns. On the other hand, it can be argued that the specific issue addressed by the Proposed Regulations is the clearest case of the double use of a loss, will frequently come up under GILTI, and should be addressed by regulations even though a more comprehensive solution to the problems created by Section 245A must necessarily await Congressional action.

In the remainder of this Part IV, we first describe the basis adjustment rules in the Proposed Regulations and provide a detailed set of comments. Then, with this background, we describe in Part IV.G two alternative approaches to ameliorate or eliminate loss duplication. We prefer those other approaches to the approach in the Proposed Regulations because we believe they are simpler and generally achieve the goals of the Proposed Regulations in preventing loss duplication. We acknowledge, however, that they may raise additional issues of authority. We have not had time to fully consider all the detailed rules that would be necessary under these alternative approaches, but we would be happy to consider these issues further if the Treasury is interested in pursuing these approaches.

B. Proposed Regulation Section 1.951A-6: The CFC basis reduction rule

1. *Summary of Proposed Regulation*

This Proposed Regulation introduces several key concepts. The "**offset tested income amount**" of a CFC for a particular year with respect to a U.S. shareholder is the tested income of the CFC allocable to the shareholder that is offset at the shareholder level by tested losses of other CFCs allocable to the shareholder.[84] Likewise, the "**used tested loss amount**" of a CFC for a particular year with respect to a U.S. shareholder is the tested loss of the CFC allocable to the shareholder that offsets tested income of other CFCs allocable to the shareholder. Tested losses of CFCs with tested losses are allocable proportionately against tested income of CFCs with tested income.

In addition, for any U.S. shareholder and any CFC, (a) the CFC's aggregate used tested loss amount with respect to the shareholder for all taxable years to date, is

[84] Prop. Reg. § 1.951A-6(e)(1)(i).

compared to (b) the CFC's aggregate offset tested income amount with respect to the shareholder for all taxable years to date. If (a) exceeds (b), the excess is the "**net used tested loss amount**" of the CFC with respect to the shareholder at that time. If (b) exceeds (a), the excess is the "**net offset tested income amount**" of the CFC with respect to the shareholder at that time.[85]

As a substantive matter, immediately before the disposition of Section 958(a) stock of a CFC owned directly or indirectly by a domestic corporation that is a U.S. shareholder, the tax basis of the stock of the CFC is reduced by the net used tested loss amount, if any, attributable to the stock that is disposed of. If the basis reduction exceeds the basis in the stock immediately before the disposition, then such excess is treated as gain from the sale of such stock. This rule is referred to as the "**CFC basis reduction rule**."

The CFC basis reduction rule can be illustrated by the following examples. Unless otherwise indicated, all examples assume that U.S. shareholder S is a domestic corporation that directly owns 100% of CFCs indicated as CFC1, CFC2, etc.[86]

> **Example 21.** *Used tested loss and offset tested income; single year*. In year 1, CFC1 has $100 of tested income and CFC2 has $100 of tested loss. Therefore, S has no net tested income and no GILTI inclusion. However, CFC1 has $100 of offset tested income, and CFC2 has $100 of used tested loss. The net used tested loss amount for CFC2 is $100 at the end of the year. Moreover, since there is no GILTI inclusion, there is no change in S's basis in the stock of CFC1 or CFC2 under Section 961.
>
> **Example 22**. *Used tested loss and offset tested income; two years*. Same facts as Example 20 in year 1, but in year 2, CFC1 has $100 of tested loss and CFC2 has $100 of tested income. For year 2, CFC1 has $100 of used tested loss and CFC2 has $100 of offset tested income. At the end of year 2, both CFCs have a $0 net used tested loss amount and net offset tested income amount, since in each case, the CFC has an equal used tested loss in one year and offset tested income in the other year.

In Example 21, if S sells the stock of CFC2 at the end of year 1, the tax basis of CFC2 will be reduced by the net used tested loss amount of $100. The stated rationale for this reduction in basis is the following. Absent additional facts (discussed in Part IV.B.2(a)), the tested loss of CFC2 reduces the GILTI inclusion of S by $100. In addition, CFC1 would normally have $100 of e&p that it can distribute to S on a tax free

[85] Prop. Reg. §§ 1.951A-6(e)(2), (e)(3).

[86] The considerations are different for individuals, who (at least in the absence of a Section 962 election) are not entitled to the deduction under Section 245A in the case of a tested income CFC, and are not required (and, as discussed below, should not be required) to reduce basis in a tested loss CFC.

basis under Section 245A, without any reduction in S's basis in CFC1.[87] The value of CFC1, and the tax basis in CFC1, would be the same as before year 1, and so any built-in gain is unchanged. If no dividend was paid but the stock of CFC1 was sold, the gain attributable to the $100 of tested income would be tax free under Section 1248(j).

In addition, CFC2's tested loss would reduce the value of CFC2, assuming a corresponding economic loss. Absent the Proposed Regulations, S could sell the stock of CFC2 at an increased loss or reduced gain on account of such tested loss. On these facts, the tested loss has thus provided a double tax benefit to S. As noted above, the purpose of the Proposed Regulations is to prevent this double tax benefit.

Notably, the Proposed Regulations do not eliminate the incentive to taxpayers to create income in one CFC and an equal loss in another in order to obtain this tax benefit. In particular, any time S is planning on selling the stock of CFC1, it can first have CFC1 sell its assets at a gain equal to the stock gain, and avoid the GILTI inclusion by having another CFC such as CFC2 sell its own assets at an equal loss. There is no GILTI inclusion, the cash proceeds on the sale of CFC1 are received tax-free, and the basis reduction in CFC2 stock is deferred.

2. *Policy Issues*

(a) *Not Always a Double Tax Benefit*

The Preamble justifies the basis reduction on the ground it is necessary to prevent the double tax benefit from the tested loss. We consider first exactly what is meant by preventing a double benefit. Even in the simple case in Example 21, the used tested loss of CFC2 eliminates a GILTI inclusion that would otherwise be taxed to S at 10.5%. Absent the Proposed Regulations, the capital loss on the sale of stock of CFC2 would potentially result in a tax savings of 21% to S if it had other capital gain.

The Proposed Regulations are therefore reducing this potential tax savings of 31.5% of the net used tested loss amount to a tax savings of 10.5% of the net tested loss amount. This is more than eliminating a double benefit from the tested loss—it is eliminating the potential 21% benefit that would arise in the absence of tested income, and converting that into a deduction against income otherwise taxable at 10.5%.

Put another way, the basis reduction is causing S to pay tax at a 21% rate on the increased gain or reduced loss on the sale of the CFC (assuming no exempt gain under Section 1248), while the tested loss only provided a benefit at the 10.5% rate. S would actually be better off if CFC1 had tested income, and CFC2 had tested loss, in different

[87] An exception is Section 961(d), which would effectively disallow a loss on the stock to the extent of the Section 245A dividend.

taxable years, since that might lead to income taxed at 10.5% and a loss on the CFC2 stock providing a 21% benefit.[88]

On the other hand, arguably it is correct to say that rate differentials should be disregarded in determining whether net used tested loss without a basis reduction gives rise to a double tax benefit. After all, tested income, whether or not offset, is taxed at 10.5% but can result in reduction of corporate tax of the U.S. shareholder at the 21% rate.

In any event, accepting the Preamble's concept of a double tax benefit from a tested loss, a key aspect of the Proposed Regulations is that it reduces basis of a CFC *without regard to whether, as a factual matter, the net used tested loss amount provides both (i) the "first" tax benefit to the U.S. shareholder by offsetting tested income of the shareholder, and (ii) the "second" tax benefit by allowing the stock of the tested loss CFC to be sold at an increased loss or reduced gain*. As will be seen below, in many cases the shareholder with tested income will receive no net tax benefit from a reduction in its tested income, and it might even receive a net detriment. Likewise, in many cases the shareholder will receive no net tax benefit from owning stock of a CFC that had a used tested loss.

In those cases, the net used tested loss amount of a CFC does not provide a double tax benefit to the shareholder, and the need to prevent such a double benefit does not provide a justification for the basis reduction. This result can arise in a number of situations based on the simple fact pattern of Example 21:

NDTIR/QBAI: Suppose that S had enough NDTIR, from the QBAI held by its CFCs with positive tested income, to eliminate its entire GILTI inclusion. The tested loss from CFC2 then provided no tax benefit to S.

To be sure, there might be other good policy reasons for the Proposed Regulations to reduce basis in CFC2 in this case. Absent such reduction, there would be an incentive for S to arrange its business activities so that some of its CFCs had positive tested income and NDTIR, and others had tested losses. The tested losses would be "wasted" if they were in the same CFCs as the tested income and NDTIR, but a loss in a different CFC could give rise to a tax loss on sale of the stock of that CFC. The basis reduction in the Proposed Regulations would eliminate the incentive for this uneconomic tax planning, but could not be justified by the need to prevent double deductions.

Foreign tax credits: Suppose S had enough foreign tax credits from CFC1 to wipe out its U.S. tax liability on its $100 GILTI inclusion from CFC1 standing alone. On these facts, in Example 21, the foreign tax inclusion percentage for S under Section 960(d) would be zero because of the offsetting tested income and tested loss. In form, the tested loss of CFC2 is reducing the GILTI inclusion of S. However, in substance, the

[88] The Proposed Regulations would not provide a basis reduction in the stock of CFC2, assuming the tested loss was not a used tested loss in the year it arose.

tested loss is not reducing the taxes of S below what they would have been in the absence of the tested loss, so there is no double benefit from the tested loss.

Section 956: Suppose the tested income of CFC1 was inadvertently used to acquire a Section 956 asset in the current year, and, if the recently proposed regulations under Section 956 apply,[89] Section 245A would not apply to a dividend from CFC1 (e.g., because S's stock in CFC1 is debt for foreign tax purposes and thus the dividend would be a hybrid dividend not eligible for Section 245A). Absent the tested loss in CFC2, the GILTI inclusion would be $100, the tax would be $10.50, and the Section 956 amount would be tax-free PTI. With the tested loss, there is no GILTI inclusion, and the $100 is taxed to S at the ordinary 21% rate. (Foreign tax credits might reduce both the GILTI and Section 956 calculations.) The tested loss has actually increased the tax liability of S before foreign tax credits. While this detriment would be offset by a tax loss on the sale of the stock of CFC2, there is no double benefit from the tested loss.

No e&p: Suppose CFC1 has no e&p, because of an expense that reduces e&p but is not allowed as a deduction in computing tested income. Assume S sells the CFC1 stock for $100 in excess of its preexisting basis. If CFC2 has tested loss of $100, there is no GILTI inclusion and there is no deemed dividend on the sale because of the lack of e&p. Therefore, S has $100 of capital gain on the sale taxed at 21%. Absent the used tested loss, S would have a $100 GILTI inclusion from CFC1, the basis in CFC1 would increase by $100, and there would be no gain on the sale of the stock. The tested loss has increased S's tax liability by converting $100 of GILTI inclusion to $100 of capital gain. Again, a loss on the sale of the stock of CFC2 would offset this increase in tax liability but would not be a double benefit from the tested loss.

Section 1059: Suppose CFC1 pays a dividend of its $100 of e&p, and that dividend is an extraordinary dividend under Section 1059. Section 1059 applies if a dividend of sufficient size is paid by CFC1 to S before S has held the CFC1 stock for two years. In that case, the dividend is still tax free to S under Section 245A, but S's tax basis in CFC1 is reduced by $100. As a result, the tested loss of CFC2 has prevented an upfront GILTI inclusion of $100 from CFC1, but at the cost of the basis reduction. When the stock of CFC1 is sold, overall there has been no second benefit to S from the tested loss, except for timing.

This example illustrates the complexity of determining whether a double tax benefit of a tested loss arises. At the time the CFC2 stock is sold, if the dividend of the CFC1 tested income has not yet been paid, it may not yet be clear whether it will be later paid in a manner subject to Section 1059. Even if the dividend has been paid and the basis in CFC1 was already reduced under Section 1059, the failure to reduce the basis in CFC2 will cause the CFC2 tested loss to result in a double tax benefit upon the sale of the

[89] REG-114540-18, Federal Register Vol. 83, No. 214, November 5, 2018 at 55324-55329. This proposed regulation turns off Section 956 to the extent the U.S. shareholder of CFC1 would be eligible for Section 245A on a dividend from CFC1.

CFC2 stock. However, this second tax benefit would be offset upon a sale of the CFC1 stock at its reduced basis. Therefore, any basis reduction in the stock of CFC2 designed to prevent a double use of the tested loss on sale of CFC2 would logically have to be either not made in the first place, or else reversed upon the sale of CFC1 with a reduced basis.

Sale of Tested Income CFC at a Loss. The tested loss of CFC2 will likewise not provide a double tax benefit if S sells the CFC1 stock with a loss effectively disallowed under Section 961(d). That section provides that if CFC1 pays a dividend to S to which Section 245A applies, then (unless Section 1059 applies), S's basis in CFC1 is reduced by the amount of the dividend for purposes of calculating loss on a sale of CFC1.

For example, assume S owns a single CFC1 with an initial basis of $100 and value of $100. Assume $100 of tested income, and a distribution of the tested income as PTI. The shareholder has a GILTI inclusion of $100 and an ending tax basis of $100. If the shareholder sells the stock for $0, a tax loss of $100 is allowed. If instead S also owns CFC2 with a tested loss of $100, there is no GILTI inclusion. The distribution of $100 from CFC1 is eligible for Section 245A, and assuming no extraordinary dividend, the basis of $100 remains unchanged. However, if the stock is sold for $0, Section 961(d) disallows the loss.

The existence of the tested loss in CFC2 has allowed S to avoid upfront tax on $100 of tested income from CFC1, but at a cost of a disallowed loss of $100 on sale of the stock of CFC1. Of course, since Section 961(d) only reduces basis for purposes of determining loss, if the stock is sold for $100 or more, the tested loss has offset the tested gain with no further detriment to S.

As a result, if the CFC1 stock is sold at a disallowed loss before the CFC2 stock is sold, it would be clear at that time that the tested loss would not be providing a double tax benefit. If the CFC2 stock is sold first, as in the discussion of Section 1059 above, it would not be clear at that time whether a loss would be disallowed on a future sale of CFC1 stock, thereby preventing a cumulative double benefit from arising from the tested loss of CFC2.

The same denial of a double tax benefit can arise if the CFC1 stock is sold at a loss, even in the absence of a Section 245A dividend that causes Section 961(d) to apply. Return to the example where S owns CFC1 with a basis and value of $100, and CFC1 has $100 of tested income. If the tested income results in a GILTI inclusion, the stock basis increases to $200, and if the stock is later sold for $100, there is an allowed loss of $100. No provision disallows this loss. On the other hand, if CFC2 has a tested loss of $100 that offsets the tested income of CFC1, there is no GILTI inclusion, the basis in CFC1 remains at $100, and there is no tax loss on the sale of that stock for $100. The tested loss in CFC2 has provided no benefit to the U.S. shareholder in connection with the tested income and sale of CFC1.

Inside/outside basis differences. The tested loss of CFC2 also may not provide a double tax benefit where there are disparities in inside and outside stock basis in CFC1 or CFC2. For example, suppose S bought the stock of CFC2 for $100 when CFC2 had a single asset with a basis of $200 and value of $100. CFC2 sells the asset for $100, and the tested loss of $100 offsets $100 of tested income of CFC1. The tested loss does not create a potential loss on the sale of the CFC2 stock, because that tested loss is already reflected in the cost basis of that stock. To be sure, there is arguably a policy reason to reduce S's basis in CFC1 by the amount of the tested loss, as would be the case if CFC1 were a consolidated subsidiary of S or a partnership that had S as a partner. However, the argument for such a basis reduction is arguably distinct from the duplicated loss issue in *Ilfeld* that is the claimed source of authority for the CFC basis reduction rule.

The same issue would arise if CFC1 had an asset with a basis of $0 and value of $100, S bought the CFC1 stock for $100, and then CFC1 sold the asset for $100. Absent the tested loss of CFC2, S would have a $100 GILTI inclusion that would increase the basis in CFC2 to $200, allowing the stock to be sold for $100 at a tax loss of $100. As a result, as long as S has other gain that can be sheltered with the $100 loss on the stock sale, S has obtained no net tax benefit from the tested loss of CFC2, and so logically the basis in CFC2 should not be reduced.[90]

No economic loss to match tested loss. Suppose the tested loss of CFC2 arises from an expense that does not reduce the value of the stock of CFC2, e.g., an r&d expense, or deductible start-up costs that create value. In this case, the tested loss does not create a potential second tax benefit in the form of a capital loss on the sale of the CFC2 stock. In this case, reducing the tax basis of CFC2, and creating gain when it is sold for its unchanged value, would even eliminate the single tax benefit from the tested loss that arose from offsetting the tested income of CFC1.

Future exempt income in tested loss CFC. Suppose that CFC2 has exempt income (not offset tested income) in a future year equal in amount to the tested loss in the example. The exempt income might be from a GILTI inclusion reduced by NDTIR, or from high-taxed Subpart F income. If that income is not distributed out of current e&p in the year earned, and if the tested loss in the example created negative e&p, the negative e&p will prevent such exempt income from resulting in accumulated e&p in years after the exempt income was earned. As a result, the tested loss will prevent the payment of Section 245A dividends in future years out of such exempt income, and prevent the sale of the stock at a tax-free gain on account of such exempt income. In this situation, the shareholder has not received a second benefit from the tested loss in the example.

(b) *Authority for the CFC Basis Reduction Rule*

[90] As previously noted, if the stock loss offsets gain otherwise taxed at 21%, S is worse with the tested loss than without it.

The Code does not contain any explicit authority for the Treasury to write regulations to reduce the tax basis in stock of a CFC. In fact, Section 961 provides explicit rules for adjusting the basis of stock of a CFC. Moreover, Section 951A(c)(2)(B)(ii) (which increases e&p by tested losses for purposes of the e&p limitation on Subpart F income) is entitled "Coordination With Subpart F To Deny Double Benefit of Losses." There is no indication in the Code or legislative history that additional basis adjustments may be made by regulations to prevent duplicated losses or otherwise.

The Preamble relies on the *Ilfeld* and *Skelly Oil* cases decided by the Supreme Court.[91] However, there are several reasons that these cases might not be considered determinative in this context.

First, *Ilfeld* involved a double deduction of a single economic loss on a consolidated tax return and is generally cited in that context. It is true that the double tax benefit from a tested loss can arise in the context of a consolidated return, but that is only because a consolidated group is treated as a single corporation under the Proposed Regulations. Conceptually, the issue arises when a single U.S. corporation has multiple CFCs, some with tested income and some with tested loss.

In fact, the *Ilfeld* doctrine was recently discussed at length in the *Duquesne Light* case in the Third Circuit.[92] The court affirmed the application of *Ilfeld* to a consolidated group. It also discussed the uncertainty of whether *Ilfeld* applies outside a consolidated group, and cited several cases that arose before *Gitlitz* (discussed below) where the doctrine was so applied.

Second, *Skelly Oil* involved the common law claim of right doctrine, and neither *Ilfeld* nor *Skelly Oil* involved a specific statutory scheme that on its face provided for a double deduction. In fact, *Ilfeld* stated that "*in the absence of a provision in the Act or regulations that fairly may be read to authorize [a double deduction]*, the deduction claimed is not allowable" (emphasis added). When the Code or regulations deal specifically with the subject matter, the courts are much more willing to defer to the literal language of the Code or regulations.

For example, in *Gitlitz*,[93] the government objected to the taxpayer's proposed interpretation of the Code on the ground that it would give a "double windfall" to taxpayers. The Supreme Court summarily rejected this argument, stating that "[b]ecause the Code's plain text permits the taxpayers here to receive these benefits, we need not

[91] *Charles Ilfeld Co. v Hernandez*, 292 U.S. 62 (1934); *U.S. v Skelly Oil Co*, 394 U.S. 678 (1969).

[92] *Duquesne Light Holdings, Inc. v Comm'r*, 861 F.3d 396 (3d Cir. 2017), *cert denied* (138 S. Ct. 2651).

[93] *Gitlitz v Comm'r*, 531 U.S. 206 (2001).

address this policy concern."[94] Even in the consolidated return context, courts reject reliance on *Ilfeld* when the regulations are clear and specific.[95] Arguably the existence of Section 961, dealing specifically with tax basis, is enough to satisfy this requirement.

Third, the *Ilfeld* line of cases deals with a double deduction. The consequences of a used tested loss are both a single deduction to the shareholder (through offset of tested income) and the failure to reduce basis of the loss CFC. However, the failure to reduce basis may not give rise to an actual loss on the sale of the stock of the loss CFC, but rather to a reduced gain on the sale of the stock.[96] The Code and regulations clearly make this distinction in various rules.[97] We are not aware of *Ilfeld* being applied to require the creation of income or gain, as opposed to denying a loss considered to be duplicative (although the Supreme Court has arguably characterized *Ilfeld* in broader terms).[98] Therefore, it is possible that *Ilfeld* would at most justify a rule disallowing losses on the sale of the stock of the tested loss CFC, as opposed to a basis reduction rule that also increases the amount of taxable gain on the sale.

On the other hand, if *Ilfeld* applies to disallow duplicative losses in a consolidated group, the logic seems even more applicable for disallowing duplicative losses in a single corporation. Here, the U.S. shareholder first obtains the benefit of a reduction in its tested income inclusion, then it has a potential capital loss on the stock of the tested loss corporation. In fact, the regulations have long prohibited double deductions in a single corporation[99] and this principle was recently applied by the Federal Circuit.[100] Moreover, notwithstanding Section 961, it can be argued that Congress was not purporting to

[94] *See also Brown Shoe Co. v. Comm'r*, 339 US 583 (1950) (property contributed to capital by a nonshareholder had a depreciable basis). This result was changed by Section 362(c).

[95] *See, e.g., Woods Investment Co. v Comm'r*, 85 T.C. 274 (1985).

[96] As noted above, a tested loss may not give rise to *either* an increased loss or reduced gain to the shareholder, if the shareholder's stock basis is purchased basis that already reflects the loss.

[97] *E.g., compare* Section 1059 (reducing basis by the nontaxed portion of a dividend), *with* Section 961(d) (reducing basis by the amount of a Section 245A dividend only for purposes of calculating loss on a sale of the CFC stock).

[98] *See McLaughlin v. Pac. Lumber Co.*, 293 U.S. 351, 355 (1934) ("But a consolidated return must truly reflect taxable income of the unitary business and consequently it may not be employed to enable the taxpayer to use more than once the same losses for *reduction of income*. Losses of [taxpayer] that were subtracted from [taxpayer's] income are not *directly or indirectly* again deductible." (emphasis added)).

[99] *See* Treas. Reg. § 1.161-1 ("Double deductions are not permitted. Amounts deducted under one provision of the Internal Revenue Code of 1954 cannot again be deducted under any other provision thereof.").

[100] *See Sunoco, Inc. v. United States*, No. 2017-1402 (Fed. Cir. Nov. 1. 2018) ("Congress does not generally allow taxpayers to receive a tax benefit twice.") (denying the taxpayer an increase in cost of goods sold for an excise tax liability that was offset by a tax credit).

exclusively prescribe all the collateral effects of the GILTI rules and did not intend to preclude regulations that would deny a double tax benefit to taxpayers.

Fourth, as discussed in Part IV.B.2(a), a used tested loss will often not give rise to a double tax benefit. Nevertheless, the only rationale for the CFC basis reduction rule provided in the Preamble is to prevent a double tax benefit, and there is no explanation of why a narrower rule would not be sufficient to prevent double tax benefits. This disconnect between the rule and the explanation for the rule could prevent the rule from satisfying the Administrative Procedure Act, even if a good explanation would have validated the rule.[101] As a result, the rule might be held invalid even as to a taxpayer that does have a double tax benefit.

In light of the foregoing, if the final regulations will retain the CFC basis reduction rule or a similar rule, we suggest that the Treasury request a statutory amendment to confirm its authority to issue regulations to modify the basis rules of Section 961. Absent such legislation, the preamble to the final regulations should further explain the nature of the double tax benefit the Proposed Regulations are designed to prevent. Moreover, unless the CFC basis reduction rule is narrowed as we suggest in Part IV.B.2(c), the preamble to the final regulations should also explain why the rule applies to all used tested losses without regard to whether an actual double tax benefit is obtained by the U.S. shareholder.

(c) *Proposed Modification of the Rule*

The Proposed Regulations generally follow the approach of the statute of treating each CFC as a separate entity, and then apply principles similar to consolidated return principles to achieve economically correct results. Within the framework of the Proposed Regulations, we have the following comments.

We agree with the fact that the Proposed Regulations do not require an upfront reduction in the basis in a tested loss CFC to the extent of its used tested loss amount, even when the U.S. shareholder clearly derived a benefit from the tested loss. We acknowledge that an immediate basis reduction would be administratively simpler than to wait until the CFC stock is sold, and would more closely match the adjustments in Proposed Regulation Section 1.1502-32 described in Part IV.D.1. However, such a basis reduction would create upfront gain any time there was not sufficient basis, would still allow a CFC to recognize loss to offset tested income of another CFC any time there was sufficient basis in the former CFC, and would raise significant additional authority issues. Congress clearly did not intend there to be a net income inclusion, from a basis reduction or otherwise, merely because CFC1 has tested income and CFC2 has tested loss.

Moreover, no approach to preventing the double use of a tested loss will be fully satisfactory. The plausible times for an income inclusion are when the shareholder has

[101] *See, e.g., Altera Corp. v Comm'r*, 145 T.C. 91 (2015) (currently pending before the Ninth Circuit).

taken advantage of Section 245A for its offset tested income, or taken advantage of its unreduced stock basis following a Section 245A distribution, or (as in the Proposed Regulation) disposed of the CFC2 stock.

As noted in Part IV.A, we recommend that the fundamentally different approach in Part IV.G be adopted. However, if the CFC basis reduction rule is retained, we believe it should be modified to allow an exception in at least the first of the following circumstances, and possibly the second.

First, a U.S. shareholder should be permitted to eliminate all or part of the used tested loss amount for purposes of the CFC basis reduction rule to the extent it can show, as of the time of the sale of the CFC stock, that it had not received any tax benefit from the net used tested loss amount and could not reasonably expect to receive any benefit in the future.[102] This calculation would be made on a "but for" basis, and could take into account any actual or expected offsets to the double benefit because of Section 1059 or Section 961(d). As a protection for the government against future benefits not originally taken into account, there could be a recapture rule designed to reach the same result as if those future benefits had been taken into account at the time of the sale of the CFC2 stock.[103]

We believe this is the theoretically correct rule to protect both the government and taxpayers. We acknowledge it would result in considerable additional complexity. However, the burden would be on taxpayers if they wished to take advantage of this rule, and in many cases taxpayers would be more than willing to do so. The rationale for the additional complexity is that it is quite unfair to taxpayers to require a basis reduction in the CFC stock (even below zero) if the used tested loss has not provided any tax benefit to the shareholder, or if any benefit is expected to be temporary because of future increased gain or disallowed loss on the sale of CFC1. While the purpose of the CFC basis reduction rule was to avoid a *double* benefit from a tested loss, in these cases the tested loss is providing *no* tax benefit as a result of the basis reduction.

Simplified versions of this rule would also be possible, although by looking only at a single tax year of the shareholder, they might not protect the interests of the government and taxpayers in all cases. For example, the future basis reduction could be eliminated if, solely taking account the year in which the used tested loss arose, the shareholder could show it has sufficient NDTIR to eliminate a GILTI inclusion, and/or

[102] A rule that also looks to the receipt of an actual tax benefit is Prop. Reg. § 1.951A-3(h)(1), stating that temporarily held specified tangible property will be disregarded if, among other things, the acquisition of the property reduces the GILTI inclusion amount of a U.S. shareholder.

[103] The dual consolidated loss rules are somewhat analogous. *See* Treas. Reg. §§ 1.1503(d)-6(d), (e), providing an elective regime under which an annual certification is made that a loss used in the U.S. has not been used abroad, with a recapture of the U.S. use of the loss if a foreign use later occurs.

sufficient foreign tax credits to eliminate tax on a GILTI inclusion, without regard to any used tested losses.

We also believe that this exception to the CFC basis reduction rule would make the rule less vulnerable to challenge by taxpayers. Since the rule would only apply when the taxpayer actually received a double benefit from a tested loss, or could not show otherwise, the argument for basing the rule on *Ilfeld* is strengthened.

Second, in addition to the foregoing, consideration should be given to a rule that a U.S. shareholder would be permitted to elect to forego the tax benefit of a tested loss. The result would be as if the tested loss had not occurred.[104] This would prevent a double benefit (or even a single benefit) from directly arising from the tested loss, and there would be no net used tested loss amount to cause a basis reduction under the CFC basis reduction rule.

This elective elimination of tested loss is analogous to the rules in Treasury Regulation Section 1.1502-36(d), which is designed to prevent a duplicated loss from arising in both the stock and assets of a member of a consolidated group. For example, suppose P contributes $100 to new member M, M buys an asset for $100, and the asset declines in value to $60. Absent the regulation, P could sell the stock for $60, and M could subsequently sell the asset for $60, resulting in a double tax loss for a single economic loss.

The regulation prevents this result by requiring a reduction in the basis of the assets of M, at the time of sale of the M stock, by the duplicated loss of $40, so the M asset basis becomes $60. In addition, there is an election to cause all or any portion of the reduction in asset basis to be replaced by a reduction in stock basis. For example, the asset basis could remain at $100 if the stock basis is reduced to $60, eliminating the entire loss on the stock.

Another analogous election in the consolidated return regulations allows a group acquiring a corporation with an NOL carryover to elect to waive the carryover. The election prevents the group from suffering adverse consequences if the carryover expires (under old law) while the purchased member is in the group.[105]

Several issues would have to be addressed in developing this election to forego the use of a tested loss. As an initial matter, it would have to be determined whether the election could be for part rather than all of the tested loss of a particular CFC for a particular year, whether a U.S. shareholder with multiple tested loss CFCs in a particular year must make consistent elections for each, whether an election is binding for a

[104] We do not intend, however, that a CFC with a “real” tested loss would thereby no longer be a tested loss CFC, so that QBAI and foreign tax credits from the CFC would be available for use against the tested income of other CFCs.

[105] Treas. Reg. § 1.1502-32(b)(4).

particular CFC in future years, whether a consistent election must be made by all related U.S. shareholders, and so on. It can be argued that to the extent the waiver of a tested loss merely eliminates the double benefit associated with the particular loss, the election should be available in whole or in part, CFC by CFC, and year by year. However, to the extent the election is more favorable to the taxpayer than eliminating the double benefit of a tested loss, as discussed below, there is greater justification for a consistency requirement.

Moreover, Section 951A states that the GILTI inclusion takes account of the tested income of tested income CFCs, reduced by the tested loss of tested loss CFCs. There is no provision for an election to disregard tested losses. If the Treasury believes that a waiver is appropriate as a policy matter, we suggest that it request a statutory change.

Next, even if the election was adopted, some version of the CFC basis reduction rule would be needed for taxpayers that do not make the election. As a result, the complexity of the CFC basis reduction rule would remain, although it would apply to fewer taxpayers. The decision would then have to be made whether our first proposal above should also be adopted, both for fairness to taxpayers and to strengthen the validity of the CFC basis reduction rule under *Ilfeld*.

Finally, this election might provide a greater tax benefit to the U.S. shareholder than merely eliminating the double tax benefit from a tested loss. The election might be made even if the taxpayer has no plan to ever sell the stock in the tested loss CFC, and therefore is relatively indifferent to the CFC basis reduction rule. Note that a tested loss reduces the U.S. shareholder's FTC inclusion percentage under Section 960(d). As a result, the FTC benefit from the waiver might be greater than the reduction in net tested income from the waiver.

Similarly, if the tested income CFC was to be sold at a loss, the U.S. shareholder might elect to waive the use of tested loss in order to create a GILTI inclusion and a basis increase in the tested income CFC. This would increase tax basis at a 10.5% cost (or less if FTCs are available), thereby increasing the tax loss on the stock at a 21% benefit. In addition, unless the e&p of the CFC with the tested loss was reduced in the normal way notwithstanding the election, the election could increase the untaxed e&p of the CFC and allow the shareholder to take increased advantage of Section 245A to that extent.

The tax planning opportunities created by the rule should be taken into account in the decision of whether to adopt the rule. However, such opportunities could be mitigated by adopting various consistency requirements for the making of elections, as discussed above.

As a result, further consideration would need to be given to this proposal. We would be happy to consider it further if the Treasury believes it would be useful.

3. *Technical Issues*

(a) *The Netting Rule for Basis Reductions*

As noted above, the basis on disposition of CFC stock is reduced by the net used tested loss amount. This is the shareholder's share of the aggregate used tested loss of the CFC for all years over its share of the aggregate offset tested income of the CFC for all years. Consider Example 22 above, where CFC1 has offset tested income of $100 in year 1 and used tested loss of $100 in year 2, and CFC2 has the reverse. When the CFC1 stock is sold, the net used tested loss amount is $0, and there is no basis reduction.

This failure to reduce basis might be considered incorrect, because CFC1 could pay a tax-free dividend in year 1 without a basis reduction. The result for both years would be a decrease in value of the stock of CFC1 ($100 income and distributed earnings in year 1, $100 loss in year 2) with no reduction in stock basis. Thus, a built in loss has been created in the stock of CFC1 as a result of offset tested income.

However, we believe the netting approach in the Proposed Regulations is appropriate. In year 1, when CFC1 has offset tested income, CFC2 has a used tested loss. As a result, the basis of CFC2 will be reduced whenever it is sold in the future (and before taking account of CFC2's offset tested income in year 2) to take account of the fact that CFC1 might pay a tax exempt dividend. Since that future basis reduction already takes account of the assumed dividend, there is no reason for any further basis reduction when the dividend is actually paid. In year 2 when CFC1 has a used tested loss and CFC2 has offset tested income, the usual rules would apply.

(b) *Basis Reduction Upon the Sale of a U.S. Shareholder*

Clarification should be provided concerning the basis consequences of the sale of stock of the U.S. shareholder of a CFC. In Example 21, suppose corporation C owns all the stock of S, and C sells the stock of S to a buyer (Buyer). Assume C and S do not file a consolidated return.[106] The Proposed Regulations trigger a basis reduction in CFC2 upon the disposition of stock of a CFC owned directly or indirectly by a domestic corporation under Section 958(a). Since C does not own Section 958(a) stock of CFC2, the Proposed Regulations by their terms do not require a reduction in the tax basis of CFC2 upon the sale of S, notwithstanding the net used tested loss amount in CFC2.

The final regulations should contain an example illustrating this point to avoid any doubt. We believe this is the correct answer assuming, as discussed in the following paragraph, that the potential basis reduction continues following the sale of S. Outside of a consolidated group, S and C should be treated as separate entities, and S's basis in CFC2 should not depend upon transactions in the S stock.

[106] The issues when C and S file a consolidated return are discussed separately in Part IV.D.

The Proposed Regulations also appear to provide that even after S is acquired by Buyer, S's disposition of CFC2 will result in a basis reduction in the CFC2 stock. In other words, it appears that the attribute of net used tested loss amount stays with S even when S is owned by a new buyer. This appears to be the correct answer as an economic matter. The CFC2 net used tested loss amount reduced the tested income of CFC1 and tax liability of S before S was sold. In addition, the cash from such offset tested income could be withdrawn from CFC1 to S, and (except if Section 1059 applies) from S to C, without any further tax or basis reduction.

On the sale of S at its reduced value, C has received a second tax benefit from the used tested loss, and it is reasonable to offset that benefit with a reduction in the basis in CFC2 when it is sold. Moreover, it would be very unusual, if not unique, outside the consolidated group and partnership contexts, for the tax basis of an asset at a lower tier (i.e., S's basis in CFC2 upon the sale of CFC2) to be affected by a transaction occurring at a higher tier (i.e., C's sale of S stock).

However, continuing to apply the CFC basis reduction rule after the purchase of the S stock creates a trap for the unwary. Any purchaser of a U.S. shareholder of a CFC would be taking the risk that the stated tax basis in the CFC is good "for today only." When the basis really matters, i.e., when the stock in the CFC is sold, the basis could go down by an undetermined amount. Knowledgeable purchasers will protect themselves with new language in many if not most acquisition agreements. However, to put unsuspecting taxpayers on notice of this new concept, we believe it is very important that the final regulations make very clear, ideally through a simple example, that the potential basis reduction in stock of a CFC can occur following a sale of the stock in the U.S. shareholder of the CFC.

(c) *Collateral Effects of Stock Basis*

Until the stock of the CFC is disposed of, there is no reduction in the basis of its stock. This could have collateral effects.

(i) *Allocation of Interest Expense*

Depending on future regulations concerning allocation of interest expense of the U.S. shareholder, the unreduced basis may result in an allocation of interest expense to the CFC for foreign tax credit purposes determined by reference to this unreduced stock basis.

This result does not seem justified, since the U.S. shareholder will not be able to take advantage of the unreduced basis when the CFC stock is sold. Moreover, the basis reduction upon a sale represents a net used tested loss amount, which would normally represent a true decline in value of the CFC. Regulations should clarify the consequences to a U.S. shareholder of unreduced basis in the stock of a CFC, where the basis will be reduced immediately before a disposition.

(ii) *NUBIG and NUBIL*

Likewise, under Section 382(h)(1), if S has a change in ownership under Section 382, net unrealized built in gain (NUBIG) and loss (NUBIL) is based on the difference between the tax basis and fair market value of the assets of S at that time.[107] In particular, recognized NUBIG of S increases the Section 382 limit of S for the year, and recognized NUBIL is treated as a loss carryover subject to Section 382.

The NUBIG and NUBIL rules are designed to put the taxpayer in the same position as if it had sold its assets on the day before the change in ownership. Gains on such assets could be offset by current NOLs without limitation, and losses on such assets that carried over to the post-acquisition period would be subject to Section 382. As a result, it seems most consistent to apply the NUBIG and NUBIL rules to a U.S. shareholder of a CFC by taking into account the future basis reduction in the stock of the CFC that would arise if the CFC were sold immediately before the change in ownership of the U.S. shareholder.[108] This would increase NUBIG, and reduce NUBIL to the extent of the potential basis reduction.

In fact, Notice 2003-65[109] defines NUBIG and NUBIL in terms of the gain or loss that would be recognized in a hypothetical sale of assets of the loss corporation immediately before the ownership change. While this Notice was obviously not drafted with the CFC basis reduction rule in mind, we believe the principle is correct and that this rule would take account of the CFC basis reduction rule. Final regulations should confirm this result.[110]

(iii) *Exempt COD income*

Regulations should also clarify the relationship between the CFC basis reduction rule and Section 108(b)(2)(E), under which a taxpayer's basis in its property can be

[107] NUBIG and NUBIL are also relevant for Section 384 and the "separate return limitation year" rules relevant to consolidated groups.

[108] These results would be analogous to the rules for "built-in items" under Section 382(h)(6), under which items of income and deduction that are taken into account after an ownership change, but that are attributable to periods before the change date, are treated as built-in gain or loss.

[109] 2003-2 C.B. 747.

[110] A similar issue arises if a CFC has untaxed e&p on the day before the change in ownership, such as from offset tested income or from tested income sheltered by NDTIR. The U.S. shareholder's gain on a sale of the stock of the CFC would be a dividend eligible for Section 245A to the extent of the untaxed e&p. Section 1248(j). However, Section 1248(a) treats the gain as recognized gain. Since Notice 2003-65 defines NUBIG and NUBIL in terms of gain or loss recognized on a hypothetical sale, it appears to treat that gain as NUBIG even though it is effectively tax-exempt. Treasury should consider whether an upward basis adjustment for NUBIG and NUBIL purposes is appropriate in this situation.

reduced (but not below $0) to the extent of the taxpayer's exempt cancellation of indebtedness ("**COD**") income.

For example, suppose the taxpayer is a corporation whose only asset is stock of a CFC with a basis of $100 and net used tested loss amount of $80,[111] and the shareholder has exempt COD income of $60. If the unreduced basis of $100 is taken into account under Section 108(b), then that section currently reduces the basis by $60 to $40. Then, the CFC basis reduction rule reduces the basis by $40, to $0, and creates additional gain of $40, all at the time of sale of the CFC stock. However, if the cap on the Section 108(b) basis reduction is the reduced basis of $20 rather than the unreduced basis of $100, then the Section 108(b) basis reduction is $20, so the unreduced basis becomes $80 and the reduced basis on a sale becomes $0 without any additional gain recognition.

It can be argued in favor of the second approach that while the shareholder has tax basis of $100 in the stock of the CFC, it will never be able to take advantage of that tax basis. Moreover, the Section 108(b) basis reduction should be limited to the tax basis that the shareholder can ultimately use. This is the result that would arise if the tax basis in the CFC had been reduced immediately rather than deferred. The second approach is also consistent with Section 1017(b)(2), which provides that the aggregate basis of the assets of the taxpayer is never reduced below the amount of liabilities of the taxpayer. This in effect gives the debtor a "fresh start" by preventing gain recognition even if all the taxpayer's assets are disposed of solely for assumption of the taxpayer's debt.

(d) *Noncorporate U.S. Shareholders*

The Preamble requests comments concerning whether the CFC basis reduction rule should be extended to non-corporate U.S. shareholders, taking into account that they are not entitled to a dividends received deduction under Section 245A. For example, suppose that S in Example 21 is an individual.

We do not believe the CFC basis reduction rule should apply in this case. It is true that the tested loss in CFC2 both offsets the tested income in CFC1 and can result in a loss on the sale of the CFC2 stock. However, the tested income in CFC1 will be taxable to the shareholder when distributed or when the CFC1 stock is sold, so the sheltering of tax on the tested income of CFC1 is only temporary. It does not seem fair to permanently deny a real economic loss on CFC2 stock in exchange for a deferral in the taxation of earnings of CFC1.

(e) *Definition of "Disposition"*

The Preamble asks for comments on whether the definition of "disposition" of CFC stock should be broadened to include transactions that do not involve a transfer of

[111] Assume the taxpayer previously disposed of the CFC with the offset tested income.

stock, but rather take advantage of the tax basis of the stock, for example Section 301(c)(2) or Section 1059. We discuss that issue here.

First, Section 165(g) allows a loss for worthless stock and is treated as a sale of the stock for "zero." This should be treated as a disposition of the stock that reduces tax basis, since there will generally be no further opportunity to avoid the double tax benefit from the tested loss.

Next, suppose S has a "regular" tax basis of $100 in the stock of a CFC2, and a net used tested loss amount of $80 in CFC2 from its tested loss that offset tested income of CFC1. On a sale of the CFC2 stock, the tax basis is reduced to $20. Suppose now that CFC2 has no e&p, and there is a Section 301(c)(2) distribution of $20. It could be argued that this is in substance a disposition of a percentage of the stock of CFC2, based on the ratio of $20 to the fair market value of CFC2. However, we do not believe that a Section 301(c)(2) distribution of even $1 should trigger taxation of the entire net used tested loss amount of $80, or that proration requiring a valuation of CFC2 is practicable.

As a result, to the extent the distribution is no more than the reduced basis that would arise in the CFC2 stock on a sale of the stock, we do not believe any gain should be triggered on account of the CFC basis reduction rule. In the example, the tax basis would be reduced to $80 under Section 301(c)(2), and the basis upon a sale would be $0.

Now, assume the distribution to S is $100 rather than $20. If the result in the prior paragraph is accepted, that same result must also apply to the first $20 of the $100 distribution. The only question is the treatment of the additional $80. That $80, as well as the original $20, is a Section 301(c)(2) distribution based on the $100 unreduced tax basis of the CFC. However, $80 is a Section 301(c)(3) distribution based on the $20 reduced tax basis of the CFC.

It can be argued that this $80 should be taxable to S. The tax free recovery of cash in this situation would arguably be a double benefit from the $80 of the used tested loss. First, the loss reduced the tested income otherwise taxable to S by $80, and then the unreduced basis allowed a tax free distribution of $80 of cash. Moreover, if S sold all the stock of CFC2 for $100, S would recognize gain of $80. Arguably S should not be in a better tax position than this by receiving a distribution of $100 from CFC2 and *keeping* all the stock. Moreover, a distribution of the cash, combined with the issuance of new stock to a third party by CFC2, is economically equivalent to a sale of part of the CFC2 stock by S to the third party, and the CFC basis reduction rule would apply in the latter case.

Finally, CFC1 can make tax-free distributions of its $80 of e&p under Section 245A, plus an additional amount equal to S's basis in CFC1. Allowing full basis recovery in CFC2 means that CFC2 can make a tax-free distribution of the unreduced tax basis of $100. Yet if CFC1 and CFC2 were a single corporation, there would be no net e&p from offsetting tested income and loss, and the total tax-free distributions would equal the combined tax bases in CFC1 and CFC2. As a result, if Section 301(c)(2) applies to the unreduced basis in CFC2, the effect is to increase the combined available tax-free distributions by the amount of the tested income and tested loss ($80 in this case) as compared to single entity treatment of CFC1 and CFC2. This is arguably an unjustifiable result.

Under this approach, S would recognize gain of $80, and the regular tax basis would be reduced to $0.[112]

On the other hand, it can be argued that the $80 should not be taxable to S. Unlike in the case of Section 165(g), which is often the final disposition of the stock, a Section 301(c)(2) distribution does not generally result in the final disposition of stock. Thus, CFC basis reduction rule can apply to the stock of CFC2 when it is sold. Moreover, there is not necessarily a double benefit from the tested loss just because the distribution exceeds the reduced basis in CFC2. The reduced basis is merely a protective measure to prevent a double benefit from arising, but this does not mean that a double benefit in fact arises every time such basis is used for some purpose by S (as discussed in Part IV.B.2(a)). For example, taxing the $80 to S could overstate the ultimate amount of duplicated benefit from the tested loss, since after the distribution, CFC2 might have offset tested income that reduces or eliminates the pre-distribution net used tested loss amount.

Furthermore, if only the reduced basis is taken into account and S had a different basis in different shares of stock of CFC2, S might have Section 301(c)(3) gain on the low-basis shares even before its aggregate reduced basis was fully recovered, since a distribution is treated as pro rata with respect to each share.[113] Regardless of the appropriateness of this pro rata rule in a typical situation involving different blocs of stock, the failure to allow full recovery of the reduced basis in this case seems inconsistent with the purpose of the CFC basis reduction rule. The result is obviously also worse than if S had sold its high basis shares, undercutting the analogy of a Section 301(c)(2) and (c)(3) distribution to a sale of a portion of the shares.

Moreover, to the extent that S should not be taxed on distributions before it would be taxed if CFC1 and CFC2 were divisions of a single corporation, S should not be taxed on distributions from CFC2 unless and until the total distributions by CFC1 and CFC2 of (1) non e&p amounts, and (2) e&p amounts eligible for Section 245A, exceed S's

[112] Under this approach, if the net used tested loss amount exceeded S's tax basis in the CFC2 stock, there would at that point in substance be a hypothetical negative basis for purposes of Section 301(c)(2). Then, any cash distribution would be fully taxable, but the potential gain from the hypothetical negative basis would remain unchanged rather than being triggered in full. Likewise, if S transfers stock in a CFC in a Section 351 transaction or reorganization transaction and receives back boot, under this approach, the boot should be taxable if, and only if, it would be taxable based on the reduced tax basis that S would have in the CFC under the CFC basis reduction rule, but any potential gain from the hypothetical negative basis should not otherwise be triggered.

[113] *Johnson v. United States*, 435 F.2d 1257 (4th Cir. 1971); *Illinois Tool Works Inc. v Comm'r*, T.C. Memo. 2018-121 (Aug. 6, 2018).

aggregate unreduced basis in CFC1 and CFC2. Yet it would be extremely burdensome to require this calculation to be made every time a distribution is made by CFC2, and further adjustments would be needed if the Section 301(c) distribution was made by CFC2 before the non e&p amounts were distributed by CFC1. Thus, this argument runs, it is reasonable to use the unreduced basis of CFC2 for purposes of Section 301(c)(2) and (c)(3), and apply the CFC basis reduction rule when the CFC2 stock is sold.

Under this approach, no gain would be recognized by S on the distribution of $100, and S's basis in CFC2 on a sale would be $0 (reflecting the original $100 minus the $100 distribution under Section 301(c)(2)) and there would be $80 of gain pursuant to the CFC basis reduction rule, reflecting the $80 used tested loss.

We do not take a position on which of these alternatives should be adopted in final regulations. However, whichever rule is adopted, we believe the same rule should apply to Section 1059 in determining whether gain would be recognized when the reduced basis (or the unreduced basis) would be reduced below $0 by that section.

(f) *Tax Free Dispositions of CFC Stock*

The Proposed Regulations do not purport to override the provisions of the Code for tax free transactions, even to the extent that the CFC basis reduction rule results in the equivalence of a negative basis. Rather, they preserve the net used tested loss amount whenever possible.

For example, suppose US1 transfers the stock of CFC1 to a foreign corporation F in exchange for stock in F, in a tax free transaction. Assume that CFC1 remains a CFC and US1 remains a U.S. shareholder of CFC1, regardless of the status of F. In that case:

- If F sells the stock of CFC1, the basis in CFC1 is reduced by US1's net used tested loss amount in CFC1,[114] and, if F is a CFC and US1 does not own 100% of F under Section 958(a), any resulting increase in Subpart F income of F is specially allocated to US1.[115]

- If US1 sells the F stock, F is a CFC, and US1 is a U.S. shareholder of F, then US1's net used tested loss amount in F is adjusted upwards or downwards to reflect US1's net used tested loss amount or net offset tested income amount in CFC1.[116]

[114] Prop. Reg. § 1.951A-6(e)(1)(i).

[115] Prop. Reg. § 1.951A-6(e)(7).

[116] Prop. Reg. § 1.951A-6(e)(1)(ii). In addition, although not affecting the gain or loss to US1, immediately before such basis adjustment, F's basis in CFC1 is reduced by US1's net used tested loss amount in CFC1. Prop. Reg. §§ 1.951A-6(e)(1)(i), (iv).

- If US1 sells the F stock but F is not a CFC, then F is treated as a CFC with no net used tested loss amount or offset tested income amount, and US1's basis in F is reduced by CFC1's net used tested loss amount.[117]

However, the Proposed Regulations do not by their terms trigger a basis reduction upon disposition of a CFC if, at that time, the U.S. shareholder with the net used tested loss amount in the CFC is no longer a Section 958(a) U.S. shareholder of the CFC, or if the CFC is no longer a CFC.

For example, suppose that US1 is a Section 958(a) U.S. shareholder of CFC1 and has a net used tested loss amount in CFC1. CFC1 issues additional stock to a third party and either ceases to be a CFC, or remains a CFC but US1 ceases to be a Section 958(a) U.S. shareholder owning 10% of CFC1. It appears that US1 can then sell the stock of CFC1 without any basis reduction.

Similarly, suppose that US1 is a Section 958(a) U.S. shareholder of CFC1, and transfers the stock of CFC1 to foreign corporation F that might or might not be a CFC. Suppose that CFC1 ceases to be a CFC, or it remains a CFC but US1 ceases to be a Section 958(a) U.S. shareholder of CFC1.[118] It appears that F can sell the stock of CFC1 without any basis adjustment for US1's former net used tested loss amount in CFC1. Alternatively, it appears that US1 can sell the stock of F without any adjustment for its former net used tested loss amount in CFC1. The same result would arise on a Section 332 liquidation of CFC1 into US1, where the tax basis of the stock of CFC1 disappears.

Regulations should clarify the results in these cases. Under FIRPTA and Section 367, gain is triggered before an asset leaves the taxing jurisdiction of the relevant Code sections. On the other hand, those results are based on clear Code provisions or clear grants of regulatory authority. The Code does not contain such a rule for the basis reduction amount of CFCs, nor is there a specific grant of regulatory authority for such a result.

Consequently, it appears that under the Proposed Regulations, a U.S. shareholder of a CFC can avoid the adverse consequences of a net used tested loss amount in a CFC by having the CFC issue new stock to an unrelated party and cause the U.S. shareholder to lose such status. However, if a net used tested loss amount can be eliminated using this or similar methods, considerable tax planning will be possible.

[117] Prop. Reg. § 1.951A-6(e)(1)(iii). In addition, although not affecting the gain or loss to US1, immediately before such basis adjustment, F's basis in CFC1 is reduced by US1's net used tested loss amount in CFC1. *Id.*

[118] Treas. Reg. § 1.367(b)-4(b) would require US1 to include in income, as a deemed dividend, the Section 1248 amount with respect to CFC1 in these cases, although the dividend would presumably be eligible for Section 245A.

Regulations should also clarify the result where US1 has a net used tested loss amount in CFC1, and CFC1 transfers assets to newly formed CFC2 and spins off CFC2 to US1 in a transaction described in Section 368(a)(1)(D) and Section 355 (a "**divisive D reorganization**"). It is not clear whether the net used tested loss amount remains with CFC1 or is allocated between CFC1 and CFC2.

(g) *Section 381 Transactions*

The Proposed Regulations[119] apply if a U.S. shareholder US1 has a net used tested loss or offset tested income amount with respect to a CFC (the "**acquired CFC**") that is the distributor or transferor to another CFC (the "**acquiring CFC**") in a Section 381 transaction. Then, "the domestic corporation's net used tested loss amount or net offset tested income amount with respect to the acquiring CFC is increased by the amount of the net used tested loss amount or net offset tested income amount of the acquired CFC." This raises a number of questions.

First, the final regulations should clarify that the reference to "the domestic corporation" is to the U.S. shareholder of the acquired CFC.

Second, the formula in the Proposed Regulations assumes that the acquired CFC and the acquiring CFC both have a net offset tested income amount, or both have a net used tested loss amount. The formula does not contemplate that one of the CFCs might have a net offset tested income, and the other a net used tested loss. In that case, the two numbers should be netted to get an overall net used tested loss amount or overall net offset tested income amount.

Third, as discussed in Part IV.B.3(f) concerning exchanges of stock, the Proposed Regulations do not apply if the acquired CFC merges into a foreign corporation F that is not a CFC. Alternatively, if F is a CFC but US1 is not a U.S. shareholder of F, the Proposed Regulations literally treat US1 as having a net used tested loss amount or net offset tested income amount in F. However, there is no provision that would trigger a basis adjustment upon the disposition of the stock of F by a shareholder of F that is not a U.S. shareholder of F. If the intent of the Proposed Regulations is that the net used tested loss amount in F not be triggered in this case, the Proposed Regulations would be clearer if it only applied in the first place when the U.S. shareholder of the acquired CFC is a U.S. shareholder of the acquiring CFC immediately after the transfer.

We also observe that these rules are different than the rules for "hovering deficits" that apply to a CFC that is acquired in a Section 381 transaction.[120] However, hovering deficits relate to e&p deficits of the CFC itself, and separate tracking of pre-acquisition e&p deficits of the transferor CFC is possible. Those rules would not work

[119] Prop. Reg. § 1.951A-6(e)(5).

[120] Treas. Reg. § 1.367(b)-7(d)(2).

for a shareholder level concept such as combining the U.S. shareholder's net used tested loss amount in the acquired CFC with its net offset tested income amount in the acquiring CFC.

As a result, while the need for an additional set of rules is unfortunate, we see no alternative. We also note that these rules will likely lead to at least partially tax-motivated mergers designed to reduce or eliminate the basis reduction attributable to the net used tested loss amount of a CFC.

(h) *Special Allocation of Subpart F Income*

As noted above, a special rule (the "**special allocation rule**") applies if CFC1 sells stock in CFC2, a U.S. shareholder owns less than 100% of CFC1 under Section 958(a), and the basis in the stock of CFC2 is reduced because of a net used tested loss amount in CFC2 allocable to the shareholder. In that case, any increase in Subpart F income of CFC1 attributable to the increased gain on the CFC2 stock is allocated solely to the U.S. shareholder rather than pro rata among all shareholders of CFC1.

The special allocation rule is logical. If CFC1 has additional Subpart F income because of a basis reduction in its stock in CFC2 attributable to a particular U.S. shareholder (US1), it makes sense to allocate that Subpart F income solely to US1. Moreover, it makes sense for that rule to apply only when US1 owns less than 100% of CFC1 under Section 958(a). If US1 owns 100%, it would be allocated all the Subpart F income anyway and there would be no need for the special allocation rule.

We note, however, that while the rule specially allocates an increase in Subpart F income resulting from a shareholder's net used tested loss amount in CFC2, it does not specially allocate the effects of a reduced tax loss arising on the stock sale. This can shift the burden of a net used tested loss amount from the shareholder that is allocated that amount to other shareholders of CFC1.

For example, suppose that CFC1 is owned 50% by US1 and 50% by US2, CFC1 has a basis of $100 in the stock of CFC2, US1 has a net used tested loss amount of $70 in its indirect 50% interest in CFC2, US2 has no net used tested loss amount or offset tested income amount in its indirect 50% interest in CFC2, and CFC1 sells all the stock of CFC2 for $30.

It appears that the basis of CFC1 in CFC2 is reduced from $100 to $30, resulting in no gain or loss to CFC1 on the sale. Regulations should confirm that CFC1 has an overall gain or loss taking into account its own tax basis reduced by net offset tested losses from all its U.S. shareholders. Since there is no Subpart F income to reallocate, neither US1 nor US2 has any gain or loss. Yet if US1 did not have any net used tested loss amount, US1 and US2 would each benefit from $35 of CFC1's $70 loss on the stock sale (e.g., through a reduction in Section 951(a) inclusions from CFC1's gains on other sales of stock). In effect, US2 has borne the tax cost of 50% of the basis reduction attributable to the net used tested loss amount of US1. Regulations should confirm that this is the intent of the rule. The alternative would be to allocate the entire basis reduction to US1, resulting in US1 being attributed gain of $35 on the stock sale (possibly resulting in a Subpart F inclusion) and US2 being attributed a $35 loss on the stock sale (potentially offsetting $35 of other Subpart F income allocable to US2).

As a separate matter, we note that while the Proposed Regulations specially allocate additional Subpart F income arising from the net used tested loss amount of CFC2, there is no special allocation of exempt gain to shareholders of CFC1 on the basis of their share of the net offset tested income amount of CFC2. Such tested income would normally give rise to tax exempt e&p in CFC2, and as a result the corresponding gain to CFC1 on the sale of stock of CFC2 would be tax exempt income to the shareholders of CFC1.[121]

However, different shareholders of CFC1 may have used their own tested losses to offset different amounts of the tested income of CFC2, and so the tax exempt e&p in CFC2 may not be allocable pro rata to the different shareholders of CFC1 as an economic matter. We recognize the difficulty of specially allocating exempt gain to shareholders of CFC1. However, it seems anomalous that there is a special allocation of increased gain from net used tested losses of some shareholders, but no special allocation of exempt gain corresponding to net offset tested income allocable to other shareholders.

(i) *CFCs Held by Partnerships*

The Proposed Regulations apply the CFC basis reduction rule to Section 958(a) stock of a CFC held directly or indirectly by a domestic corporation. Section 958(a) stock is stock held by any U.S. shareholder, whether a corporation or not. The Proposed Regulations do not discuss the extent to which the CFC basis reduction rule applies to stock in a CFC held by a partnership that is a U.S. shareholder of the CFC. The ambiguity arises because the partnership, as a U.S. shareholder, is a holder of Section 958(a) stock, and a corporate partner of the partnership is indirectly holding that Section 958(a) stock through the partnership.

Final regulations should clarify this issue. We believe the following principles should apply:

First, as discussed in Part III.F.1(b), if a corporate partner of the partnership is a U.S. shareholder of the CFC, Proposed Regulation Section 1.951A-5 applies aggregate principles and requires the partner to determine its own GILTI calculations. As a result, the CFC basis reduction rule should apply to the partner, just as it would if the CFC stock were held directly by the partner. This should be true if the corporate partner sells the partnership interest, or the partnership sells the stock in the CFC. It would make no sense

[121] Sections 964(e)(1) and (e)(4).

to allow a corporate U.S. shareholder of a CFC to be able to avoid the CFC basis reduction rule by merely holding the stock in the CFC through a partnership.

Second, if an individual partner of the partnership is a U.S. shareholder of the CFC, Proposed Regulation Section 1.951A-5 applies aggregate principles and requires the partner to determine its own GILTI calculations. As a result, the CFC basis reduction rule should apply to the partner to the same extent as it would if the partner owned stock in the CFC directly. As discussed in Part IV.B.3(d), we believe that an individual that is a direct U.S. shareholder of a CFC should not incur a basis reduction, since an individual is not eligible for Section 245A on dividends form the CFC, and we believe the same is true for the individual U.S. shareholder holding the CFC through a partnership.

Third, consider the corporate and individual partners of a partnership that are not themselves U.S. shareholders of the CFC. Under Proposed Regulation Section 1.951A-5, the GILTI calculation is done entirely at the partnership level and the GILTI inclusion is allocated to such partners. It can be argued that absent the application of the CFC basis reduction rule, the partnership and these partners would obtain a double benefit from the tested loss of a CFC, since the tested loss reduces the GILTI inclusion and also allows the partnership to sell the stock in the CFC at a loss.

However, none of these partners is eligible for Section 245A if the CFC with offset tested income pays a dividend of its earnings. The reason is that Section 245A only applies to 10% corporate shareholders. As a result, the benefit of the used tested loss to shelter the offset tested income from tax is somewhat illusory. Tax will have to be paid on the income when it is distributed or the stock of the CFC with tested income is sold. Consequently, we believe that the CFC basis reduction rule should not apply to the partnership level calculation of GILTI inclusion for its partners that are not U.S. shareholders of the CFC. Likewise, the CFC basis reduction rule should not be relevant for such a partner selling its interest in the partnership.

(j) *Retroactivity of Basis Reduction Rule*

The CFC basis reduction rule applies even to losses that arose before the Proposed Regulations were published. As a result, taxpayers may have unexpectedly large gains on prior stock sales, and this rule could change before being finalized. Regulations should provide relief from estimated tax penalties for underpayments attributable to not properly applying the CFC basis reduction rule for dispositions of CFCs prior to 30 days after the rule is finalized.

C. Proposed Regulation Section 1.1502-51: Basis Reduction for CFC Stock Held in a Group

1. *Summary of Proposed Regulations*

Under Proposed Regulation Section 1.1502-51(c), the CFC basis reduction rule described in Part IV.B.1 applies in the usual manner to stock of a CFC that is owned by a member M of a consolidated group. In particular, the CFC basis reduction rule reduces the tax basis of stock in the CFC in the hands of M by M's net used tested loss amount in the stock.[122] However, as would be expected, a member's net used tested loss amount or offset tested income amount in a CFC is based on the allocation of tested loss to tested income among members as determined under the usual rules for allocating tested loss to tested income among members of a consolidated group.[123] See Part III.G.1.

To illustrate, in Example 20 in Part III.G.1, CFC1 (owned by M1) and CFC3 (owned by M2) each has tested income of $100 and offset tested income of $50, and CFC2 (owned by M1) has a used tested loss of $100. Thus, under the CFC basis reduction rule, M1's basis in CFC1 goes up by M1's GILTI inclusion of $50, M2's basis in CFC3 goes up by M2's GILTI inclusion of $50, CFC1 and CFC2 each has $50 of untaxed e&p that can be distributed under Section 245A, and M1's basis in CFC2 goes down by $100 when the CFC2 stock is sold.

2. *Comments*

(a) *Single Entity Principles*

The effect of applying the CFC basis reduction rule in this manner in the consolidated return context is to make the basis reduction in a CFC the same regardless of where in a group the particular CFC is located. Moreover, the total basis reduction is always the same as if a single corporation owned all the CFCs owned by various group members. Thus, this rule carries out the single entity concept of a consolidated group, and we applaud the result.

(b) *Effects of Sale of Member Stock*

Final regulations should clarify the effects of the CFC basis reduction rule upon and following a sale of the M stock, and examples should be provided.

> **Example 23**. *Consolidated P sells M stock.* Assume that P owns M, and M owns a CFC with a used tested loss of $100. Under "Rule 1" of the -32 Proposed Regulations, discussed in Part IV.D.1, P's basis in M is reduced currently by the net used tested loss amount in the CFC. P sells the stock of M. P's gain is increased (or P's loss is reduced) by $100 under Rule 1.

As discussed in Part IV.B.3(b), outside the consolidation context, the CFC basis reduction rule does not appear to reduce M's basis in the CFC by $100 at the time of the sale of M, but appears to continue to apply to M if M leaves the P group and then sells the CFC.

[122] Prop. Reg. § 1.1502-51(c)(1).

[123] Prop. Reg. §§ 1.1502-51(c)(2), (c)(3).

Assuming this is correct, final regulations should clarify whether the same rules apply under -51(c)(1) when M was a member of the P group when the net used tested loss amount in the CFC arose, and M later leaves the P group and sells the CFC. If so, M retains its net used tested loss amount in the CFC when M leaves the group, and the CFC basis reduction rule will apply to M upon its later sale of the CFC stock.

As a technical matter, -51(c)(1) incorporates by reference the CFC basis reduction rule that applies outside the consolidated return context. Moreover, tax basis in the CFC is an attribute of M rather than the P group, and nothing in the Proposed Regulations states that the potential basis reduction is turned off when M leaves the group in which the net used tested loss amount arose.

In addition, as a policy matter, we believe that M's basis in the CFC should be treated the same after the purchase of M regardless of whether the net used tested loss amount in the CFC arose while M was a member of another group (or a nonmember of any group). It would be administratively complex and cause considerable confusion if M's tax basis in the CFC after the purchase of M depended upon whether M had previously been a member of a group (any group) when the net used tested loss amount arose.

Arguably there is less reason to apply the CFC basis reduction rule to M if the net used tested loss amount arose while M was a member of a prior group, since in that case the basis of the M stock to group members would have been reduced (and the gain on the sale of the M stock by group members increased) under Proposed Regulation Section 1.1502-32(b)(3)(iii)(C) (discussed as "Rule 1" in Part IV.D.1). However, under that rationale, the further distinction would have to be made to continue to apply the CFC basis reduction rule to M if M had been the parent of a group, since the -32 basis reduction would not apply to stock in a parent corporation and so there would not have been increased gain on the sale of the M stock.

On the other hand, as a technical matter, "tested loss amount" and "net used tested loss amount" are defined as the stated amounts "with respect to a member." Arguably, when the "member" ceases to be a "member" of the group in which the net used tested loss amount arose, its net used tested loss amount while it was in the group ceases to exist. Under this reading, the treatment of the basis of the CFC in the hands of the buyer of M would depend upon whether M had been a member of a group when the net used tested loss amount arose (without regard to whether M was the parent of the group, if the old group terminated upon the purchase of M).

As an economic matter, when M is a subsidiary in a consolidated group, there is less reason for the net used tested loss amount to carry over after M leaves the P group than if M is not a group member. In the former case, but not the latter, P's basis in M is reduced by the net used tested loss amount in the CFC under Rule 1 (discussed in Part IV.D.1). As a result, P has an increased gain on the sale of the M stock that does not exist in the nonconsolidated case. As a result, while the tested loss was used to offset tested income in the group, the basis reduction in the M stock avoids the creation of a second benefit to the group from the tested loss.

On the other hand, even in the case of a consolidated seller, the failure to reduce the basis of the CFC on its sale by M after M leaves the P group would result in an overall double benefit from the tested loss, once in the P group and once outside the P group. The P group would get a benefit from the offset of tested income, with Rule 1 denying the second benefit of loss on the sale of M, but M (and any group buying the stock of M) would get a benefit of the unreduced basis if M sold the CFC stock after leaving the P group.

An analogous situation would be the case where, instead of M owning a CFC with a tested loss of $100 that offset other group tested income of $100, M owned a U.S. group member M2 that had a current loss of $100 that offset other group tested income of $100. When that loss was used to offset the tested income, M’s basis in M2 would be reduced by $100 under the existing -32 regulations, and this basis reduction would tier up to reduce P’s basis in M. When P sold the stock of M, there would be additional gain of $100. Nevertheless, in the hands of the buyer of M, M’s basis in M2 would retain its reduced basis and would not “snap back” when M left the P group. Based on this analogy, it would be logical for the basis reduction in -51(c)(1) to continue to apply to M after it leaves the P group.

Moreover, if -51(c)(1) provided for an immediate reduction in the basis of the CFC at the time M received the benefit of a net used tested loss amount, there is no doubt that the resulting reduced basis in the CFC would continue with M after M left the P group. It would be odd if the deferral of the reduction in basis until the sale of the CFC were to result in no basis reduction at all if the sale occurred after M left the P group, when the deferral was intended as a mere timing benefit.

On balance, therefore, we believe final regulations should retain the basis reduction rule upon the disposition of the CFC after M leaves the P group.

If final regulations adopt this approach, they should also clarify whether, if M joins a new group, the basis reduction of the CFC in the new group tiers up under -32 to members within the group. This basis reduction should not tier up in the P group because the resulting basis reduction would duplicate the Rule 1 basis reduction in the stock of M.[124] No such duplication exists in the buying group.

However, the buying group would have paid fair market value for the M stock, M’s basis in the CFC would decrease on the sale of the CFC by the used tested loss amount, and M’s gain would increase (or loss would decrease) by the same amount. M’s gain or loss would tier up to its shareholder (New P) under the usual rules. If New P’s basis in M was increased by the additional gain (or reduced loss) recognized by M as a

[124] Treas. Reg. § 1.1502-32(a)(2) prohibits duplicative adjustments to the stock of a member.

result of the reduction in basis in the CFC stock, but was not decreased by the basis reduction itself, New P would have a net increase in tax basis in M without any corresponding economic profit.[125] As a result, the reduction in CFC basis to M at the time of sale of the CFC should tier up to New P.

(c) *Taxable Intra-Group Dispositions of a CFC*

Regulations should clarify the results when stock of a CFC is sold from one member of the group to another member of the group, or distributed in a taxable transaction to another member. An example in the final regulations would be helpful.

> **Example 24**. *Intra-group sale of CFC*. P owns M1, and M1 has a CFC with a $100 net used tested loss amount. Under -32, P's basis in M1 has been reduced by $100, and M1's basis in the CFC will be reduced by $100 upon its disposition of the CFC. M1 sells the CFC to M2. Assume the CFC has no untaxed e&p, so there is no Section 1248 issue.

Presumably the M1 basis in the CFC is reduced by the net used tested loss amount, even though the sale is to another group member, but this should be clarified. If this is correct, M1's gain is increased, and the gain is deferred under the -13 consolidated return regulations. Regulations should clarify that the gain to M1 is deferred even if the gain is due to the used tested loss amount being greater than M1's basis in the CFC. The uncertainty arises because, strictly speaking, that gain arises on the basis reduction rather than on M1's sale of the CFC. However, the CFC basis reduction rule treats this gain as additional gain on the sale of the stock of the CFC, and this result is necessary in order for the consolidated group to be treated as a single entity. Moreover, the intercompany transaction rules apply to items that arise "directly or indirectly" from an intercompany transaction.[126]

In addition, final regulations should clarify that M2 does not inherit the net used tested loss amount in the CFC in the hands of M1. The basis in the CFC has already been reduced by that amount in the hands of M1 and has increased M1's gain on the sale to M2.

(d) *Special Allocation of Subpart F income*

[125] For example, assume New P buys M for $100, and M's only asset is CFC1 with a value of $100 and net used tested loss amount of $100. If M immediately sells the CFC1 stock for $100, it will have gain of $100. If the gain, but not the basis reduction, tiers up to New P, P will have a basis of $200 in M even though M has a value of $100. Likewise, if the value of CFC1 declines and M sells the CFC1 stock for $0, M will have no gain or loss. If the basis reduction does not tier up to New P, New P will have a basis of $100 in stock of M that is worth $0. In both cases, the effect of the CFC basis reduction rule would be negated if the amount of the CFC basis reduction did not tier up.

[126] Treas. Reg. § 1.1502-13(b)(2)(i).

Under the Proposed Regulations, for purposes of determining the application of the special allocation rule described in Part IV.B.3(h) to a consolidated group, the amount of stock considered to be owned by a member of a group within the meaning of Section 958(a) includes any stock the member is deemed to own under Section 958(b) (the "**consolidation modification**").[127]

The consolidation modification raises significant questions. First, final regulations should confirm that the consolidation modification relates only to determining the applicability of the special allocation rule. That is, it only applies to the "on/off" switch in the special allocation rule that applies the rule only when the shareholder with the net used tested loss amount (the "**responsible shareholder**") owns less than 100% of the stock in CFC1 under Section 958(a).

For example, if the responsible shareholder owns 50% of CFC1 under Section 958(a), and 50% under 958(b), then it is clear that the special allocation rule does not apply and the Subpart F income of CFC1 is allocated pro rata to all Section 958(a) shareholders. Moreover, if the responsible shareholder owns 50% of CFC1 under Section 958(a) and 40% under Section 958(b), it is clear that the special allocation rule applies. Once it applies, the consolidation modification should be irrelevant, and the Subpart F income of CFC1 should be specially allocated to stock owned under Section 958(a) by the responsible shareholder, not stock owned under Section 958(b) by that shareholder. The latter category might even include stock directly held by non-group members, such as by an individual owner of the parent of the group, yet it would not include stock held under Section 958(a) by third parties where the responsible shareholder was not a Section 958(b) owner. These distinctions would defeat the purpose of the special allocation rule and would be quite illogical.

Second, the purpose of the 100% trigger for the consolidation modification is unclear. If the group as a whole owns 100% of CFC1 under Section 958(a) and thus the responsible member owns 100% under Sections 958(a) and (b), there is no special allocation of the additional Subpart F income to the responsible member. Then, when CFC1 sells CFC2, all members of the group that own CFC1 immediately before the sale are allocated proportionately, based on their ownership of CFC1, the Subpart F income of CFC1 attributable to the responsible member's net used tested loss amount in CFC2. In fact, multiple members might be responsible members, with the result that the aggregate net used tested loss amount of the group in CFC2 is allocated to all the members in proportion to their Section 958(a) ownership in CFC1.

This approach is consistent with the rule that allocates tested losses of a tested loss CFC proportionately to all members with tested income, without a priority allocation to a shareholder of the CFC that has tested income. However, this approach is inconsistent with the fact that when multiple members own a first tier CFC, and they all sell their stock in the CFC, the net used tested loss amount attributable to each member

[127] Prop. Reg. § 1.1502-51(c)(4).

increases the gain of the member itself and is not allocated pro rata to all members holding stock in the CFC.

Moreover, if a pro rata allocation of the additional Subpart F income among group members owning CFC1 is appropriate when the group owns 100% of CFC1 under Section 958(a) and (b), it seems equally appropriate when the group owns less than 100% of CFC1. The existence of non-group interests in CFC1 should not affect the methodology for the members to share their own aggregate net used tested loss amounts among themselves. In fact, the 100% ownership requirement for turning off the special allocation rule makes that rule elective. If the group owns 100% of CFC1 but desires the special allocation rule to apply, it can have CFC1 issue one share of its stock (perhaps nonvoting preferred stock) to an unrelated third party.

The 100% ownership requirement to turn off the special allocation rule also creates an undesirable cliff effect. If the responsible member has 99.9% Section 958 ownership in CFC1, the increased Subpart F income attributable to that member is allocated entirely to that member. The rule changes dramatically if the member reaches 100% ownership. The rule can also be a trap for the unwary. A third party that is unexpectedly determined to own one share of CFC1 (even debt treated as preferred stock for tax purposes) can cause the special allocation rule to apply when it was not expected to.

Third, it is not logical for the 100% ownership test under the consolidation modification to count stock held outside the group towards the requisite 100% ownership. Suppose the members together own 50% of the stock of CFC1 and the individual owner of the parent corporation owns the other 50%. On the sale of CFC2, the consolidation exception applies, so the individual is allocated 50% of the Subpart F income from all the members' net used tested loss amounts. This is so despite the fact that the group members obtained all the benefit of those tested losses.

Moreover, if the individual shareholder owned 49% instead of 50% of CFC1, and an unrelated party held the other 1%, the special allocation rule would apply and all the additional Subpart F income would be allocated solely to the responsible members. There is no logical reason that the allocation of Subpart F income to the responsible members should depend upon the level of ownership of a non-group member, or why there should be such a benefit to the non-group member from selling one share of stock of CFC1 to an unrelated third party.

Fourth, by counting stock held outside the group, the consolidation exception treats a shareholder of a CFC that is a member of a consolidated group differently than a shareholder of a CFC that is not a member of a group. If a U.S. shareholder owns less than 100% of CFC1 under Section 958(a), but constructively owns all the remaining stock under Section 958(b), the special allocation rule will apply if the U.S. shareholder is not a member of a consolidated group, but will not apply if the U.S. shareholder is a member of a consolidated group.

For example, suppose US1 owns 50% of CFC1 under Section 958(a), and 50% of CFC1 under Section 958(b) through an individual shareholder of US1. If US1 is not a member of a group, the special allocation rule applies and there is a special allocation of 100% of the additional Subpart F income to US1. If US1 is a member of a group, even though no other member of the group owns any stock in CFC1, the consolidation exception applies, and there is a 50/50 allocation of the Subpart F income to US1 and to the individual shareholder of the CFC. This result is inconsistent with treating the group in the same manner as a single corporation, and the results seem quite illogical.

Fifth, the consolidation modification is presumably intended, at a minimum, to cause the special allocation rule not to apply if all the stock of CFC1 is held by group members. However, this result will not always be achieved, because the group member with the net used tested loss amount in CFC2 may not own, under Section 958(b), all the stock in CFC1 held by other group members. The reason is that the Section 1504(b)(4) disregards straight nonvoting preferred stock for purposes of the 80% vote and value test for consolidation, but the Section 318 attribution rules, incorporated by reference (with modifications) by Section 958(b), are based solely on the value of stock without any such exclusion for preferred stock.

For example, if M1 owns stock in CFC1, and more than half the value of M1 is in the form of preferred stock held outside the group, M1 will not own under Section 318(a)(2)(C), and therefore under Section 958(b), any stock in CFC1 owned by any other group member. As a result, to achieve single entity principles for the group, any test for the consolidation modification should be based on all CFC1 stock held by group members, without regard to Section 958(b).

Based on the foregoing, we believe that the consolidation modification should be either eliminated or substantially revised. If it is retained, its purpose should be stated in the preamble to the final regulations. We also believe that if it is retained, it should provide that any time the special allocation rule would apply to one or more members of a group, the total Subpart F income specially allocable to particular members under that rule will instead be allocated pro rata to group members based on their relative ownership in CFC1. However, even that rule, while logical on a stand-alone basis, is inconsistent with the result that arises when multiple members of a group own stock in a CFC and sell that stock simultaneously.

D. Proposed Regulation Section 1.1502-32: Upper Tier Basis Adjustments

1. *Summary of Proposed Regulations*

As background, if a member of a consolidated group has a subsidiary that is also a group member, the -32 consolidated return regulations generally adjust the basis of the member in the stock of the consolidated subsidiary to reflect income and loss of the subsidiary (and lower tier subsidiaries). For example, if P owns M and M has taxable income or loss, P's basis in M increases or decreases, respectively, by M's income or loss. If M has income, this avoids a second tax on the income if P sells the stock of M. If

M has a loss, this avoids the taxpayer receiving a second deduction for the loss when P sells the stock of M.

If M has tax exempt income (such as a dividend from a CFC exempt under Section 245A, or a domestic dividend entitled to the dividends received deduction), P's basis in M generally increases in the amount of the exempt income, to retain the exemption upon P's sale of the stock of M. Likewise, if M has a noncapital, nondeductible expense (e.g., a nondeductible fine or penalty), P's basis in M decreases by such amount to prevent the deduction in effect being allowed when P sells the stock of M.

The proposed amendments to the -32 regulations contain three new rules for adjustments to P's basis in the stock of M, to reflect M's ownership of stock in a CFC:

1. M has a noncapital, nondeductible expense (i.e., P's stock basis in M is reduced) for the net used tested loss amount of M's CFCs at the time the net used tested loss arises.[128] This rule is referred to herein as "**Rule 1**".

> **Example 25**. *Rule 1*. P owns M1 and M2, M1 owns CFC1 with $100 of tested loss, and M2 owns CFC2 with $100 of tested income. There is no GILTI inclusion. M1 has $100 of used tested loss. Under the CFC basis reduction rule, M1's basis in CFC1 goes down by $100 when M1 sells the CFC1 stock. But under Rule 1, P's basis in M1 goes down by $100 immediately.

Under this rule, so long as M1 continues to own the stock in CFC1, there is a mismatch between the lower outside basis of P in the M1 stock, and of the higher inside basis of M1 in the CFC1 stock. This mismatch is very unusual in the consolidated return context, since the -32 regulations are generally designed to cause a match between inside asset basis of M and the outside basis in the stock of M (except for purchased basis in M stock). The mismatch in the group ends when either P disposes of the M1 stock (in which case there is no longer a mismatch within the group) or when M1 disposes of the stock of CFC1 (in which case the basis in CFC1 goes down immediately before the disposition under the CFC basis reduction rule.

2. M has tax-exempt income (i.e., P's stock basis in M is increased) in the amount of M's offset tested income amount for a particular CFC, but the aggregate of such increases in basis cannot exceed the aggregate of the decreases in basis under Rule 1 for the used tested losses of the same CFC.[129] This rule is referred to herein as "**Rule 2**."

> **Example 26.** *Rule 2*. P owns M, which owns CFC1. In year 1, CFC1 has used tested loss of $100, and under Rule 1, P's basis in M goes down by

[128] Prop. Reg. § 1.1502-32(b)(3)(iii)(C).

[129] Prop. Reg. § 1.1502-32(b)(3)(ii)(E).

$100 (although M's basis in CFC1 only goes down by $100 when CFC1 is sold). In year 2, CFC1 has offset tested income of $150. Under Rule 2, P's basis in M goes up by $100, the offset tested income not in excess of the prior basis reductions under Rule 1. Alternatively, if CFC1 had the offset tested income in year 1 and used tested loss in year 2, there would be no positive basis adjustment under Rule 2 in year 1 (because of the cap on positive adjustments) and no negative adjustment under Rule 1 in year 2 (because at that point there is no cumulative net offset tested loss).

3. M has tax-exempt income (i.e., stock basis in M is increased) immediately before the disposition of M stock by a group member to the extent that a CFC of M has net offset tested income that could be distributed to M immediately before the disposition and that would be eligible for Section 245A (and not subject to Section 1059).[130] This rule is referred to herein as "**Rule 3**".

The basis increase under Rule 3 is the basis increase that P would have in the M stock under the existing -32 regulations if the CFC had hypothetically distributed the stated amount to M. The theory for Rule 3 appears to be that P should be able to achieve the same increase in basis in the M stock (and reduced taxable gain) without the need for an actual distribution by the CFC to M.[131]

Note that unlike Rule 2, the basis increase in the M stock with respect to a CFC can exceed prior negative adjustments with respect to the same CFC. For example, a basis increase can apply even if the CFC has had offset tested income but has never had a used tested loss.

2. *Comments*

(a) *Rule 1 and the Timing for Basis Reduction*

As noted in the discussion of Rule 1 above, that rule creates a mismatch between P's basis in M1 and M1's basis in CFC1 until the sale of CFC1. The Preamble asks for comments on whether the timing of the outside basis adjustments in M1 stock under Rule 1 should be conformed to the timing of the inside basis adjustments in the CFC1 stock under the CFC basis reduction rule. This concept is referred to herein as "**modified Rule 1**". Of course, the basis reduction in modified Rule 1 is necessary to prevent the P group from obtaining a second benefit from the used tested loss of CFC1 at the time of the sale of the M stock, to conform the result to the denial of the second benefit under the CFC

[130] Prop. Reg. § 1.1502-32(b)(3)(ii)(F).

[131] The same rationale would support applying Rule 3 to tested income of a CFC that is not taxed to the U.S. shareholder because of QBAI (or income such as high-taxed Subpart F income that is neither Subpart F income nor tested income). There is no GILTI inclusion, and a distribution to M of such income would be eligible for Section 245A and would increase P's basis in M. Consideration should be given to extending Rule 3 to these cases.

basis reduction rule. As a result, the only difference in tax result between Rule 1 and modified Rule 1 is when P's basis in M is relevant before a sale of M.

We discuss in Part IV.B.3(c) in the context of the CFC basis reduction rule our view that for the purposes of several Code sections such as Section 382, M's basis in the CFC should be treated as reduced immediately because this better reflects the economics of M holding the stock in the CFC. Likewise, we discuss in Part IV.D.2 our view that the same should be true for certain purposes of the -36 consolidated return regulation. Since the purpose of modified Rule 1 is to achieve parity in the inside and outside basis of M, we believe that if modified Rule 1 is adopted, it should reduce P's basis in M immediately for purposes of the same Code provisions for which the CFC basis reduction rule would reduce M's basis in the CFC immediately.

If this approach is adopted, the difference between Rule 1 and modified Rule 1 would be the default rule that would apply in the absence of a specific rule reducing basis under modified Rule 1 (and under the CFC basis reduction rule itself) for purposes of applying a particular Code section. The default rule would be a reduced basis under Rule 1 and an unreduced basis under modified Rule 1. The scope of the default rule might be significant, since it would be impossible (and an inefficient use of resources) for the Treasury to attempt to identify all Code sections for which P's basis in M is relevant.

As noted above, we are aware of several Code sections where we believe that P's basis in M (and M's basis in the CFC) should be treated as reduced immediately. In fact, except in cases involving spinoffs where basis must be allocated, we are not aware of any Code sections where we believe that P should be treated as having an unreduced basis in M during the period before P sells the M stock. This reason for the latter statement is that references to tax basis in the Code are by definition references to the calculation of gain or loss that would arise on a sale of the underlying asset. Of course, the same is true for M's basis in the CFC, but as noted in the Preamble, there are significant problems with an immediate reduction in basis for all purposes outside the consolidated return context.

If modified Rule 1 were to be adopted, it would cause P to have an unreduced basis in M for purposes of all Code provisions unless the modified rule created a specific exception. However, we believe it would not be practicable to identify all cases where an exception would be appropriate. Moreover, as noted above, except in situations involving spinoffs, we are not aware of any Code sections for whose purpose an unreduced basis in M would be appropriate.

Finally, the immediate basis reduction in Rule 1 does not trigger immediate gain in a consolidated group even if the amount of the reduction exceeds P's basis in M. Rather, the excess reduction creates an excess loss account in the M stock that is generally taxed on the disposition of that stock. This is in contrast to the gain that could be triggered on a reduction in basis in the stock of a nonconsolidated subsidiary in excess of the initial tax basis.

As a result, we support the approach of the Proposed Regulations (Rule 1) rather than modified Rule 1. The latter rule would require exceptions, and any list of exceptions would likely not be complete.

(b) *Rule 1 Conformity to Basis Reduction Rule*

Rule 1 reduces P's basis in M by the net used tested loss amount that M has in a CFC. We suggest above that the CFC basis reduction rule should not apply in certain circumstances where the group has not achieved a double benefit from the used tested loss of the CFC. If final regulations create any exceptions to the deferred basis reduction under the CFC basis reduction rule, the same exceptions should apply to the immediate basis reduction provided in Rule 1.

As a policy matter, there is no justification to apply Rule 1 if the CFC basis reduction rule does not apply because the group has been determined not to have realized a double benefit from the used tested loss. For example, if the used tested loss has provided no benefit because of QBAI in the CFC with tested income, the group should be entitled to achieve a single benefit from the tested loss, either on the sale of the CFC with tested loss (as discussed in Part IV.B.2(a)), or on the sale of the stock of the member owning the CFC.

(c) *Rule 2 and Section 245A Dividend Payments*

Final regulations should modify Rule 2 to take account of Section 245A dividend payments made by the CFC in question.

> **Example 27**. *Rule 2 with Section 245A dividend*. Assume CFC1 has $100 of used tested loss in year 1 and $100 of offset tested income in year 2. P's basis in M decreases by $100 in year 1 under Rule 1, and increases by $100 in year 2 under Rule 2. Suppose that in addition, CFC1 pays a Section 245A dividend in year 2 out of its offset tested income (which generated current e&p to M).

The dividend in year 2 should create tax exempt income in M and increase P's basis in M.[132] The result is a duplicative increase in P's basis in M in year 2, once under Rule 2 because of the offset tested income in year 2, and again under existing -32 because of the dividend of that offset tested income. The final regulations should eliminate this duplication. Logically, all offset tested income would still count against the "cap" for basis increases under Rule 2. However, a basis increase under Rule 2 should not occur if it would result in duplication with basis increases from prior Section 245A distributions of the related tested income.

[132] We ask for clarification of this point in the Section 245A Report at 40.

We note that the issue raised by Example 27 does not arise from the fact that the dividend paid in year 2 is a nimble dividend, i.e., where the dividend is paid out of current earnings even though the accumulated earnings are negative or zero. The same issue would arise if the offset tested income and dividend were in year 1, and the used tested loss was in year 2. In that case, at least absent the dividend, there would be no basis adjustment under Rule 1 or Rule 2 in either year 1 or year 2. As in Example 27, the effect is that the dividend first increases P's basis in M in year 1, and the same earnings in year 1 then prevent a decrease in basis in year 2 that would otherwise arise from the year 2 tested loss.

We also note that, assuming conformity between e&p and tested income, a Section 245A dividend can result in a basis increase that is duplicative of a Rule 2 basis increase only if the dividend is paid by the CFC in the year the offset tested income arises, or in a later year before the year of the tested loss. Once the year with the tested income and the year with the tested loss have both passed, the tested income of the CFC in one year and the tested loss of the CFC in the other year will generally result in no net e&p and no ability to pay a Section 245A dividend out of the tested income. As a result, the rule proposed above would not in practice require a look-back period to determine whether Rule 2 and a Section 245A dividend had resulted in a duplicative basis increase.

It should also be noted that Rule 3 avoids this duplication issue for Section 245A dividends. It provides for a basis increase in M only for distributions that would be eligible for Section 245A. If earnings are actually distributed and are eligible for Section 245A, this reduces the remaining earnings that could be so eligible, and so the basis increase under Rule 3 is automatically decreased by the amount of the dividend.

(d) *Rule 2 and the "Same CFC" Limitation*

As noted above, Rule 2 allows an offset to the basis reduction for the net used tested loss amount of a CFC only on account of offset tested income of the same CFC. We have considered whether the offset should be expanded to apply to offset tested income of other CFCs owned by the same U.S. shareholder.

> **Example 28**. *Rule 2 and netting*. Suppose M owns CFC1 with $100 of tested income and CFC2 with $100 of tested loss. P's basis in M is reduced by $100 under Rule 1 because of the used tested loss in CFC2, without offset for the offset tested income in CFC1. There is no increase in the basis in M under Rule 2 on account of CFC1, because no net positive adjustments for a particular CFC are allowed under that rule.

If an offset was allowed, there would be no reduction in P's basis in M in that year. This would reduce the taxpayer-unfavorable mismatch that arises when the basis in M is reduced for used tested losses of one of its CFCs notwithstanding the existence of offset tested income in another of its CFCs.

On the other hand, the lack of netting in Rule 2 is in many cases not disadvantageous to the taxpayer. In the example, if M sells the stock of CFC1 and CFC2, M has no gain on the sale of CFC1 because of Sections 1248 and 245A, and M has no loss on the sale of CFC2 because of the CFC basis reduction rule. If P sells the stock of M, the same result would arise under netting, but it would also arise under the existing Proposed Regulations. P's basis had initially been decreased by $100 under Rule 1 on account of CFC2, but immediately before the sale of M, it would be increased by $100 under Rule 3 on account of CFC1.

Moreover, the lack of netting in the Proposed Regulations has the significant advantage of making irrelevant the location of different CFCs within the consolidated group for purposes of making the adjustments under -32. With netting, the overall tax basis in the group can be significantly higher if the same member own CFCs with both offset tested income and used tested loss. This is true notwithstanding the pro rata allocation of tested losses among members with tested income in the Proposed Regulations. In Example 28, netting would result in no basis decrease in the M stock, but if CFC1 and CFC2 were held by M1 and M2, respectively, there would be a basis decrease in the M2 stock and no adjustment in the M1 stock.

In addition, if netting was allowed, the effect is an increase in basis to reflect the offset tested income of CFC1 and a decrease in basis to reflect the used tested loss of CFC2. This would increase the complexity of Rule 2 and Rule 3, since if offset tested income of CFC1 arising from a tested loss in CFC2 is deemed to give rise to a basis increase in M, it cannot give rise to another basis increase under Rule 2 or Rule 3. For example, since Rule 3 is based on M's net offset tested income amount in the CFC being sold, this would depend not only on prior tested income and losses of the same CFC (as under the Proposed Regulations), but on tested income and losses of all other CFCs owned by M.

Netting would also require the adoption of prioritization rules for purposes of the CFC basis reduction rule. For example, suppose that in year 1, CFC1 had used tested loss of $100 and in year 2, CFC1 had tested income of $100 and CFC2 had tested loss of $100. Under Rule 1, there would be a basis reduction in M of $100 in year 1, and no basis increase or decrease in year 2. The issue would be whether, for purposes of the CFC basis reduction rule, the CFC1 tested income in year 2 is "matched" with the CFC1 tested loss in year 1 (reducing M's net used tested loss amount in CFC1) or whether it is matched with the CFC2 tested loss in year 2 (reducing M's net used tested loss amount in CFC2).

As a result, netting would not avoid the need to trace of the separate offset tested income and used tested loss amounts of all the CFCs owned by the particular U.S. shareholder. It would not promote simplification, and in fact would likely increase the complexity of the already-complex basis regime adopted in the Proposed Regulations.

On balance, we believe the most important factor is that the location of a CFC within the group should not matter, consistent with the other results in the Proposed Regulations. As a result, we support the lack of netting in Rule 2.

(e) *Rule 3 Following a Sale of M Stock*

The final regulations should clarify several aspects of Rule 3 that arise in connection with the sale of the M stock.

> **Example 29**. *Rule 3 upon sale of M stock.* M owns CFC1 with $100 of offset tested income and e&p. Assume Section 245A would apply, and Section 1059 would not apply, to a dividend of such income. The stock of M is sold, and under Rule 3, P's basis in M is increased by $100.

P gets the benefit of this basis increase on the sale of M, just as it would if CFC1 had paid a $100 Section 245A dividend before the sale, or if M had sold CFC1 and recognized $100 of Section 1248 gain eligible for Section 245A.

Assume now that the buyer (Buyer) of the stock of M is a member of a different consolidated group, the "Buyer group." Immediately before and after the purchase, M holds stock in CFC1, and immediately before the purchase, CFC1 had $100 of net offset tested income. Regulations should clarify whether the attribute of net offset tested income continues to reside with M after its purchase by Buyer, so that immediately before Buyer sells M in the Buyer group, Buyer's basis in M is increased by the amount of net offset tested income that arose in the P group.

This question on its face is similar to the question discussed in Part IV.C.2(b) of whether the net used tested loss amount of a CFC should carry over into a new group under Rule 1 to increase the gain when the CFC is sold. However, the considerations here are very different.

On the one hand, if CFC1 paid a dividend of the net offset tested income amount to M in the Buyer group, Buyer would increase its basis in the M stock by the same amount. To the extent the purpose of Rule 3 is to make such a dividend unnecessary, Rule 3 should apply to increase the basis of the Buyer's stock in M. To be sure, this might cause Buyer's basis in M to exceed its fair market value, since the cost basis is the fair market value of the M stock and this basis would be increased by the then-existing net offset tested income amount of CFC1. However, the -36 consolidated return regulations will potentially disallow any noneconomic or duplicated loss arising from this basis increase.

On the other hand, the P group got the benefit of Rule 3, and the purchase price for M already reflects the existing undistributed earnings in CFC1. Allowing a basis increase each time a new buyer acquires the M stock could result in an unlimited number of basis increases in the M stock in the hands of each buyer. While Treasury Regulation Section 1.1502-36(c) would generally disallow a loss to the buyer on the sale of the M stock to the extent the loss arose from this basis increase, the basis increase could still shelter post-sale appreciation in the M stock. This would be an ironic result for a rule designed to put P in the same position as if CFC1 had paid out all its earnings in the P group. After all, a CFC can only pay out the same earnings once, and a single amount of earnings of $100 cannot justify an unlimited number of $100 basis increases through the successive applications of Rule 3.

As a result, we recommend that the final regulations make clear that the basis increase in Rule 3 only applies to the consolidated group in which the net offset tested income amount arises.

Even this rule, though, would not be sufficient. In Example 29, P's basis in M is increased by $100 to reflect the fact that CFC1 could have paid a tax-free dividend of $100 before the sale. However, this is not treated as a real dividend and, in particular, does not reduce the e&p of CFC1. As a result, if P2 was the parent of another consolidated group and bought the M stock, CFC1 could pay an *actual* dividend of the same $100 to M after the purchase by P2. This would be tax-free to M under Section 245A and increase the basis of P2 in M. The double increase in tax basis would be unjustified for the reasons discussed in the second preceding paragraph.

Moreover, Treasury Regulation Section 1.1502-36(c) would not have any effect in this case. There would be no "disconformity amount" under that regulation as a result of the dividend because P2's increased basis in M from the dividend would match M's increase in inside tax basis from the receipt of the cash dividend. One possible way to avoid this result would be an amendment to the -32 regulations to prevent the tiering up of dividend income from a CFC if the dividend is paid from e&p that had resulted in a prior basis increase in a different group under Rule 3. Such a rule would, however, require a buyer of the stock of M to know the history of the Rule 3 basis increases in the selling group, and the rule would frequently cause buyers in acquisition transactions to require representations and/or indemnities from sellers concerning such basis increases in the selling group.

(f) *Sale of M Stock in Middle of Year*

We believe that final regulations should further clarify and illustrate certain aspects of the sale of stock of M in the middle of a tax year.

> **Example 30**. *Rule 3: Sale of stock mid-year*. P owns M, which owns CFC1. CFC1 has no attributes from prior years, but has $100 of tested income in 2019. P sells M to unrelated Buyer on June 30, 2019. M remains the sole shareholder of CFC1 for all of 2019, so CFC1 remains a CFC for all of 2019. All parties have a calendar year tax year.

First, since CFC1 remains a CFC through the end of 2019, and the tax year of M ends when it leaves the P group, we believe that the U.S. shareholder inclusion year is the tax year of the Buyer group that includes December 31, 2019. Assume first that the

Buyer group has no other CFCs. Then, the Buyer group has a GILTI inclusion of $100 for 2019, there is no offset tested income to M from CFC1 for any part of 2019, and Rule 3 has no application to the P group during 2019. Regulations should illustrate these conclusions.

Second, assume that for 2019, the Buyer group has $100 of tested income from CFC1 and $100 of tested loss from another of its CFCs. It therefore has no GILTI inclusion for 2019, and CFC1 has untaxed e&p of $100 for calendar year 2019. Rule 3 assumes a hypothetical distribution to M of the net offset tested income amount of the CFC allocable to the transferred shares immediately before the sale of the M stock, to the extent a dividend of such amount would be eligible for Section 245A.

A shareholder that is not a U.S. shareholder of the CFC on the U.S. shareholder inclusion date would not include in income any portion of the tested income for the year. Thus, there appears to be no net offset tested income amount allocable to the P group for the year. As a result, there is no hypothetical distribution to M under Rule 3. More generally, Rule 3 could never apply to any tested income that arises in the year of sale of a CFC, if the CFC remained a CFC after the sale. The result in this situation should be clarified in the final regulations, perhaps by an example.

Third, consider the same facts as Example 30, except that CFC1 pays a dividend of $50 to M on June 30, 2019, just before the sale of the M stock. The U.S. shareholder inclusion year is still the Buyer tax year that includes December 31, 2019. However, this fact pattern raises additional questions:

> (a) Assume the Buyer group has no tested losses. Then, the general GILTI inclusion amount would be $100. However, Section 951(a)(2)(B) reduces the GILTI inclusion to the U.S. shareholder on the last day of the year by the amount of distributions received by "any other person," subject to certain limitations. In form, M is the "person" that both received the dividend on June 30, 2019 and is the U.S. shareholder on December 31, 2019. Thus, arguably, the GILTI inclusion to the Buyer group should not be reduced by the amount of the dividend, and the distribution to M on June 30 would be PTI.
>
> However, this result would not make sense. In reality, the P group is the economic shareholder before the sale, and the Buyer group is the economic shareholder after the sale. Moreover, if "person" is defined without regard to treating consolidated groups as a single "person", then a transfer of CFC stock within a single group would be a transfer to a different "person." Regulations under Section 951(a)(2)(B) should clarify that the relevant "person" in respect of a member of a consolidated group is the common parent of the group.
>
> (b) Next, assume that the Buyer group has $100 of tested income and e&p from CFC1 and an equal tested loss from another CFC. Then,

> there is no GILTI inclusion to the Buyer group and Section 951(a)(2)(B) is irrelevant. It seems that a dividend of $50 (or even $100) paid to M before the sale would a dividend out of current e&p, would be eligible for Section 245A, and would increase P's basis in M under existing -32. There is not necessarily a policy objection to this result, since the Buyer group will have a used tested loss that corresponds to the offset tested income distributed to M. However, the Buyer group is then bearing the cost, through a basis reduction in M equal to the used tested loss, of providing exempt income and an increased tax basis in M to the P group. This would be a very surprising result, and, if intended, should be discussed explicitly in the final regulations.

(g) *Rule 3: Creating a Tax Loss on M Stock*

Regulations should explicitly state, or provide an example showing, that the basis increase provided in Rule 3 can create or increase a tax loss in the M stock. Arguably this is already clear, since the rule states that M is treated as having tax-exempt income immediately prior to a transaction in which P recognizes income, gain, deduction or loss with respect to M stock. If P recognized loss before taking Rule 3 into account, the only possible effect of Rule 3 would be to increase such loss, so this indicates that there is no limit on the basis increase under Rule 3.

However, to avoid the need to make such an inference on a very significant issue, an explicit statement or an example such as the following should make this point.[133]

> **Example 31**. *Tax loss on M stock*. P forms M with a cash contribution of $1000, and M forms CFC1 with a cash contribution of $1000. Thereafter, CFC1 has offset tested income of $100. Suppose P sells the M stock for $1060. Rule 3 will increase P's basis to $1100, and P will have a tax loss of $40 subject to the loss limitation rules in -36.

(h) *Avoiding the Loss Disallowance Rule*

An example to the final regulations should also illustrate the following fact pattern.

> **Example 32**. *Rule 3 avoiding loss disallowance*. M holds stock in a CFC with a tax basis and value of $200 at a time when the CFC has $100 of offset tested income. Suppose also that P's basis in M is $100, so that P would recognize a gain of $100 (before applying Rule 3) on the sale of the

[133] An example should also illustrate a discontinuity between Rule 3 and an actual dividend eligible for Section 245A. A basis increase in M under Rule 3 can result in a tax loss subject to -36 but not to Section 961(d), since the latter provision only applies when an actual dividend is subject to Section 245A. An actual dividend would give rise to the same basis increase, but in that case a loss in the stock would also be subject to Section 961(d).

M stock for $200. In fact, if P sells the M stock, under Rule 3, P's basis in M increases by $100 to $200, and P has no gain on the sale.

If the CFC had actually paid a Section 245A dividend of $100 to M, M's basis in the CFC would not change, and M would have a loss of $100 on the sale of the CFC stock for $100. That loss would be disallowed under Section 961(d). However, Rule 3, like an actual dividend, increases the basis of P in the M stock and thereby avoids the loss disallowance rule and eliminates P's gain on the sale of the M stock. We believe this is the correct result, but it is not intuitive and an example would be helpful to confirm the result.

(i) *Rule 3 and Second Tier CFCs*

Under Rule 3, a hypothetical distribution that would be a dividend subject to Section 1059 does not create a basis increase in the M stock. This result makes sense, since an actual dividend subject to Section 1059 would not result in such a basis increase. In the case of offset tested income of a second tier CFC, it is not clear how the Section 1059 test in Rule 3 is to be applied. Similarly, it is not clear how the requirement that the distribution would be eligible for Section 245A is applied. For example, there might be intermediate entities with hybrid stock, with dividends on such stock not eligible for Section 245A.

Regulations should clarify whether these tests are applied solely to a dividend from the second tier CFC to the first tier CFC, whether they are based on whether the cash could be returned to the U.S. with Section 245A applying and without Section 1059 applying at either level, or whether they are based on whether, on the return of the cash to the U.S., there would in fact be a basis increase in the M stock taking Sections 245A and Section 1059 into account. The latter appears to be the most logical interpretation.

(j) *Rule 3 and PTI*

The test in Rule 3 is how much of a hypothetical distribution equal to the net offset tested income amount of the CFC would be a dividend eligible for Section 245A. However, if the CFC has any PTI, any distribution will first be out of PTI and will not be a dividend eligible for Section 245A. This will skew the calculation under Rule 3. For example, if the net offset tested income amount is $100, and there is also unrelated PTI of $90, the size of the deemed distribution is the net offset tested income amount of $100. On a hypothetical distribution of $100, $90 would be PTI and only $10 would be a dividend eligible for Section 245A, so the Rule 3 basis increase would only be $10.

This is clearly not the intent of Rule 3. As a result, the hypothetical distribution should either assume that the CFC has no PTI, or else the size of the deemed distribution should be the sum of the net offset tested income amount plus the PTI. We prefer the former formulation because it is more targeted. However, the latter formulation will be equivalent as long as the hypothetical PTI distribution is not counted towards the threshold tests for an extraordinary dividend under Section 1059, which we believe is the correct result.

(k) *Tiering Up of CFC Basis Reductions*

Regulations should confirm that if P owns M and M owns a CFC, a downward basis adjustment in the stock of the CFC under the CFC basis reduction rule does not tier up under -32 to reduce P's basis in M. P's basis in M has already been reduced for the net used tested loss amount under Rule 1, and another reduction would be duplicative.

(l) *E&P Adjustments*

Regulations should clarify whether a reduction of P's basis in M under Rule 1 decreases the e&p of P. Arguably there should not be a current decrease in e&p, since there is no current increase in P's e&p on account of offset tested income of a CFC held by M, unless the income is distributed. On the other hand, a decrease in P's e&p to reflect the Rule 1 basis decrease in the M stock would better match M's inside e&p with the outside tax basis in M.

When a CFC is sold, M's ending e&p balance should not generally be affected by whether the reduction in the basis of the CFC stock under the CFC basis reduction rule is a reduction in M's e&p. Any such reduction in e&p should reduce the tax basis of the stock for e&p purposes, and so the reduction in e&p would normally be offset by increased e&p to M arising from increased gain (or reduced loss) on the sale as a result of the basis reduction.

Correspondingly, on the disposition of the CFC, any increased gain to M as a result of the CFC basis reduction rule should not increase the e&p of P unless P's e&p has been reduced on account of Rule 1.

Regulations should clarify these results.

(m) *Predecessor/Successor Rule*

Regulations should confirm that the predecessor/successor rule in existing Treasury Regulation Section 1.1502-32(f) applies to a member's interest in a CFC's net used tested loss amount and net offset tested income amount, when a member of the group transfers the CFC to another member in a nonrecognition transaction.

(n) *Loss Duplication under -36(d)*

Treasury Regulation Section 1.1502-36(d) is designed to prevent "loss duplication." Loss duplication arises when M1 sells stock of M2 at a loss to the extent that such loss is also reflected in built-in loss in the assets M2. In that case, if M2 were to sell its assets immediately after the stock sale, a second tax loss would be allowed even though there is a single economic loss on the assets. The regulations prevent this result by reducing the basis of the assets in M2 to eliminate the duplication, with an election to instead reduce the basis in the stock to the extent of the loss duplication amount. The loss duplication amount is, simply stated, the lesser of the loss on the stock and the net loss that would arise if the assets were sold for the sale price of the stock (disregarding for simplicity liabilities of M2, NOLs and other factors).

The final regulations should state that in applying this rule on the sale of M, if a CFC has a net used tested loss amount, the tax basis of the CFC stock to M for this purpose is its basis after taking the CFC basis reduction rule into account. This is necessary to prevent -36(d) from disallowing tax losses that are not duplicated losses.

> **Example 33**. *The CFC basis reduction rule and loss duplication*. Suppose P buys M stock from a third party for $100, and M's only asset is stock of CFC1 with a tax basis of $60 and no prior history. Assume that CFC1 then has a net used tested loss amount of $40, reducing P's basis in M to $60 under Rule 1. The value of CFC2 goes down to $20, and P then sells the M stock for $20.

P has a real economic loss of $80 on the sale, and $40 of the corresponding tax loss was used to offset the tested income of other CFCs. However, if M is treated as having an unreduced tax basis of $60 in CFC1, P's remaining unused economic loss of $40 is duplicated by M's built-in loss of $40 in the stock of CFC1, which has a basis of $60 and value of $20. As a result, -36(d) would require either that P's loss be disallowed or that M's basis in CFC1 be reduced to $20 at the time of the sale of the M stock (in addition to a further reduction of $40 when M sells the CFC1 stock).

These results make no sense as an economic matter. Immediately after P sells the M stock, if M were to sell the CFC1 stock for $20, M's basis in CFC1 would be reduced from $60 to $20 and so M could not obtain a tax loss on the sale of the stock. There is simply no potential for a duplication of P's loss on the sale of the M stock, and there is no logical reason for -36(d) to apply in this case. The correct answer is reached only if M is treated as having a tax basis of $20 in the CFC, i.e., the basis that it would have immediately before a sale of the CFC stock, in testing for loss duplication under -36(d).[134]

We note that the problem is not solved by the election in -36(d) to allow P its $40 loss on the M stock at the cost of reducing the basis in the CFC stock by the duplicated loss of $40. This election would not prevent another reduction in the basis in the CFC

[134] This application of -36(d) when there is in reality no duplicated loss would also arise frequently if P bought the stock of M at a time when M already had a net used tested loss amount in a CFC that it owned. For example, assume P buys stock of M for $100 when M owns a CFC with a basis of $100 and net used tested loss amount of $100. If M's basis in the CFC is $100 for purposes of -36(d), any loss by P on the sale of M will be a duplicated loss. In reality, no such loss is a duplicated loss because M has a basis of $0 immediately before the sale of the CFC and so can never recognize a loss on the sale.

stock under the CFC basis reduction rule immediately before the sale of the CFC stock, resulting in a double reduction in basis for a single net used tested loss amount.

Moreover, it would not be adequate for a regulation to prevent this second reduction in basis. For example, regulations might say that to the extent that M's unreduced basis in the CFC causes a loss disallowance under -36(d) that would not otherwise arise, there is no additional basis reduction when M sells the stock of the CFC. In fact, P's tax loss of $40 should not be disallowed in the first place, there should be no reduction in M's $60 basis in the stock of the CFC under -36(d), and M should only be subject to the usual CFC basis reduction rule upon the sale of CFC1. The only way to achieve this result under -36(d) is to apply the CFC basis reduction rule in determining the tax basis of M's stock in a CFC for purposes of -36(d).

A similar issue arises under -36(d) if M owns a CFC with a net offset tested income amount. Under Rule 3, P's basis in M will increase by such amount immediately before the M stock is sold. This increased basis should be taken into account in determining whether there is loss duplication under -36(d).

> **Example 34**. *Rule 3 and loss duplication.* P buys the stock of M for $50. At that time, M's only asset is stock in CFC1 with a basis of $100. CFC1 has no prior tax history. CFC1 then generates a net offset tested income amount of $40. P then sells the stock of M for $50. Under Rule 3, P's basis in M increases from $50 to $90 immediately before the sale, resulting in a $40 loss to P on the sale before application of -36(d).

If P's basis in M is determined without regard to Rule 3, P has a basis of $50 in the stock, so it has no loss on the sale of the stock for $50 for purposes of -36(d). As a result, there could not be a duplicated loss under -36(d). Yet P in fact had a loss of $40 on the sale of M because of the basis increase from $50 to $90 under Rule 3.

Moreover, if M then sold the stock of CFC1 (basis $100) for $50, there would be a loss of $50 to M. This would result in a double loss of $40, to both P and M. The only way to carry out the purpose of -36(d) is to treat P as having a basis in M that is increased as it would be under Rule 3. In that case, P's loss for purposes of -36(d) would be $40, and this would duplicate $40 of the built in loss of $50 in the M assets.

As a result, to carry out the purposes of the loss duplication rule in -36(d), when P sells the stock of M and M is a U.S. shareholder of a CFC, we believe it is necessary to take account of both (1) the CFC basis reduction rule in determining M's tax basis in the CFC, and (2) Rule 3 in determining P's basis in M. We note that the former rule will reduce the amount of duplicated losses under -36(d) and the latter rule will increase the amount of such duplicated losses, but we believe both results are appropriate.[135]

[135] In theory, the application of -36(d) should also depend upon whether an M loss on the sale of CFC1 would be disallowed under Section 961(d). If so, there is no loss duplication and no need to disallow

(o) *Loss Disallowance under -36(c)*[136]

Under -36(c), loss is disallowed on P's sale of stock of a consolidated subsidiary M to the extent of the lesser of (1) the "disconformity amount," which is the excess of P's outside basis in M stock over M's inside basis in its assets and its other tax attributes and (2) the net positive increase in P's basis in M under -32 (disregarding distributions) while M was held by P.

The purpose of -36(c) is to prevent a "son of mirror" transaction, where P buys the stock of M at a time when M has assets with unrealized gain. P's basis therefore already reflects the unrealized gain in the M assets. M then sells the assets at a taxable gain, increasing P's basis in M above fair market value of the stock. Absent -36(c), P could then sell the stock of M at a tax loss, with no economic loss, and that tax loss would offsets M's gain on the asset sale. The result is a tax free step up in the basis of the M assets in the hands of the buyer. To prevent this result, -36(c) would disallow P's loss on the sale of the M stock.

We believe that for purposes of determining the disconformity amount under -36(c), the basis of the stock of a CFC in the hands of M should take into account the CFC basis reduction rule as well as Rule 3.

> **Example 35**. *The CFC basis reduction rule and -36(c).* P buys the stock of M for $100 at a time when M's only asset is stock of a CFC with a basis of $100 and with a used tested loss amount of $100.

If the CFC basis reduction rule is disregarded under -36(c), the disconformity amount is $0, since the outside basis in M stock and inside basis in the M assets are both $100. As a result, -36(c) cannot apply. Then, M can sell the stock of the CFC for $100 and recognize $100 of gain, and this will increase P's basis in M to $200. P can sell the M stock for $100, recognizing a loss of $100 that offsets the $100 gain to M. The buyer of the CFC does not have any net used tested loss amount in the CFC. The result is that the detriment of the net used tested loss amount of $100 has been eliminated from the tax system at no cost to the P group or anyone else.

We believe this is inconsistent with the purposes of -36(c), and so the CFC basis reduction rule should be taken into account in determining the disconformity amount. Then, the disconformity amount is $100 and the net increase in basis to P is $100

P's loss on the sale of M stock. However, -36(d) currently determines loss duplication under a formula that is based solely on the tax basis of assets, not on whether a loss on a hypothetical sale assets held by M would be disallowed under any provision of the Code. If Section 961(d) were to be taken into account for purposes of -36(d), other loss disallowance provisions of the Code for all assets held by M should also be taken into account. This narrowing of -36(d) is beyond the scope of this Report, and we take no position on it.

[136] The issues arising under -36(c) are discussed further in the Section 245A Report, at 41-44.

resulting from the sale of the CFC. The lesser of these two numbers is $100 and so P's entire loss of $100 on the sale of the M stock is disallowed. We believe this is the correct result. In fact, if the net used tested loss amount in the CFC exceeds M's basis in the CFC, we believe that M's basis in the CFC should be treated as negative for purpose of computing the disconformity amount.

On the other hand, we do not believe that Rule 3 is relevant for purposes of -36(c). As discussed in Part IV.D.2(e), we believe that if a net offset income amount arises in one group, and P sells the stock of M to another group, it should not continue into the buying group. As noted above, -36(c) is aimed at the case where the purchase price of the M stock includes built in gain in the M assets, and the recognition of gain in those assets causes the basis in the M stock to be above fair market value. Assuming Rule 3 does not increase the basis of M stock when the new group sells the M stock, we do not believe that -36(c) requires any adjustment to take account of Rule 3.

However, if regulations were to apply Rule 3 to the net offset tested income in the buying group, additional issues would arise. Assume P buys the stock of M for $200, M has a basis of $100 in the CFC, and M has a net offset tested income amount of $100 in the CFC. If Rule 3 applies, when P sells the M stock for its purchase price of $200, M's basis would increase to $300 and it would have a loss on the sale. This is because M's purchase price already reflects the net offset tested income amount. The issue is in substance the same as the issue in the "son of mirror" transaction described above. Since Section 961(d) does not disallow a loss on the sale of the M stock, -36(c) should logically apply in this case.

(p) *Intra-group Sales of a CFC*

Regulations should confirm that the attribute redetermination rule of Treasury Regulation Section 1.1502-13(c)(1) applies to Rules 1-3. Under that rule, if M1 sells CFC1 to M2, and M2 later sells CFC1 to a third party, the attributes of M1 and M2 are redetermined if necessary to reach the same overall result for the group as if M1 and M2 were divisions of a single corporation.

For example, M1 might have increased deferred gain on the sale of the stock of CFC1 to M2 as a result of the CFC basis reduction rule. However, if CFC1 has offset tested income in the hands of M2, on an overall group basis the CFC basis reduction rule might be inapplicable when M2 sells the stock of CFC1 to a third party. In that case, the attribute redetermination rule should put the group as a whole in the same position as if the CFC basis reduction rule did not apply. As another example, if final regulations adopt our proposal that the CFC basis reduction rule does not apply in the absence of a double tax benefit from a used tested loss, this determination should be made at the time of the sale of CFC1 by M2 to a third party, and the treatment of M1 adjusted accordingly.

(q) *Rule 1 and Internal Spin-offs*

We believe that the final regulations should modify the rules for allocation of basis following an internal spin-off within a consolidated group, when the member receiving a spin-off distribution has had its basis in the distributing company reduced under Rule 1.

Suppose M1 has a CFC with a net used tested loss amount, and P has a reduced basis in M1 under Rule 1. M1 transfers some of its assets (which may or may not include the stock in the CFC) to newly formed M2, and spins off M2 to P in a divisive D reorganization. P's basis in M1 would be divided between its post-spin stock in M1 ("**New M1**") and M2 based on the relative fair market values of New M1 and M2.[137] Absent any special rule, P's original basis reduction in M1 becomes, in effect, partly a basis reduction in New M1, and partly a basis reduction in M2, in proportion to the relative values of New M1 and M2.

However, the prior reduction in P's basis in M1 was entirely attributable to the CFC, which is now held by either New M1 or by M2. We refer to the member owning the CFC as the "**CFC owner**" and to the other member as the "**non-CFC owner**". If P's reduced basis in M1 is allocated between New M1 and M2, it will result in a partial disassociation of the prior basis reduction in the M1 stock and the net used tested loss amount in the CFC stock that is now held by the CFC owner. This is inconsistent with the idea that Rule 1 and the CFC basis reduction rule are intended to result in merely a different timing for basis reduction, rather than shifting part of the consequences of the Rule 1 basis reduction to a party other than a direct or indirect shareholder of the CFC.

A closer match of the Rule 1 basis reduction with the net used tested loss amount in the CFC could be achieved if (1) the unreduced basis of P in M1 was initially allocated between New M1 and M2 under Section 358, and (2) the resulting basis in the CFC owner was then reduced by the Rule 1 amount (the "**alternative approach**").

> **Example 36**. *Rule 1 and internal spinoffs*. M has two assets, land with a basis of $100, and a CFC with a basis of $100 and net used tested loss amount of $100. P's basis in M is $200 minus the Rule 1 reduction of $100, or $100. Assume the land and CFC stock is each worth $100, and the value of the M stock is therefore $200. Disregarding the substantive spin-off requirements under Section 355, assume P transfers the land to M2 and spins M2 off to P.

After the spin-off, New M1's inside basis (after taking account of the CFC basis reduction rule) is $0 and M2's inside basis is $100. Under the Proposed Regulations, P's $100 basis in M is allocated $50 to New M1 and $50 to M2, creating a disparity in basis. The alternative approach eliminates this disparity: P would be viewed as having a $200

[137] Treas. Reg. § 1.358-2(a)(2)(iv).

basis in M that would be allocated $100 to New M1 and $100 to M2, and Rule 1 would then apply to P's basis in New M1, leaving P with a basis of $0 in New M1 and $100 in M2. The Rule 1 basis reduction in New M1 then exactly matches the future basis reduction that New M1 will have in the CFC under the CFC basis reduction rule.

It can be argued that the alternative approach should not be adopted because, as a general matter, no special adjustments under Section 358 are made for other deductions of M that are allocable to specific assets of M. For example, if M has a Section 168(k) expense deduction for a capital asset, P's basis in M is reduced by the amount of the expense, but there is no comparable adjustment under Section 358 to initially disregard that basis reduction in the M stock. More generally, because the allocation of the basis in M stock under Section 358 is based on the values of New M1 and M2 rather than their inside asset basis, the allocation inherently creates differences between the inside and outside basis of New M1 and M2.

On the other hand, the situation here is unique, because the Proposed Regulations themselves create the pre-spin disparity between higher inside tax basis of the CFC and the lower outside tax basis in M. Normally, any change to the inside basis of the M assets would result in an equal change to the outside basis of the M stock. It therefore seems reasonable to temporarily "undo" the disparity created by the Proposed Regulations in order to recalculate basis allocations following a spinoff.

A more significant problem with the alternative approach, however, is that it may make the disparity between inside and outside basis *worse* than under the normal application of Section 358. For example, assume the same facts as in Example 36, except the land is worth $900 so the M stock is worth $1000. Again, after the spin-off, New M1's inside basis (after taking account of the CFC basis reduction rule) is $0 and M2's inside basis is $100. Under the Proposed Regulations, P has a basis of $10 in New M1 and $90 in M2.[138]

Yet under the alternative approach, P has an excess loss account of $80 in New M1 and a basis of $180 in M2.[139] This result makes no sense. It arises because the increase in the M basis by the Rule 1 adjustment is mostly allocated to the M2 stock, which has 90% of the combined value, and yet the second step Rule 1 basis reduction is made entirely to the New M1 stock. To be sure, this is the result that would have arisen if Rule 1 only applied when the CFC stock is sold. However, the result would make no more sense if in fact the Rule 1 basis reduction was deferred in that manner.

These examples illustrate that the alternative approach appears to reach the "proper" result in some cases, retaining the match between the net used loss amount of

[138] P's $100 basis in M is allocated 10% to New M1 ($10) and 90% to M2 ($90).

[139] P's $100 basis in M is initially considered $200, of which 10% ($20) is allocated to New M1 and 90% ($180) is allocated to M2, and the basis in New M1 is then be reduced by $100 to an excess loss account of $80.

the CFC and the outside tax basis of the CFC owner. However, in other cases it reaches results that are clearly incorrect. As a result, we do not recommend it in the form we have discussed so far.

However, we believe a variation of the alternative approach would be appropriate. Under that variation, initially, as in the alternative approach, the unreduced basis of P in M1 would be allocated between New M1 and M2 under Section 358. However, in the second step, the resulting basis in the CFC owner would then be reduced by the Rule 1 amount, but (unlike in the alternative approach) this basis reduction would be limited to an amount that would not reduce the basis in the stock of the CFC owner below the inside basis of the assets of the CFC owner (taking into account the CFC basis reduction rule). Any remaining basis reduction would be allocated to the non-CFC owner. We believe that this approach fairly balances the goals of undoing the new basis disparities created by the Proposed Regulations, and not having a revised basis allocation system create new basis disparities that would not otherwise exist.

Under this approach, in the variation of Example 36, since the inside basis of the New M assets is $0 (after taking account of the CFC basis reduction rule), the $20 of basis initially allocated to New M1 would not be reduced by $100 (as under the alternative approach), but would only be reduced by $20. The remaining $80 of basis reduction would apply to the stock in M2, reducing it from $180 to $100. As a result, the final basis in New M1 would be $0 and the final basis in M2 would be $100. On these facts, inside and outside basis match for both New M1 and M2. This approach would also not change the result in Example 36, since there the alternative approach already resulted in a match of inside and outside basis in both New M1 and M2.[140]

(r) *Rule 1 and External Spin-offs*

We believe that final regulations should provide rules for the application of Rule 1 when P spins off the stock of M to the shareholders of P in an external spin-off.

First, consider the case where P's unreduced basis in M is $100, but because of a net used tested loss amount of $150 in a CFC held by M, Rule 1 has reduced P's basis in M to an excess loss account (ELA) of $50. P then spins off M in a Section 355 spin-off or divisive D reorganization. Under Section 355(c) or Section 361(c), P would not recognize a gain on the distribution, but the ELA of $50 would be taxable under the consolidated return regulations. However, no such ELA would have existed, and no gain would have been taxable, in the absence of Rule 1.

We believe that except in the situations involving cash distributions described below, final regulations should provide that no gain is recognized on the spin-off of a

[140] Note that the various approaches to allocating basis may create discontinuities with the allocation of e&p, which is generally allocated in proportion to fair market value. See NYSBA Tax Section Report No. 1333, *Report on the Allocation of Earnings and Profits in Connection with Divisive Transactions* (Dec. 1, 2015).

member if the gain represents the triggering of an ELA that would not have existed absent the application of Rule 1. The reason for Rule 1 is that an unreduced basis in M allows P to obtain a second tax benefit from the single tested loss in the CFC. Here, even without the application of Rule 1, P is not obtaining any tax benefit from its basis in M, and it will never be able to in the future. In addition, except in the situations described below, P is not receiving any cash on account of its interest in M.

Of course, if it is assumed that the basis reduction is the "norm", and that the failure to reduce basis results in avoidance of tax on the ELA gain, it could be argued that this is a double benefit. However, this argument assumes the conclusion. In fact, the reason to reduce basis is to prevent a reduction in value of M resulting from the net used tested loss amount from allowing a taxable disposition of M at a reduced gain or increased loss to P. Here, no tax benefit or cash is being received by P on the spin-off of the M stock, so there is no reason to reduce the tax basis of M.

Next, consider the case where P's unreduced basis in M is $100, its reduced basis under Rule 1 is $20, and in a divisive D reorganization, P contributes M to a new Spinco in exchange for Spinco stock and $50 of cash, and then P spins off Spinco. P would not recognize gain under Section 361(b) if P distributed the cash to its shareholders or creditors. However, the cash would nevertheless reduce P's basis in Spinco, and any resulting ELA would be taxable to P.

The question here is whether P's unreduced or reduced basis in M should be used to determine whether (and to what extent) the cash distributed to P creates an ELA. We believe it is appropriate here to use the reduced basis, taking account of Rule 1. The reason is that when cash is actually received by P, P is obtaining the benefit of a tax-free receipt of cash to the extent of P's tax basis in M. Unless the Rule 1 basis is used for this purpose, a second benefit of tax-free cash is being received from the unreduced basis. This situation is similar to the issue involving Section 301(c)(2) and (c)(3) discussed in Part IV.B.3(e). However, here unlike there, P will no longer own the stock of M, so the time of the spin-off is the last opportunity for P to be taxed on the receipt of cash from M.

Finally, consider the case where the CFC basis reduction rule creates an ELA not on account of cash received as part of a reorganization transaction, but because of a debt financed distribution of cash, or debt financed losses that give rise to a tax benefit to P. By way of illustration, assume that P forms M with $100 and M forms CFC1 with $100. CFC1's assets then appreciate to $200. In a later year, M borrows $30 and distributes the $30 to P. CFC then has $100 of used tested loss (offset against tested income of another CFC in a different chain).

Under Rule 1, P's basis is reduced so that it has an ELA of $30 in the stock of M. P distributes M to its shareholders under Section 355. Arguably, if there is no ELA recapture, the P group has achieved two benefits from the tested loss and associated stock basis, once upon offset against the tested income and once to "shelter" the debt-financed distribution. The result is in substance no different than the result in the preceding paragraph. Arguably the same issue arises if M borrows the $30 and creates a tax loss that is used by the P group and reduces P's basis in M. (By contrast, if P had simply acquired M for $70 and there were no debt-financed distributions before the spin-off, there would be no "double benefit.") Regulations should clarify the result in this case.

E. Basis Issues in Intra-Group Reorganizations

1. *The Proposed Regulations*

Under Proposed Regulation Section 1.1502-51(c)(5), if M1 engages in a nonrecognition transaction with another group member M2 and receives stock in exchange for CFC stock held by M1, M1's basis in the stock received (which normally would be the basis in the CFC stock) is reduced by the net used tested loss amount of the CFC. This rule complements Rule 1. The purpose of the -51 rule is to mirror P's existing reduced basis in M1 with a new reduced basis by M1 in the member stock acquired in exchange for the CFC.

> **Example 37**. *Intercompany Section 351 transaction*. P's initial basis in M1 is $150, and M1's initial basis in the CFC is $150. The CFC has a used tested loss of $100, reducing P's basis in M1 to $50, but not changing M1's basis in CFC of $150. Then, M1 contributes the CFC to M2 in exchange for M2 stock. Under the general rules, M2 obtains a carryover basis of $150 in the CFC, and M1 obtains a substituted basis of $150 in the M2 stock. The Proposed Regulations require that the M1 basis in M2 be reduced by $100, to $50, to be the same as P's basis in M1.

2. *Comments on Proposed Regulation Section 1.1502-51*

The -51 Proposed Regulation makes sense in this example. However, it does not work if it is intended to apply to an intercompany asset reorganization.

> **Example 38**. *Intercompany asset reorganization*. P owns M1 and M2. P's initial basis in M1 is $150, and M1's initial basis in the CFC is $150. The CFC has a used tested loss of $100, reducing P's basis in M1 to $50, but not changing M1's basis in the CFC of $150. M1 merges directly into M2, with P deemed to receive additional M2 stock in exchange for its M1 stock. Absent the rule in -51, P's basis in the new M2 stock would be its old basis in M1, or $50. However, if the Proposed Regulation applies, it would reduce this basis again by another $100, the used tested loss of the CFC.

This double reduction of basis would not make sense. It is possible to interpret this Proposed Regulation so that it does not affect P's basis in M2. Under this interpretation, the basis of the new M2 stock deemed received by M1 in the reorganization would be reduced in the hands of M1, but this reduced basis would "wash out" on the deemed liquidation of M1 into P. Then, P's basis in the M1 assets (including M2 stock) would be a substituted basis from P's basis in the M1 stock under Section 358.

This Proposed Regulation could be modified to state that it does not apply to asset reorganizations. However, it is doubtful that this exclusion was intended, because Proposed Regulation Section 1.1502-51(c)(5) goes on to describe the application of the regulation to an intercompany transaction that is an all-cash D reorganization (as discussed below). It is possible that this Proposed Regulation is thought to be needed in case there is an asset reorganizations in which a basis reduction has not already occurred. To address this possibility, this Proposed Regulation could be modified so that the basis reduction for a used tested loss only applies to the extent that the used tested loss of the CFC has not already been reflected as a reduction in the basis of the stock received in the nonrecognition transaction involving the CFC.

Moreover, as noted, Proposed Regulation Section 1.1502-51(c)(5) goes on to say that in the case of an intercompany transaction that is an all-cash D reorganization, the basis reduction under (c)(5) is made prior to the application of the rule in the consolidated return regulations that an intra-group reorganization with boot is treated as an all-stock reorganization, followed by a separate distribution of cash.[141] If this rule is needed at all, it is not clear why it should only apply to an all-cash D reorganization, as opposed to any intra-group reorganization. In addition, it is not clear why this rule is necessary. It is especially difficult to see a situation involving an all-cash D reorganization in which the basis of the transferring member in the stock of the transferred member would not have already been reduced under Rule 1.

Finally, regulations should clarify the application of the -51 regulation to a net used tested loss amount that arises in the year that the stock of the CFC is transferred. Since a GILTI calculation is only made at the end of the tax year of the CFC, it appears that the -51 adjustments do not take account of a pro rata portion of the current-year net used tested loss amount. Rather, the CFC reduction rule and Rule 1 would apply at the end of the tax year, and to the shareholders at that time, on the basis of the net used tested loss amount for the entire year.

3. *Comments on Proposed Regulation Section 1.1502-13(f)(7)*

The Proposed Regulations modify Example 4 in Treasury Regulation Section 1.1502-13(f)(7) to reflect the modification to the -51 Proposed Regulation discussed immediately above.

Example 4 involves an "all-cash D" reorganization in which the transferor member S in the reorganization is deemed to receive stock in the transferee corporation B, followed by S's liquidation into its shareholder member M. In the example, M has a tax basis in S of $25, S has a value of $100, S's only asset is stock in a CFC, and the CFC has a net used tested loss amount of $15. B pays $100 to S for the stock in the CFC and S liquidates into M. Under the all cash D regulations, B is first treated as paying $100 worth of stock to S, with S then liquidating and M taking a basis in the B stock equal to

[141] Treas. Reg. § 1.1502-13(f)(3).

its old $25 basis in the S stock. The revised example states that M now owns stock in B and B owns the CFC, M's basis of $25 in the B stock must be reduced by $15, the used tested loss amount of B.

This last point does not appear to be correct. In the example, M's initial basis in S ($25) should already have been reduced under Rule 1 by the $15 of net used tested loss amount in the CFC. When S transfers the CFC to B and B issues its stock to S and S liquidates, M's basis in the B stock should be the same as its basis in the S stock (i.e., $25). That basis should not be reduced again by the CFC's used tested loss, since M's basis has already been reduced by that amount.[142] This is the same point concerning Proposed Regulation Section 1.1502-51(c)(5) discussed immediately above.

F. General Basis Issues Under the Proposed Regulations

1. *Aggregation of Shares*

The Proposed Regulations do not discuss specifically the question of whether all shares of a particular shareholder of a CFC are to be aggregated in making the calculations required by the Proposed Regulations. Alternatively, the calculations might be made on a share by share (equivalent to bloc by bloc), class by class, or shareholder by shareholder basis.

Under the Proposed Regulations, tested income and tested losses of a CFC are allocated to shareholders of the CFC based on the manner in which distributions of earnings would be made by the CFC.[143] An equal amount of tested income or loss is allocated to each share of the same class, although different amounts might be allocated to shares of different classes. On the other hand, the Proposed Regulations appear to contemplate that a U.S. shareholder of a CFC will have a single net used tested loss amount or net offset tested income amount for the CFC.[144]

However, a U.S. shareholder may have different shares in the same CFC that gave rise to different used tested loss amounts and/or offset tested income amounts while they were held by the U.S. shareholder. This could arise if the shares are of different classes, or if the shares are identical but were acquired at different times by the U.S. shareholder. Even if all of these amounts are aggregated in determining the U.S. shareholder's net

[142] The existing Example 4 also erroneously refers to S receiving B stock with a basis of $25 under Section 358 that it distributes to M in liquidation. In fact, M rather than S will have a basis of $25 in the B stock. This does not affect the conclusion of the example.

[143] Prop. Reg. §§ 1.951-1(e), 1.951A-1(d).

[144] *See, e.g.*, Prop Reg. § 1.951A-6(e)(2) (definition of net used tested loss amount); Prop Reg. § 1.951A-6(e) (definition of net offset tested income amount); Prop Reg. § 1.951A-6(e)(4)(i) (allocation of either of such items to particular shares); Prop Reg. § 1.951A-6(e)(1)(i) (basis on disposition of specified shares is reduced by the corporation's net used tested loss amount with respect to the CFC allocable under usual allocation rules to the specified shares).

used tested loss amount or net offset tested income amount at any time, it is not clear whether the underlying shares maintain their separate underlying attributes, for example if they are sold.

> **Example 39**. *Aggregation of shares*. In year 1, US1 owns 50 out of 100 shares of CFC1 (the "**year 1 shares**"), CFC1 has a tested loss of $100, and US1 uses its $50 share of the tested loss against other tested income. At the end of the year, US1 acquires the remaining 50 of the shares (the "**year 2 shares**"). In year 2, CFC1 has another tested loss of $100 that is used by US1 against other tested income. US1 sells the year 1 shares or the year 2 shares (but not both) at the end of year 2.

Under the Proposed Regulations, US1 has a net used tested loss amount in CFC1 of $150, $50 from year 1 and $100 from year 2. Under an aggregation approach, this represents $1.50 per share owned at the time of the sale, so the sale of the 50 year 1 shares or the 50 year 2 shares would result in a basis reduction of $75 in the shares sold. Under a tracing approach, the $150 of net used tested loss amount would be allocated $2 per share to the 50 year 1 shares and $1 per share to the 50 year 2 shares, so the basis reduction would be $100 if the year 1 shares were sold or $50 if the year 2 shares were sold.

The question is even more difficult if the CFC has offset tested income in some years.

> **Example 40**. *Aggregation of shares with offset tested income*. In year 1, US1 owns 50 out of 100 shares of CFC1 (again, the "**year 1 shares**"), CFC1 has a tested loss of $200, and US1 uses its $100 share of the tested loss against other tested income. At the end of the year, US1 acquires the remaining 50 of the shares (again, the "**year 2 shares**"). In year 2, CFC1 has tested income of $100 that is offset by other tested losses of US1. US1 sells the year 1 shares at the end of year 2.

US1 has a used tested loss amount of $100 from year 1, and an offset tested income amount of $100 in year 2. Therefore, on an aggregate basis, US1 has no net used tested loss amount, and there is no basis reduction when the year 1 shares are sold. However, under a share by share approach, the year 1 shares have a used tested loss amount of $100 from year 1 and a $50 offset tested income amount from year 2, while the year 2 shares have a $50 offset tested income amount from year 2. Under this approach, there is a $50 basis reduction when the year 1 shares are sold, and the year 2 shares have $50 of untaxed e&p.

The issue also arises if a U.S. shareholder holds different classes of stock, say common and preferred. Suppose first that the preferred stock is allocated tested income and the common is allocated tested loss in a single year, so that there is no GILTI inclusion. Presumably there is netting so that Rule 1 does not cause a reduction in the tax basis of the U.S. shareholder, and the CFC basis reduction rule does not apply if the U.S.

shareholder sells the common stock. However, the results under both rules is less clear if the only allocations from the CFC are of tested income on the preferred stock in year 1 that is offset tested income to the U.S. shareholder, and of tested loss on the common stock in year 2 that is used tested loss to the U.S. shareholder.

Another issue would arise if the U.S. shareholder held common stock with a used tested loss, and then purchased preferred stock of the same CFC. If part of the existing used tested loss was then reallocated to the preferred stock under an aggregation approach, it would be possible for the U.S. shareholder to use this technique to avoid part of the basis reduction that would arise on a sale of the common stock.

More generally, under a bloc by bloc approach, if a particular U.S. shareholder held shares of the same class acquired at different times, or shares of different classes, the results would be the same as if each bloc was held by a different shareholder. As illustrated above, the shareholder might have a separate net used tested loss amount or net offset tested income amount in each bloc, and might even have a net used tested loss amount in one bloc and net offset tested income amount in the other bloc.

As a result, the U.S. shareholder would be required to keep track of each bloc of shares separately. This would be a significant burden. Each bloc would have its own net used tested loss amount or net offset tested income amount in each CFC held by the shareholder. The CFC basis reduction rule, which is based on the cumulative net used tested loss amount, would apply separately to each bloc, and the shareholder could presumably designate the shares that it was selling even if the shares were otherwise identical.

The complexities of the bloc by bloc approach would be even greater in the consolidated return context, since Rules 1, 2 and 3 would apply on a bloc by bloc basis. If M held some shares in a single CFC with a net used tested loss amount and other shares with a net offset tested income amount, P's basis in M would decrease by the former without an offset for the latter. A rule would also be necessary to determine whether, under Rule 1, P's basis in M is reduced equally for each share that P owns in M, in an aggregate amount equal to the total net used tested loss amounts for blocs of stock in the particular CFC. Alternatively, P could be permitted to designate particular shares in M to obtain the reduced tax basis in different amounts, corresponding to the different shares that M holds in the CFC that might have different (or no) net used tested loss amount.

The same issue would arise for offsets under Rule 2 to basis reductions under Rule 1. If offset tested income arises in different shares than those that had the used tested loss, there would be no offset to the basis reduction that arose in the shares that had the used tested loss. Likewise, Rule 3 is limited to offset tested income, and the total of the net offset tested income amounts of the shares with offset tested income might be greater or less than the shareholder's net offset tested income amount for the CFC as a whole.

Moreover, in a consolidated group, it is very common for a member to contribute cash to a subsidiary member. Under a bloc by bloc approach, a rule would be needed as to whether such a contribution that is not in exchange for stock would be deemed to be a contribution for stock and a deemed recapitalization of the existing shares,[145] requiring separate tracking of the existing and "new" shares. Absent such a deemed recapitalization, the group could electively achieve bloc by bloc or aggregation results by choosing whether to issue additional stock in exchange for the cash.

On the other hand, aggregation of all shares held by a shareholder, even on a class by class basis, would raise its own issues. As in Example 40, suppose a shareholder holds a single bloc of stock in a CFC with a net used tested loss amount or net offset tested income amount. Suppose the shareholder then acquires additional shares of the CFC of the same class, either from a third party or from the CFC itself. Those new shares would immediately share in the preexisting attributes from the first bloc of shares, reducing the used tested loss amount or offset tested income amount for each original share.

This would encourage tax planning prior to a planned disposition of CFC stock. The result is also somewhat peculiar, since the tax basis of the shares in each bloc would remain separate. As a result, assuming a net used tested loss amount, so the tax basis taken into account on a sale of any share would be the "real" tax basis reduced by a pro rata portion of the aggregate net tested loss amount allocated to all the shares.

It should be noted that even if the regulations were to adopt a class by class or shareholder by shareholder approach, the members of a consolidated group would still need to be treated as separate shareholders. This is necessary under the Proposed Regulations in order to determine the correct amount of net offset tested income amount and net used tested loss amount for each member in each CFC, since those amounts determine the basis increases and decreases in the stock of each member under Rules 1-3.

As a result, if the regulations provided for an aggregation of all shares in a CFC held by a particular U.S. shareholder, a group that wished to have less aggregation of shares could easily have different members of the group own different shares in the CFC. This result would be inconsistent with the idea that a group should be treated as a single entity and that the location of CFCs in the group should not matter. The only way to avoid these results would be if all the calculations were made on a share by share approach, since then the allocations to each share would be the same regardless of where in the group a particular share was located.

It must be acknowledged that even today, shareholders of any corporation, including a CFC, are in principle required to keep track of the separate basis of each share. This is relevant for calculating gain or loss on the sale of individual shares, the holding period of shares for various Code provisions (including Section 245A), amounts

[145] Prop. Reg. § 1.358-2(g)(3) (2009).

taxable under Section 301(c)(3), and so on. In the case of a CFC, separate tracking is also required to determine whether a distribution is PTI, since shares owned during a period of a GILTI or Subpart F inclusion would have a basis increase and PTI allocation, while shares acquired afterwards would not. However, as a practical matter, separate tracking rarely makes a difference today, and so the calculation of basis for particular shares is often not made unless and until it becomes necessary. This is in contrast to separate tracking for GILTI purposes, which if required would be far more complex and far more difficult (if not impossible as a practical matter) to do retroactively.

To conclude, we believe that a share by share, or bloc by bloc, approach is the most theoretically correct approach, and avoids electivity in a consolidated group through nonproductive tax planning. However, this approach would be quite complex and could considerably increase the basis reductions arising under the CFC basis reduction rule and under Rule 1 in the consolidated return context. The Proposed Regulations already create an enormously complex basis regime, and, absent a compelling reason, it should not be made more complex.

On the other hand, an aggregation approach lends itself to tax planning because of the ability it creates to shift net used tested loss amounts and net offset tested income amounts from some shares in a CFC to other shares in the CFC owned by the same shareholder. On balance, we suggest aggregating all shares of the same class owned by a single U.S. shareholder in a CFC, with an anti-abuse rule for transactions undertaken with a principal purpose of taking advantage of the aggregation approach to achieve noneconomic tax results that would not be achieved on a share by share approach.[146] If a U.S. shareholder owns both common and preferred stock, the preferred should be treated separately because of the significantly different ongoing allocations to the two classes of stock and the resulting uneconomic effects that could arise from aggregation.

2. *Complexity*

We cannot submit this Report without an expression of concern about the enormous amount of complexity in basis calculations created by the Proposed Regulations. It is very common, both in the consolidated group context and otherwise, for a U.S. shareholder to sell stock of a one or more CFCs. It is not even unusual for dozens or even hundreds of CFCs to be sold at one time, often in multiple chains of ownership and including cross-ownership among CFCs.

In the past, the basis in the stock of the CFCs being sold has been relatively easy to determine. Now, in light of the CFC basis reduction rule, this will be enormously complicated. A U.S. shareholder will have to know the net used tested loss amount of

[146] Similarly, we suggested simplified rules allowing aggregation of basis in many cases where proposed regulations issued in 2009 would have required calculations be made on a share-by-share basis. NYSBA Tax Section Report No. 1316, *Report on Proposed Regulations Regarding Allocation of Consideration and Allocation and Recovery of Basis in Transactions Involving Corporate Stock or Securities* (February 6, 2015).

every CFC being sold. It will be impossible to make this calculation on a retroactive basis at the time a CFC is sold. As a result, it will be necessary for the U.S. shareholder to keep track, on an annual basis, of the tested income and loss of each CFC, and the allocation of the tested losses of tested loss CFCs to the tested income of tested income CFCs. For CFCs in the same chain, the interactions among members of the chain will add more complexity. Foreign tax credits, not discussed in this Report, will add yet another significant amount of complexity.

The complexity will increase further in the context of a consolidated group. It is very common for a group to sell stock of a member of the group that directly or indirectly owns numerous CFCs. A group will not only need to keep track of the data necessary to determine the net used tested loss amount of each CFC in case the CFCs are sold. It will also need to keep track of the data needed to determine the gain or loss that will arise on a future sale of stock of any member that owns any CFCs. Thus, a group will need to keep track, on a member by member basis, of all the data needed to determine the Rule 1, Rule 2, and Rule 3 adjustments to the basis of member stock. Again, it will not be possible as a practical matter to make these calculations retroactively, so this will be an annual exercise.

As discussed in Part III.F.2(b)(vii), the rules for partnerships holding stock in CFCs are also extraordinarily complicated. It is difficult to imagine partnerships making accurate tax reports to their partners, partners reporting accurately on the CFCs they hold directly and through partnerships, and IRS agents auditing these issues.

Some of the suggestions in this Report will make the basis adjustment rules even more complicated. We make some of the suggestions in order to make the rules work properly as a technical matter, such as the need to keep track of dividends paid by CFCs in order to make adjustments under Rule 2. Other suggestions are to grant taxpayers relief from rules that seem unfair, such as our proposal not to reduce basis under the CFC basis reduction rule for tested losses that do not give rise to an actual tax benefit.

It is possible that major accounting firms will develop computer software that will allow the input of the basic underlying information and will then, in seconds, generate data concerning all tax basis adjustments in the stock of all the CFCs and stock of all members of a group directly or indirectly owning CFCs. However, not all U.S. shareholders of CFCs will have access to such software, and the need for taxpayers to rely on the algorithms in such a "black box" is unfortunate. The resulting complexities and uncertainties could even have a chilling effect on transactions if the taxpayer is concerned that the gain on a sale might be unexpectedly large.

We understand that the purpose of the rules, as well as our suggestions, are to have basis results that reflect economic accuracy. We also understand that basis rules that err on the side of simplicity rather than economic accuracy give rise to the risk of potential manipulation by taxpayers. On the other hand, if manipulation is the concern, the rules are now so complex that it is difficult to imagine how IRS revenue agents are going to audit positions taken by taxpayers anyway.

The complexity and uncertainty of the basis rules will also cause enormous difficulties in the merger and acquisition context. Sellers may be reluctant to sell stock of CFCs, or stock of members owning CFCs, because of uncertainty about the amount of gain that might arise. A buyer might be reluctant to buy the stock of corporation holding a CFC because of concern about future basis reductions in the CFC under the CFC basis reduction rule. A buyer doing due diligence on a target might also be concerned about prior transactions engaged in by the target in which basis under the Proposed Regulations was relevant. The result of these various areas of uncertainty might be increased escrow amounts, longer indemnity periods, the purchase of tax insurance, a reduction in purchase price, or even a reduction in the level of transactions.

In any event, it is unlikely that Congress, when it passed the GILTI legislation, understood the new complexity in basis calculations that it was creating.

3. *The Broader Problem Concerning -32, Section 245A, and Section 961(d)*

As we have discussed in Part IV.D.2(e) and as is discussed further in the Section 245A Report, a noneconomic basis increase under -32 will often arise when buyer buys the stock of M, M owns a CFC, and the CFC pays a dividend of then-existing offset tested income that is eligible for Section 245A. The amount of the offset tested income is already included in the buyer's basis in M, and so the dividend results in a noneconomic basis increase in the M stock just as in a son of mirror transaction. In fact, such an uneconomic basis increase can arise from any untaxed income of a CFC, such as tested income offset by NDTIR. While beyond the scope of the Proposed Regulations and this Report, the Treasury should consider a broader reexamination of the -32 regulations to account for such income.

For example, suppose that M owns a single CFC with tested income of $100 that generates $100 of NDTIR to M. There is no GILTI inclusion, and the CFC can pay a tax free dividend of $100 to M. Under the usual -32 rules, this will increase P's basis in M by $100. This will be the correct economic answer if P's basis in M does not already reflect the $100 of earnings. However, it will be an uneconomic increase in stock basis if, say, P contributed $100 to newly formed M, M bought stock in a CFC for $200, the CFC at that time had $100 of untaxed income, and the CFC pays a $100 dividend to M eligible for Section 245A.[147] P will have a $300 basis in M and can sell it for its value of $200, resulting in a $100 tax loss without a corresponding economic loss.

While this is very similar to a son of mirror transaction, the loss disallowance rule in -36(c) will not apply because P's outside basis in M ($300) is the same as M's inside basis in its assets (cash of $100 and CFC stock with a basis of $200). However, under -36(d), there is a duplicated loss, since both the stock of M and the assets of M have a

[147] The same issue would arise if, when M bought the CFC, the CFC had an asset with unrealized appreciation of $100 and sold the asset after the acquisition, with the resulting tested income being sheltered by tested loss or NDTIR.

basis of $300 and value of $200. On P's sale of the M stock, the loss is allowed (absent an election otherwise), but M's basis in the stock of the CFC will be reduced from $200 to $100.

By contrast, if the CFC paid a dividend of $100 to M, and M then sold the stock in the CFC for $100, the $100 loss would be disallowed under Section 961(d). As a result, the group obtains a better tax result, in effect avoiding Section 961(d), if it buys the CFC through a special purpose member M, and, if there is a loss, sells the stock of M rather than having M sell the stock of the CFC.

Yet another result is achieved if M sells the stock of the CFC. Under Section 1248, the tax exempt deemed dividend is limited to the gain on the sale of the stock, and no loss on the stock is possible as a result of undistributed earnings in the CFC.

It will be difficult for regulations to reconcile and rationalize these different results. One possibility for consideration would be a rule that if P's loss on the sale of M stock would not be disallowed under -36(c) or (d), P's basis in M will be reduced by the amount that the CFC basis reduction rule would reduce the basis of M in the CFC stock if M were to sell that stock at the same time.[148]

G. Our Preferred Approaches to Avoid Loss Duplication

We discuss in this Part IV.G two different but related approaches to avoiding the double tax benefit that can arise from the use of a tested loss of CFC2 to offset the tested income of CFC1. These approaches, unlike the Proposed Regulations, are designed to reach results similar to those that would arise if all the CFCs owned by a single corporate U.S. shareholder were a single corporation. We believe these approaches will be simpler to implement than the Proposed Regulations, yet will generally carry out the goal of the Proposed Regulations in preventing loss duplication. We only provide an outline here of the issues that would arise under these proposals.[149]

We believe that either of these proposals would be preferable to the basis rules in the Proposed Regulations, although we prefer the first proposal below to the second. If

[148] See Section 245A Report, at 43.

[149] We also considered an alternative approach that would merely disallow a loss on the sale of stock of a CFC to the extent of the used tested loss amount, similar to Section 961(d) or Treas. Reg. § 1.1502-36(c). However, we do not believe such a rule would be adequate at the CFC level, since it would not prevent the used tested loss amount from reducing gain on the sale of CFC stock. Also, if the same rule was the only limitation that applied on the sale of stock of M, the rule would be almost meaningless at that level, since the group would always arrange, to the extent possible, to have its CFCs owned by group members whose stock was highly appreciated. On the other hand, the automatic denial of loss on a stock sale would also be unfair to taxpayers unless they had the ability to show that the loss was not a duplicated loss.

the Treasury is interested in pursuing either of these proposals, we would be happy to assist further in this process.

1. *The Primary Proposal*

Under the primary approach that we suggest (the "**Primary Proposal**"):

(1) the e&p of CFC1 would be reduced, with respect to a corporate U.S. shareholder, by the shareholder's offset tested income amount, so in effect the offset tested income would not create e&p for the shareholder,

(2) the e&p of CFC2 would be increased, with respect to a corporate U.S. shareholder, by the shareholder's used tested loss amount, so in effect the used tested loss would not reduce e&p for the shareholder,

(3) the shareholder's PTI account would not be changed on account of the adjustments in (1) or (2),

(4) the shareholder's basis in the stock of CFC2 would mandatorily shift to its stock in CFC1, to the extent of the shareholder's used tested loss in CFC2, but the amount of the shift would be limited to the shareholder's existing basis in CFC2 (this limitation, the "**cap**"),[150] and

(5) corresponding basis shifts would be made at the same time to the stock of members of a consolidated group owning stock in the tested loss and tested income CFCs, under Treasury Regulation Section 1.1502-32.[151]

2. *Discussion of Primary Proposal*

The Primary Proposal is analogous in some ways to the proposed regulations under Section 965. Those rules also result, in substance, in the elimination of e&p from the system when one CFC has positive e&p and another CFC has negative e&p.[152]

[150] If the tested loss of a CFC was used to offset the tested income of more than one tested income CFC, and the cap applied, the basis in the tested loss CFC would be shifted to the tested income CFCs in proportion to the tested income of each such tested income CFC.

[151] Further consideration needs to be given to whether corresponding e&p adjustments should be made at the member level.

[152] More specifically, under the proposed Section 965 regulations, when e&p of a deferred foreign income corporation ("**DFIC**") is offset by an e&p deficit of another specified foreign corporation ("**SFC**"), the offset amount ("**Section 951(b) PTI**") is not included in the U.S. shareholder's income, does not increase the U.S. shareholder's basis in the DFIC, and becomes e&p described in Section 959(c)(2). The Section 951(b) PTI is generally excluded from the U.S. shareholder's income when distributed. Assuming the distribution reduces the shareholder's basis in the DFIC and results in gain to the extent it exceeds basis, the impact of creating Section 951(b) PTI is similar to the elimination of e&p from the system. Also, under the proposed Section 959 regulations, the SFC's deficit in e&p is reduced by the offset. A number of issues are raised by this Section 951(b) PTI system, some of which are discussed in recent reports of ours.

However, there the basis shift is elective, is not limited by the cap, and causes gain to be recognized to the extent of any basis that would otherwise become negative. Here, the basis shift would be mandatory, but only to the extent of existing basis, so no gain is recognized at the time of the shift in basis.

Under the Primary Proposal, assuming CFC1 had no unrelated e&p, a distribution by CFC1 in the amount of its offset tested income would not be tax free under Section 245A, because no e&p would be created by such income. Rather, the distribution would be tax free under Section 301(c)(2) to the extent of the basis in the stock of CFC1, which would include any available basis shifted from CFC2. Any additional distribution would be taxable under Section 301(c)(3).

The Primary Proposal prevents a double tax benefit from arising from a tested loss, because no e&p is generated that is eligible for Section 245A. It is also closer to a single entity approach than would arise under the Proposed Regulations, since it in effect aggregates the basis of CFC1 and CFC2 for purpose of determining the taxability of distributions of offset tested income. It would also allow, as do the existing Proposed Regulations, the avoidance of gain in the stock of CFC1 by selling gain assets in CFC1 and loss assets in CFC2, to the extent that there was basis in CFC2 that would be shifted to CFC1. However, this result is consistent with the result that could arise if CFC1 and CFC2 were divisions of a single corporation, so perhaps it is not objectionable. Nevertheless, given the existence of two corporations, this ability to shift basis could give rise to significant tax planning opportunities.

The Primary Proposal is more favorable to taxpayers than the Proposed Regulations in some cases. In particular, it will be more favorable if the basis reduction in CFC2 is limited by the cap, there is sufficient separate basis in CFC1 to allow a full distribution of the tested income of CFC1, and if the stock of CFC2 is then sold. In that case, the Proposed Regulations will result in more gain on the sale of CFC2 than will the proposal, but the distribution of the full amount of tested income can be made tax free from CFC1 under either the Proposed Regulations or the Primary Proposal.

For example, assume shareholder M has a basis of $100 in CFC1 and $0 in CFC2. CFC1 has $100 of tested income and CFC2 has $100 of tested loss. M then sells the CFC2 stock. Under the Proposed Regulations, CFC1 can distribute the $100 of tested income tax free without any basis reduction in CFC1. However, on the sale of the CFC2 stock, the gain is $100 plus the amount realized. Under the Primary Proposal, there is no shift of basis to CFC1, but CFC1 can take advantage of M's existing basis in CFC1 to distribute $100 tax-free, reducing M's basis in CFC1 to $0. On the sale of CFC2, the gain is the amount realized.

See NYSBA Tax Section Report No. 1402, *Report on Previously Taxed Income under Section 959* (October 11, 2018); NYSBA Tax Section Report No. 1401, *Report on Proposed Section 965 Regulations* (October 5, 2018).

In summary, under the Primary Proposal compared to the Proposed Regulations, there is $100 less gain on the sale of CFC2 stock, accompanied by a $100 reduction in the basis in CFC1. This is more favorable to the taxpayer than the approach under the Proposed Regulations, but again, it is consistent with single entity treatment. A single entity would have no e&p, an outside basis of $100, and outside basis reduced to $0 on the distribution from the CFC1 division, and gain on the sale of the CFC2 business.

If the cap is considered by the Treasury to give results that are too favorable to taxpayers as compared to the Proposed Regulations, a number of variations on the Primary Proposal would be possible. Each, however, would have its own shortcomings, complexities and potential authority issues that would need to be explored further.

For example, it would be possible to trigger gain on the disposition of CFC2 to the extent that a basis shift was prevented by the cap (at least to the extent that the tested loss in CFC2 that would give rise to the basis shift arose from built-in losses that existed when M purchased CFC2). However, the basis in CFC1 should then be increased by the amount of such gain, as if the basis shift had originally occurred, and the resulting rules would be complex.

Alternatively, the amount of tested loss of CFC2 that could be used to offset tested income of other CFCs of M could be limited to M's existing tax basis in CFC2. In the example, M would have a $100 GILTI inclusion from CFC1, and the CFC basis reduction rule would not apply to CFC2 because there is no used tested loss. This rule would be somewhat analogous to Section 704(d), which limits a partner's allocable share of partnership losses to the partner's tax basis in the partnership.

Finally, an anti-abuse rule could be adopted to cover the case where M buys CFC2 with built-in loss assets for the purpose of selling those assets at a loss, uses the tested loss to shelter tested income of CFC1, relies on the cap to limit the basis reduction in CFC2, and then sells the stock of CFC2 at a gain that does not reflect the full basis reduction because of the cap.

On the other hand, the Primary Proposal will give worse results for taxpayers than the Proposed Regulations in some cases. This will be true if there is less total basis in CFC1 and CFC2 than the amount of offset tested income in CFC1. The reason is that the offset tested income could be distributed tax-free under the Proposed Regulations, but not under the Primary Proposal. For example, suppose shareholder M has a $0 basis in both CFC1 and CFC2, CFC1 has $100 of tested income, and CFC2 has $100 of tested loss. Under the Proposed Regulations, CFC1 can distribute the $100 of income tax-free under Section 245A, at the price of additional gain of $100 when the stock of CFC2 is sold. Likewise, M can sell the stock of CFC1 at a gain of $100 that would be tax exempt under Section 1248.

Under the Primary Proposal, CFC1 would have no e&p, and M would have no basis in CFC1, so the $100 of tested income could not be distributed tax free and the $100 of gain would be taxable. To be sure, this result is consistent with the result that would arise if CFC1 and CFC2 were divisions of a single corporation that had no net e&p and where the shareholder had a $0 basis in the stock.

The Primary Proposal would also raise the issue of how to deal with the case where the offset tested income of CFC1 would not be taxed even without regard to the used tested loss of CFC2. For example, the U.S. shareholder might have NDTIR or foreign tax credits that would shelter the tested income even in the absence of the tested loss. This is similar to the question under the Proposed Regulations about whether there is really a duplicated loss that requires a basis reduction in CFC2. However, the issue will come up less often under the Primary Proposal because of the inapplicability of Sections 245A, 961(d), and 1059.

On the merits, under single entity principles there would be no net e&p in the single entity, no benefit from NDTIR, and no eligibility for FTCs for foreign taxes paid by the single entity. As a result, the usual basis adjustments for tested income and tested loss would logically apply without regard to NDTIR or FTCs. The loss of FTCs arises because the Primary Proposal is applying single entity principles to multiple CFCs, while foreign jurisdictions are (naturally) applying separate entity principles. There should also be less concern about the Primary Proposal applying even in the absence of loss duplication, since the result here is "only" a shift in basis as opposed to a permanent elimination of basis as under the Proposed Regulations.

Another question would arise if, say, M has a $100 basis in CFC1 and a $0 basis in CFC2, and in year 1, CFC1 has offset tested income of $100, and CFC2 has used tested loss of $100. Normally, $100 of basis would shift from CFC2 to CFC1, but there is no basis in CFC2 to shift. Suppose now that in year 2, CFC1 has $100 of used tested loss and CFC2 has $100 of offset tested income. While $100 of basis would normally shift from CFC1 to CFC2, as an economic matter that should not occur here since the two CFCs end up in the same economic position as they started. Rather, there should only be a "notional" shift of basis in year 2 from CFC1 to CFC2 that offsets the failure to make the reverse basis adjustments in year 1.

As a result, any time the cap on basis reduction applies, there would need to be created a notional account for unutilized basis reduction in the tested loss CFC, and unutilized basis increase in the tested income CFCs. Future basis adjustments would have to offset these accounts before being reflected in actual basis numbers.

As to the consolidated return regulations, the basis reduction in the stock of the member holding the CFC would match the basis reduction in the CFC stock. This would be similar to Rule 1, but with the cap on basis reduction in the CFC limiting the reduction to M's basis in the stock of the CFC. The discussion in the preceding paragraph is comparable to Rule 2, and only actual basis adjustments (not notional adjustments described therein) in the stock of the CFCs would tier up to M. Rule 3 would logically still apply, since a CFC with exempt e&p (such as arising from NDTIR without the existence of any tested losses) should not be required to distribute its e&p in order to reduce the gain on the sale of stock of the member holding the CFC.

Issues would also arise under the Primary Proposal from the failure to include the tested income of CFC1 in its e&p allocable to the U.S. shareholder, and the failure to reduce the e&p of CFC2 allocable to the U.S. shareholder by its tested loss. We note as background that under the basic GILTI regime, different U.S. shareholders of a CFC might have different GILTI inclusions because of different amounts of NDTIR or tested losses in other CFCs. As a result, different U.S. shareholders of a single CFC might have different amounts of PTI in the CFC. However, in general, each shareholder of a CFC should have, on a per share basis, the same total of e&p and PTI, representing their share of the total undistributed untaxed and taxed earnings of the CFC, respectively.[153]

This relationship would no longer be true under the Primary Proposal. If a CFC had tested income, (1) as before, some shareholders might have a full GILTI inclusion and an increase in PTI for their share of the income, (2) as before, shareholders with unrelated NDTIR might have no GILTI inclusion and an increase in e&p for their share of the income, and (3) under the Primary Proposal, shareholders with other CFCs with tested losses might have no increase in either PTI or e&p (although they might obtain a basis increase in the stock of the CFC). Likewise, as to a CFC with a tested loss, some shareholders would have their share of the e&p reduced by their share of the loss, and others shareholders would not. The Primary Proposal would also create new disparities between inside e&p and outside tax basis, since there is a cap on the shift of outside tax basis, but no cap on the shift of e&p.

We are not claiming that the Primary Proposal would be simple, and in fact no system of sharing attributes will be simple. Moreover, this proposal would no doubt create discontinuities by treating CFC1 and CFC2 as a single corporation for some purposes when there are in fact two corporations. However, we believe that the Primary Proposal would be significantly simpler than the existing Proposed Regulations, largely because (1) there is no tax-free e&p arising from the offset of tested income in one CFC and tested loss in another CFC, and therefore no effects from the applicability or nonapplicability of Sections 245A, 961(d), and 1059, and (2) there is no basis disparity between the stock of the CFC and the stock of a member of a consolidated group holding the CFC.

In addition, unlike the proposed regulations under Section 965, the Primary Proposal does not create upfront gain from the shift in basis of CFC2, although at the cost of less ability to distribute tax-free cash under Section 301(c)(2). The Primary Proposal could be further simplified if it only applied to U.S. shareholders with an ownership (including by related parties) of 50% or 80% of a CFC.

3. *Authority for Primary Proposal*

As to the authority of the Treasury to adopt the Primary Proposal by regulations, the Proposed Regulations already cause a reduction in basis of a CFC upon its sale. We

[153] This assumes all shares are of the same class and were issued at the same time.

do not believe that the reduction of basis at the time of a tested loss under the Primary Proposal is a materially greater use of existing authority, particularly because the cap prevents any gain recognition at that time.

The adjustments to e&p under the Primary Proposal also raise questions of authority. Section 964(a) provides that the e&p of a foreign corporation "shall be determined according to rules substantially similar to those applicable to domestic corporations, under regulations prescribed by the Secretary." Although the adjustments to e&p under the Primary Proposal would not be applicable to domestic corporations, Section 964(a) contemplates at least some disparity in the calculation of e&p for domestic and foreign corporations.

Moreover, such a disparity would only arise when a shareholder's tested income of one CFC offsets the shareholder's tested loss from another CFC. This is a unique situation created by Congress in the GILTI regime, and arguably a different rule for e&p in this situation would not prevent the overall regime for determining e&p of a CFC from being considered "substantially similar" to the overall regime for a domestic corporation. Moreover, the Treasury could continue to rely on *Ilfeld* to justify this method of preventing loss duplication. Nevertheless, as we suggest in connection with Proposed Regulation Section 1.961-6(e), we acknowledge that the Treasury might wish to obtain a statutory amendment to confirm its authority to adopt this approach.

4. *The Secondary Proposal*

If the Treasury does not wish to adopt the Primary Proposal, we would propose a simplified and modified version of that proposal (the "**Secondary Proposal**"). Under this proposal, the same adjustment for e&p would be made as in the Primary Proposal. However, there would be no adjustment to tax basis (or PTI). As a result, if CFC1 had tested income and CFC2 had tested loss, CFC1 would not have any e&p as a result of its tested income, and there would be no basis shift from CFC2 to CFC1.

The Secondary Proposal is obviously simpler than the Primary Proposal. Moreover, just as does the Primary Proposal, the Secondary Proposal would avoid loss duplication by eliminating any Section 245A benefit from offset tested income. However, because of the lack of a shift in basis, the Secondary Proposal creates results that are less similar than the Primary Proposal to the results that would arise if CFC1 and CFC2 were divisions of a single corporation.

For example, under the Primary Proposal, the basis shift would mean that CFC1 could make tax-free distributions under Section 301(c)(2) to the extent of the preexisting basis of both CFC1 and CFC2. This is the same result that would arise if CFC1 and CFC2 were divisions of a single corporation. Under the Secondary Proposal, CFC1 could make tax-free distributions under Section 301(c)(2) only to the extent of the preexisting basis of CFC1, a worse result than if CFC1 and CFC2 were divisions of a single corporation.

On the other hand, as a general matter, a basis shift can either help or hurt taxpayers. If the U.S. shareholder had sufficient basis in CFC1 to permit any desired distribution by CFC1 even without a basis shift from CFC2, the shareholder might prefer the Secondary Proposal to the Primary Proposal. The basis shift under the Primary Proposal would provide no benefit to the shareholder, and could even provide a detriment because of increased gain (or reduced loss) on the sale of the stock of CFC2.

By contrast, under the Secondary Proposal, the tested loss in CFC2 reduces the GILTI inclusion of the U.S. shareholder from the tested income of CFC1, without causing any basis reduction in the stock of CFC2. As a result, if the tested loss reduces the value of CFC2, the tested loss is both reducing a GILTI inclusion and allowing a reduction in gain (or increase in loss) on the sale of the stock of CFC2.

To be sure, under this approach, there is no "double tax benefit" from the tested loss because the offset tested income in CFC1 cannot be distributed tax-free under Section 245A. Nevertheless, there could be a significant timing benefit if the U.S. shareholder had sufficient basis in CFC1 to cover desired distributions from CFC1, and desired to sell the stock in CFC2. This approach could therefore give rise to significant tax benefits and significant tax planning, particularly since the unreduced tax basis in CFC2 might prevent the creation of gain on a stock sale that could otherwise be taxable at a 21% rate or might create loss that could shelter other gain otherwise taxable at a 21% rate.

The Secondary Proposal would also increase further the incentives of taxpayers to engage in the transactions involving the cap as described in connection with the Primary Proposal. Those techniques relied on the fact that under the Primary Proposal there is no basis reduction in CFC2 in excess of the preexisting basis in CFC2. Under the Secondary Proposal, there is no basis reduction in CFC2 at all. As a result, there is even more incentive under this proposal for M to buy a CFC with a built-in tested loss in order to have the CFC sell those assets to shelter tested income of CFC1, followed by a sale of the CFC stock.

If the Secondary Proposal is adopted, there should not be any consolidated return basis adjustments under -32. If M sells CFC1 at an amount that reflects the untaxed tested income, M would have a taxable gain. The reason is that the tested income does not give rise to e&p, and so Section 1248(j) does not convert the gain into a tax-free dividend under Section 245A. In order to match this result upon the sale of the stock of M, there should not be any basis increase in the stock of M (as there is under Rule 3) when M sells the stock in CFC1. Likewise, when CFC2 has a used tested loss, M's basis in CFC2 does not change either at that time or upon the sale of CFC2. There would be no reason to create a basis disconformity by reducing P's basis in M (as in Rule 1) at either such time.

The authority issues concerning a shift in e&p under the Secondary Proposal would be the same as those issues under the Primary Proposal.

Appendix

NEW YORK STATE BAR ASSOCIATION TAX SECTION

REPORT ON THE GILTI PROVISIONS OF THE CODE

May 4, 2018

Table of Contents

I. Introduction

This Report[1] discusses the so-called "GILTI" provisions of the Code added by the legislation informally known as the Tax Cuts and Jobs Act (the "**Act**").[2] The GILTI provisions are primarily in new Code Section 951A (income inclusion) and Section 250 (deduction), although the Act made conforming changes to other Code provisions.[3] In general, the GILTI provisions require a U.S. shareholder (a "**U.S. shareholder**")[4] of a controlled foreign corporation ("**CFC**")[5] to pay, on a current basis, a minimum aggregate U.S. and foreign tax on its share of the earnings of the CFC. The GILTI rules, along with other changes to the international tax rules made by the Act, are the most far-reaching changes made to these rules in many decades.

Part II of this Report is a summary of our recommendations. Part III is a summary of the GILTI rules. Part IV is a more detailed analysis of certain of the GILTI provisions and discussion of our recommendations. Appendix 1 contains diagrams and more detailed calculations concerning some of the Examples in the Report.

The Report discusses the issues under the GILTI rules that we have identified so far and that we consider most significant. As a consequence, there are many issues that are beyond the scope of the Report. In most cases we comment on the statute as written without proposing far-reaching revisions to it, although we make some specific suggestions for statutory changes to make the GILTI regime work better.

[1] The principal authors of this report are Kara Mungovan and Michael Schler. Helpful comments were received from Neil Barr, Kimberly Blanchard, Nathan Boidman, Andy Braiterman, Peter Connors, Charles W. Cope, Michael Farber, Kevin Glenn, Peter Glicklich, David Hardy, David P. Hariton, Monte Jackel, Shane Kiggen, John Lutz, Jeffrey Maddrey, Alexey Manasuev, Teddy McGehee, David Miller, Michael Mollerus, Jose E. Murillo, John Narducci, Richard M. Nugent, Amanda H. Nussbaum, Cory John O'Neill, Paul Oosterhuis, Alexander Pettingell, Vasujith Hegde Rajaram, Yaron Z. Reich, Richard L. Reinhold, Robert Scarborough, Stephen Shay, David R Sicular, Eric B. Sloan, Andrew P. Solomon, Karen G Sowell, David Stauber, Chaim Stern, Ted Stotzer, Joe Sullivan, Jonathan Talansky, Marc D. Teitelbaum, Shun Tosaka, Richard R. Upton, Philip Wagman, Andrew Walker, Gordon E. Warnke and Robert H. Wilkerson. This report reflects solely the views of the Tax Section of the New York State Bar Association (***"NYSBA"***) and not those of the NYSBA Executive Committee or the House of Delegates.

[2] The Act is formally known as "*An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018*", P.L. 115-97.

[3] Unless otherwise stated, all "Code" and "Section" references are to the Internal Revenue Code of 1986, as amended.

[4] A U.S. shareholder is defined in Section 951(b) as a U.S. person that actually or constructively owns 10% or more of the vote or value of the stock in a foreign corporation. Prior to the Act, the test was based solely on voting power.

[5] A CFC is defined in Section 957(a) as a foreign corporation if stock with more than 50% of the total vote or value of its shares is actually or constructively owned by U.S. shareholders on any day during its taxable year.

II. Summary of Principal Recommendations

A. Purpose of the GILTI Regime

1. The GILTI regime contains elements of both a flat rate of tax on foreign income and the treatment of GILTI as an imperfect add-on to the existing rules for foreign source income. We believe that to the extent consistent with the statutory language, regulations should give significant weight to the theory that Congress intended to adopt the former approach. *See* Part IV.A.

B. Aggregation of Members of a Consolidated Group

2. Members of a group filing a consolidated U.S. Federal income tax return (a "**consolidated group**") should be treated as a single corporation for purposes of (a) the taxable income limitation under Section 250(a)(2), *see* Part IV.B.2, (b) the Section 904 foreign tax credit ("**FTC**") limit on the GILTI basket, *see* Part IV.B.3, and (c) the amount of the GILTI inclusion and the "inclusion percentage" (defined below), *see* Part IV.B.4.

3. We do not recommend applying aggregation principles to CFCs held by U.S. members of a controlled group that do not file a consolidated return, except perhaps as an anti-abuse rule if a principal purpose of having multiple owners of multiple CFCs is to avoid the purposes of the GILTI rules. *See* Part IV.B.4(b).

4. If this approach for the GILTI inclusion is adopted, Treasury and the Internal Revenue Service ("**IRS**") (Treasury and IRS referred to collectively as "**Treasury**") should consider whether the same rule should apply to CFCs held by a partnership where a specified percentage of the partnership is owned by group members. *See* Part IV.B.4(b).

C. Deductions Allowed in Calculating Tested Income

5. Regulations should clarify the method for calculating the tested income of a CFC. In general, we do not see a policy justification for deductions not allowed to a U.S. corporation to be allowed to a CFC in calculating tested income. We recommend that regulations adopt as a starting point either U.S. taxable income or the existing rules for Subpart F (which are largely based on GAAP income). In either case, Treasury should have the ability to make adjustments to bring the result closer to the other, and in the latter case the existing rule under Subpart F that the result should not be materially different than U.S. taxable income should be retained. *See* Part IV.C.2.

6. To the extent a U.S. corporation would be entitled to carry over a loss or deduction to a future year, we believe the same should be true of a GILTI loss. Therefore, if a CFC has a tested loss that is not utilized currently by its U.S. shareholders, regulations or a statutory amendment should permit the loss to be reattributed to the shareholders and carry over at the shareholder level to offset future GILTI inclusions, under rules similar to rules for domestic net operating losses ("**NOLs**"). Permitting carryovers of tested losses at the CFC level presents many complex issues and is likely not feasible. *See* Part IV.C.3(a).

7. If regulations apply Section 163(j) to CFCs, a CFC should be permitted to carry forward interest deductions disallowed under Section 163(j) in the same manner as a domestic corporation. *See* Part IV.C.3(b).

D. Other Computational Issues for GILTI Inclusions

8. Regulations should confirm that tested income of a CFC is determined before Section 956 inclusions. *See* Part IV.D.1.

9. When stock of a first tier or second tier CFC is sold, amendments made by the Act in some cases will cause the portion of the Subpart F income and Section 951A inclusions of the CFC for the taxable year of sale and attributable to the selling shareholder to permanently avoid inclusion in the U.S. tax base. We take no position on whether these results should be changed by legislation or regulations. However, we point out some possible approaches if a change is desired. *See* Part IV.D.2.

10. Regulations should clarify that under Section 951A(e)(3), while there is no minimum period of time that a CFC needs to qualify as a CFC in order for it to be a CFC during its qualification period, it is only a CFC during its qualification period rather than for the entire taxable year in which it is qualified for any period of time. *See* Part IV.D.2.

11. Regulations should address the order in which Section 163(j) and Section 250 are to be applied. The deduction in Section 250(a)(1) could come first, then the limits under Section 163(j) could apply, and then the taxable income limit for the Section 250 deduction under Section 250(a)(2) could apply. *See* Part IV.D.3.

12. Regulations should clarify that for purposes of the taxable income limit in Section 250(a)(2), taxable income includes all Section 951A, Subpart F, Section 78, and FDII inclusions, without regard to the Section 250(a)(1) deduction. In addition, regulations should clarify whether the Section 250(a)(2) carve-back applies to a Section 78 gross-up amount for a Section 951A inclusion. *See* Part IV.D.4.

13. Regulations should provide that typical nonconvertible preferred stock in a CFC is not allocated any tested income of the CFC in excess of accrued and unpaid dividends, and should clarify whether any allocation in excess of such dividends is made to convertible preferred stock. *See* Part IV.D.5.

14. Regulations should clarify whether the gross interest expense of a CFC with a tested loss reduces the NDTIR (defined below) of the U.S. shareholder without any adjustment for any notional QBAI return (defined below) of the CFC in question. *See* Part IV.D.6.

15. Regulations should address a number of issues involving tax basis and earnings and profits ("**e&p**") that arise from GILTI inclusions. *See* Part IV.D.7. The Tax Section will be submitting a separate Report discussing these issues in more depth.

E. Foreign Tax Credit Issues

16. Principles from Treas. Reg. § 1.904-6 should be applied to determine whether foreign taxes paid by a CFC are "properly attributable" to tested income of the CFC. Once such a connection is made, the foreign taxes should not need to be traced to particular dollars of tested income in order to be considered properly attributable to tested income. *See* Part IV.E.1(a).

17. When income accrues in a different year for U.S. and foreign tax purposes, foreign taxes on that income should still be treated as tested foreign income taxes eligible for FTCs. In addition, regulations should confirm that Section 905(c)(2)(B) applies to audit adjustments relating to tested income, and clarify the application of that provision. Finally, the principles of Section 905(c)(2)(B) should be extended so that, in as many situations as possible, the foreign tax will be deemed to arise in the same year as the U.S. inclusion rather than in the taxable year in which the tax is paid or accrued. *See* Part IV.E.1(b).

18. Regulations should confirm that withholding tax on a distribution of tested income that is previously taxed income ("**PTI**") is not subject to the 20% cutback on GILTI FTCs or to cutback by the inclusion percentage (defined below). *See* Part IV.E.1(c).

19. If Treasury determines that no expenses of the U.S. shareholder are "properly allocable" to income in the GILTI basket, Treasury could issue regulations that no allocation of expenses to that basket should be made. However, arguments can be made that such an interpretation would be inconsistent with the structure and purpose of the statute.

In any event, as a policy matter, we do not believe that no shareholder expenses should be allocated to the GILTI basket. Rather, we believe the existing regulatory framework for allocating expenses should not be applied wholesale to GILTI, and consideration should be given to modifying certain of the existing allocation rules to minimize allocations to GILTI inclusions that are not economically justified.

In particular, certain aspects of the allocation rules for research and development expenses should be reconsidered, and regulations should clarify that Section 864(e)(3) does not apply to stock giving rise to dividends eligible for the Section 245A deduction. In addition, regulations should determine whether expenses should be allocated to a CFC based on the exempt CFC return of the CFC for the year or based on the Section 245A dividends actually paid by the CFC during the year. Moreover, when allocations of expenses are now based on gross income rather than assets, possibly these allocations should be based on net GILTI rather than gross GILTI. *See* Part IV.E.2(a).

20. Regulations should clarify the application of new Section 904(b)(4), and in particular whether it results in the calculation of FTC baskets by disregarding all exempt income from a CFC and shareholder expenses related to such exempt income, without any reallocation of such expense to other income or assets. *See* Part IV.E.2(b).

21. Regulations should confirm that the portion of the Section 250 deduction that is allocable to the GILTI inclusion is allocated to the GILTI basket. *See* Part IV.E.2(c).

22. Regulations should specify that the Section 78 gross-up for foreign taxes deemed paid under Section 960(d) is in the GILTI basket. If this position is rejected, so the gross-up is in the general basket, regulations should provide that the portion of the foreign tax allocable to the gross-up is also in the general basket. *See* Part IV.E.2(d).

23. Regulations should confirm that interest, rent and royalties received by a U.S. shareholder of a CFC from the CFC should be treated as non-GILTI inclusions for Section 904(d) purposes. *See* Part IV.E.2(e).

24. Legislation should be adopted to treat foreign taxes on items that are not in the U.S. tax base as being in a basket determined on the basis of the facts and circumstances, rather than always being in the general basket as in the past. If this recommendation is rejected, a statutory amendment should be adopted to correct a drafting error that now puts these residual taxes in the branch basket. *See* Part IV.E.2(f).

25. Regulations should provide that withholding tax on distributions of tested income that is previously taxed income is in the GILTI basket. In addition, regulations or legislation should extend the principles of Section 960(c)(1)(A) to such withholding tax, so that excess limitation in the year of the inclusion of the underlying tested income would be available to allow FTCs for such withholding tax in the year the tax is imposed. *See* Part IV.E.2(g).

26. Regulations should clarify issues that arise in 2018 and later years from an overall foreign loss or overall domestic loss under Sections 904(f) and (g) in 2017, in light of the fact that the Section 904(d) baskets have changed in 2018. *See* Part IV.E.2(h).

27. Regulations should clarify issues involving FTCs that arise because the concept of tested income did not exist before 2018. Part IV.E.2(i).

F. U.S. Partnership as a U.S. Shareholder in a CFC

28. If a CFC is held through a U.S. partnership, the GILTI inclusion and the Section 250 deduction should be determined at the partner level. However, Section 163(j) should not apply at the partnership level in a manner that allows a greater interest deduction than if Section 250 and Section 163(j) applied at the same level. We propose two methods to achieve the latter result. *See* Parts IV.F.1 through IV.F.3.

29. If regulations determine instead that the GILTI inclusion and deduction should be made at the partnership level, they should clarify how the rule applies to certain ownership situations, whether the Section 250(a)(2) limit is determined at the partner or partnership level, and how the Section 250 deduction is to be modified at the partnership level to reflect partners (such as individuals) that are not eligible for such deduction, in order to calculate the Section 163(j) limit at the partnership level. *See* Part IV.F.4.

G. Other Issues

30. Regulations or legislation should allow a Section 250 deduction based on the deemed GILTI inclusion under Section 962, and should clarify whether a dividend from

the CFC is to be treated as qualified dividend income **("QDI")**. We also support the positions on Section 962 taken in Notice 2018-26.[6] *See* Part IV.G.1.

31. We take no position on whether Treasury should adopt anti-abuse rules to deal with fiscal year 2017-2018 transition issues under GILTI. If Treasury determines to do so, we suggest various standards it might consider. If it believes anti-abuse rules are necessary but that the statutory grant of authority is too limited, it should request legislation to conform the statute to the scope of anti-abuse authority referred to in the Conference Report. *See* Part IV.G.2.

32. The consequences of the repeal of Section 958(b)(4) should be limited, by regulations or a statutory amendment, to the intended scope of repeal as reflected in a colloquy on the floor of the Senate. However, any such regulations or amendment should only be adopted after taking into account its effect on other Code provisions. *See* Part IV.G.3.

33. Regulations should address the overlap between Section 250(a)(2) (limiting the Section 250 deduction to a percentage of taxable income) and Section 172(d)(9) (stating that the deduction cannot be used to create an NOL). *See* Part IV.G.4.

34. Regulations should clarify whether GILTI inclusions are investment income under Section 1411 (*see* Part IV.G.5), clarify the extent to which GILTI inclusions are qualified income for REIT purposes (*see* Part IV.G.6), clarify the rules for a RIC having a GILTI inclusion (Part IV.G.7), and confirm that GILTI inclusions are not UBTI to a tax-exempt U.S. shareholder (*see* Part IV.G.8).

35. Legislation should be enacted to treat all CFCs related to a particular U.S. shareholder as a single corporation for purposes of the GILTI calculations for that shareholder. The existing rules that treat each CFC separately are unjustified as a policy matter, are very unfair to taxpayers, and invite restructurings solely for tax purposes. *See* Part IV.H.

III. Summary of GILTI Rules

A. Income Inclusion

Section 951A requires each U.S. shareholder of a CFC to include in its gross income each year its share of "global intangible low-taxed income" or "**GILTI**" for the year.[7]

[6] 2018-16 IRB (April 2, 2018).

[7] Section 951A(a).

GILTI is calculated on a U.S. shareholder-by-U.S. shareholder basis. It is the excess, if any, of the U.S. shareholder's "net CFC tested income" for the year over its "net deemed tangible income return" ("**NDTIR**") for the year.[8] GILTI cannot be negative.

In addition, if the U.S. shareholder is a domestic corporation that elects to receive the benefit of FTCs for a taxable year, 100% of the foreign taxes attributable to the Section 951A inclusion are included in gross income under Section 78.

References herein to the "**GILTI inclusion**" mean the inclusion under Section 951A and, where applicable when a CFC pays foreign taxes, the Section 78 gross-up of such inclusion for such foreign taxes.

1. Net CFC Tested Income

A U.S. shareholder's "net CFC tested income" for a taxable year is based on the "tested income" or "tested loss" for the year of each CFC of which it is a U.S. shareholder. (With respect to any U.S. shareholder, each such CFC is referred to herein as a "**Related CFC**"). The U.S. shareholder's net CFC tested income is the excess (if any) of the aggregate of the U.S. shareholder's *pro rata* share of the tested income of each Related CFC with positive tested income, over the U.S. shareholder's *pro rata* share of the tested loss of each Related CFC with a tested loss.[9] Net CFC tested income cannot be negative.

"Tested income" of a CFC for a taxable year is the excess (if any) of the CFC's gross income, with certain specified exceptions, over the "deductions (including tax) properly allocable to such gross income under rules similar to the rules of section 954(b)(5) (or to which such deductions would be allocable if there were such gross income)".[10] The specified exceptions are:

(1) effectively connected income described in Section 952(b),

(2) gross income taken into account in determining the Subpart F income of the CFC,

(3) gross income excluded from foreign base company or insurance company Subpart F income by reason of the high-tax exception in Section 954(b)(4),[11]

[8] Section 951A(b)(1).

[9] Section 951A(c)(1).

[10] Section 951(c)(2)(A).

[11] This exclusion means that high-taxed Subpart F income is excluded from GILTI, but other high-taxed operating income is included. It can be helpful to taxpayers to allow the averaging of high- and low-taxed tested income for FTC purposes, but it can also be harmful because it can "waste" high GILTI FTCs that cannot be carried over as GILTI credits (*see* the discussion in Part III.D) but might be usable currently or as future carryovers in the general basket or passive basket. Note that Treas. Reg. § 1.954-1(d)(1) allows the high-tax exception from Subpart F income to be elected on a CFC by CFC basis, but the exclusion from

(4) dividends received from a related person (as defined in Section 954(d)(3)), and

(5) foreign oil and gas extraction income (as defined in Section 907(c)(1)).[12]

Tested loss is the excess (if any) of the deductions described above over the income, calculated as described above.[13] Accordingly, a CFC can have tested income or tested loss, but not both. A CFC that breaks even has neither tested income nor tested loss.

2. NDTIR

A U.S. shareholder's NDTIR for a year is determined by a multi-step process. First, for each Related CFC with positive tested income for the year, its "specified tangible property" is its tangible property used in the production of tested income,[14] and its "qualified business asset investment" ("**QBAI**") is the aggregate adjusted tax basis of its specified tangible property that is used in a trade or business and subject to an allowance for depreciation.[15] If a CFC does not have positive tested income for a year, none of its tangible property for the year is taken into account and it has no QBAI.

Second, the U.S. shareholder aggregates its *pro rata* share of the QBAI for all of the Related CFCs. Third, this aggregate QBAI amount is multiplied by ten percent, which is considered a deemed return on the tangible assets that should not be subject to U.S. tax.[16] Fourth, this deemed return is reduced by any interest expense taken into account in calculating the shareholder's net CFC tested income for the year, except to the extent interest income attributable to that interest expense was also taken into account in determining the shareholder's net CFC tested income.[17] The reduction applies even if the interest expense is not in the same Related CFC as is the QBAI. The result is the U.S. shareholder's NDTIR.[18] Note that gross interest expense of a CFC (unless paid to a Related

GILTI will apply to a CFC whether or not such an election is made (under the Subpart F exclusion if no election is made or under the exclusion for high-taxed Subpart F income for which the election is made).

[12] Section 951A(c)(2)(A).

[13] Section 951A(c)(2)(B)(i).

[14] Section 951A(d)(2)(A). If property is used in the production of tested income and other income, then it is treated as specified tangible property in the same proportion as the tested income bears to the total income. Section 951A(d)(2)(B).

[15] Section 951A(d)(1). The adjusted tax basis is determined at the end of each quarter of the taxable year and then averaged.

[16] Section 951A(b)(2)(A).

[17] Section 951A(b)(2)(B).

[18] Section 951A(b)(2).

CFC of the same U.S. shareholder) reduces the U.S. shareholder's NDTIR to the extent thereof, even if the CFC has offsetting interest income from an unrelated party.

It is important to distinguish calculations that are done at the CFC level and calculations that are done at the U.S. shareholder level. Tested income is purely a CFC level concept, and NDTIR is purely a shareholder level concept. Each CFC with positive tested income has its own QBAI, but the calculation of the exempt return on QBAI is done at the shareholder level by aggregating QBAI of all Related CFCs and multiplying the total by 10%. Likewise, each CFC has its own interest expense allocable to its own tested income, but the total of such interest expenses of all Related CFCs of a U.S. shareholder (except if paid to another Related CFC of the same U.S. shareholder) is aggregated at the shareholder level in calculating the reduction to NDTIR.

Stated simply, the GILTI gross income inclusion is essentially the U.S. shareholder's share of (1) the aggregate net tested income, if positive, of all Related CFCs, with limited exceptions such as Subpart F income, minus (2) 10% of the tax basis of the tangible depreciable assets of those Related CFCs with positive tested income. However, any gross interest expense (not paid to a Related CFC of the same U.S. shareholder) will reduce the size of item (1) and automatically also reduce the size of (2), so such interest expense does not reduce the GILTI gross income inclusion except to the extent it exceeds the size of item (2).

For convenience, we use the term "**QBAI return**" of a particular CFC with tested income to refer to 10% of the QBAI of the CFC, without reduction for any interest expense. In practice, this is the amount of exempt income generated by the CFC for the U.S. shareholder, before reduction for interest expense. If a particular CFC does not have positive tested income, we use the term "**notional QBAI return**" to refer to the QBAI return the CFC would have if it had positive tested income. Unless indicated otherwise, we assume throughout that there is no interest expense that reduces QBAI return.

B. Section 250 Deduction

1. Initial Calculation

A domestic corporation is entitled to a deduction equal to the sum of (A) 37.5% of its "foreign-derived intangible income", or "**FDII**", (B) 50% of the Section 951A inclusion and (C) 50% of the Section 78 amount included in its income and attributable to GILTI (together, the "**Section 250 deduction**").[19]

> Example 1. U.S. shareholder with no FDII has $100 of Section 951A inclusion solely from a CFC with no foreign taxes. The Section 250 deduction

[19] Section 250(a)(1). The percentages are lowered from 37.5% and 50% to 21.875% and 37.5%, respectively, for taxable years beginning after December 31, 2025. A discussion of the Section 78 amount is included below. FDII is calculated pursuant to Section 250(b), but a detailed discussion of FDII is beyond the scope of this report.

is $50, resulting in $50 of taxable income. The income is taxed at 21% to a corporate U.S. shareholder, for an effective tax rate of 10.5% on GILTI.

2. Carve-Back to Deduction

Under Section 250(a)(2), if the sum of the U.S. shareholder's FDII and Section 951A (and possibly Section 78) inclusions exceeds its taxable income (not taking into account the Section 250 deduction), then, solely for purposes of calculating the Section 250 deduction, those inclusions are reduced *pro rata* by the excess (the "**carve-back**").[20] In addition, the Section 250 deduction is disallowed in calculating a net operating loss.[21]

The carve-back comes into effect if the U.S. shareholder has current losses or loss carryovers to the year in question, and those losses exceed the non-GILTI, non-FDII income of the corporation. In that case, the carve-back requires that these losses be used to offset FDII and GILTI eligible for the Section 250 deduction, and the deduction is calculated by reference to the FDII and GILTI that remain (if any) after the losses have been used. As a result, the excess losses might be absorbed in the year but provide the U.S. shareholder with a tax benefit of only a fraction of the usual tax benefit of a loss.

> Example 2(a). U.S. shareholder has $100 of operating income and $100 of Section 951A inclusion. If the shareholder has no other income or loss, the Section 250 deduction is $50, taxable income is $150, and the tax is $31.50. If the shareholder instead has a $100 NOL carryforward to the year, the pre-Section 250 taxable income and Section 951A inclusion for the year are both $100, so there is no carve-back. The Section 250(a)(1) deduction is $50, the taxable income is $50, and the tax is $10.50. The tax savings from the NOL is $21, as would be expected.
>
> Example 2(b). Same facts as Example 2(a), except the NOL is $150. Now, the taxable income before Section 250 is $50, and the carve-back limits the Section 250 deduction to 50% of that, or $25. Taxable income is $25, and tax liability is $5.25.

[20] Section 250(a)(2). It is not clear if the carve-back applies to Section 78 inclusions. *See* the discussion in Part IV.D.4. The reductions in GILTI and FDII are not completely symmetrical, because expenses of the U.S. shareholder allocable to its FDII income reduce its FDII, while expenses of the U.S. shareholder allocable to its Section 951A inclusion do not reduce that inclusion.

[21] Section 172(d)(9).

> The tax savings from the extra $50 of NOL is $10.50 minus $5.25, or $5.25, a rate of savings of 10.5% rather than 21%.

In fact, every $100 of NOL that exceeds non-GILTI, non-FDII income reduces the GILTI and FDII inclusion in taxable income by $100, and therefore reduces the Section 250 deduction by $50. This results in a net decrease in taxable income of $50, for a net tax saving of $10.50, half the usual benefit from an NOL.[22]

C. Foreign Tax Credits

1. Calculation of the FTC

If a domestic corporation includes GILTI in income, and elects to credit foreign taxes, it is treated as having a "deemed paid" FTC equal to the product of (1) 80% of the aggregate "tested foreign income taxes" paid or accrued by the Related CFCs, and (2) the domestic corporation's "inclusion percentage".[23]

"Tested foreign income taxes" are foreign income taxes paid or accrued by a Related CFC that are "properly attributable" to the tested income of the CFC taken into account by the U.S. shareholder in calculating GILTI.[24] Accordingly, foreign taxes include taxes attributable to QBAI return, since tested income is not reduced by QBAI return. However, if a particular CFC does not have positive tested income for a year, foreign taxes paid by that CFC for that year do not give rise to tested foreign income taxes for the year.[25]

A domestic corporation's "inclusion percentage" is a fraction, the numerator of which is its Section 951A inclusion and the denominator of which is the aggregate of its share of the tested incomes of all Related CFCs with positive tested income.[26]

Note that the corporation's Section 951A inclusion is the tested income of Related CFCs with positive tested income, reduced by (1) tested loss of Related CFCs with tested loss, and (2) NDTIR based on QBAI of Related CFCs with positive tested income. As a

[22] Under the rules for FTCs discussed below, the tax saving from the NOL is further reduced if the Section 951A inclusion carried with it a foreign tax credit, since in that case the U.S. residual tax rate on the inclusion is less than 10.5%. As a general matter, subject to various complications discussed herein, the higher the foreign tax rate (up to a point), the lower the U.S. residual tax and the smaller the benefit from the carryforward.

[23] Section 960(d)(1).

[24] Section 960(d)(3).

[25] Section 960(d)(3); Conference Report, at 643 n. 1538, describing the Senate Bill ("Tested foreign income taxes do not include any foreign income tax paid or accrued by a CFC that is properly attributable to the CFC's tested loss (if any).)"

[26] Section 960(d)(2).

result, these two items reduce the numerator but not the denominator of the inclusion percentage, and so they reduce the percentage.

> Example 3. U.S. shareholder owns (1) CFC1 with tested income of $100 after foreign taxes, foreign taxes of $15, and QBAI return of $20, and (2) CFC2 with tested loss of $30 after foreign taxes and foreign taxes of $10. The Section 951A inclusion is $100 (tested income of CFC1)) minus $20 (NDTIR) minus $30 (tested loss of CFC2), or $50, and the tested foreign income taxes are $15. The inclusion percentage is $50 (the Section 951A inclusion) divided by $100 (the positive tested income of CFC1), or 50%. The allowed FTC is therefore 80% times 50% times $15, or $6.

2. GILTI Basket

For FTC purposes, GILTI is a separate basket, with no carrybacks or carryforwards.[27] Any income that is GILTI is not general category income.[28]

3. Section 78 Amount

As noted above, if a domestic corporation elects to receive the benefit of FTCs for a taxable year, 100% of the foreign taxes deemed paid by the domestic corporation are counted in the deemed dividend, or "Section 78 amount".[29] The Section 250 deduction is allowed against the full grossed-up amount.[30]

> Example 4(a). In Example 3, the U.S. shareholder would have a Section 78 amount of $7.50, for total GILTI inclusion of $50 plus $7.50, or $57.50.[31] We assume hereafter that the gross-up goes in the GILTI FTC basket.[32]

[27] Section 904(c) and (d)(1)(A).

[28] Section 904(d)(1)(A) and (2)(A)(ii).

[29] Section 78.

[30] Section 250(a)(1)(B)(ii).

[31] The U.S. shareholder's allowed FTC was 80% times 50% times $15, or $6. Its inclusion under Section 78 is the same as the allowed FTC, but without the 20% cutback, so it is 50% times $15, or $7.50.

[32] *See* Part IV.E.2(d).

> Example 4(b). Consider the simple case where the U.S. shareholder owns a single CFC with $100 of pre-tax tested income, no QBAI return, and $13.125 of foreign taxes. The tested income and Section 951A inclusion are $86.875. The inclusion percentage is 100% (86.875/86.875), so it does not reduce the foreign tax credit of $13.125. The credit results in a Section 78 inclusion of $13.125. The GILTI inclusion is $100 and the allowed foreign tax credit is 80% of $13.125, or $10.50. If the full Section 250 deduction of $50 is allowed, taxable income will be $50 and the tentative U.S. tax liability is $10.50. If no expenses are allocated to GILTI income (*see* Part III.D) the FTC will exactly offset the U.S. tax.

D. Limitations on Use of FTCs

In general, a taxpayer's FTC for a year is limited to (1) the taxpayer's foreign source taxable income for the year, multiplied by (2) the effective U.S. tax rate on the taxpayer's worldwide taxable income for the year.[33] This determination is made separately for each FTC basket, including the GILTI basket.[34] The U.S. shareholder must therefore determine which items of gross income belong in the GILTI basket, and then allocate and apportion its deductions to determine net income in the GILTI basket.[35]

Under preexisting law, deductions that are "definitely related" to gross income are generally allocated and apportioned to that gross income, and other deductions are generally ratably allocated and apportioned.[36] Following the Act, interest deductions are generally allocated and apportioned on the basis of the tax basis of assets, rather than the value of assets or income.[37]

[33] Section 904(a). The formula in the text assumes no U.S. source losses. The statutory formula is that the allowed FTC cannot exceed the same proportion of total U.S. tax liability (before FTCs) that foreign source taxable income bears to worldwide taxable income. Mathematically, this is equivalent to the rule that the allowed FTC cannot exceed (1) total U.S. tax liability, multiplied by (2) foreign source taxable income, with the product divided by (3) worldwide taxable income. Since (1) divided by (3) is the effective U.S. tax rate on worldwide taxable income, the formula is equivalent to that in the text. New Section 904(b)(4), discussed below, modifies this formula in certain cases.

[34] Section 904(d).

[35] Various re-sourcing rules under Section 904 must be taken into account but are beyond the scope of this discussion.

[36] *See generally,* Sections 861(b), 862(b), 863(a) and Treasury Regulations thereunder.

[37] Section 864(e)(2), Temp. Treas. Reg. § 1.861-9T(a). Prior to the Act, Section 864(e)(2) allowed an allocation based on the basis or value of assets, but now basis is required. There are exceptions to this general rule, including that (i) interest expense is directly allocated to income generated by certain property

> Example 5(a). Same facts as Example 4(b). U.S. source income is $0, foreign source income (after Section 250 deduction) is $50, U.S. tax before FTC is $10.50, and effective U.S. tax rate is 21% ($10.50/$50). The Section 904 limit is $50 (foreign source income) multiplied by 21% (effective U.S. tax rate), or $10.50, so the full credit is allowable.
>
> Example 5(b). Same facts as Examples 4(b) and 5(a), except that U.S. shareholder also has U.S. source business income of $10 (before interest deductions) and $10 of interest deductions. Assume the interest deductions are all treated as U.S. source deductions. The result is the same as in Example 5(a).
>
> Example 5(c). Same facts as Example 5(b), except $5 of the interest deductions are allocable to the foreign source GILTI inclusion. Then, nothing changes except the FTC limit under Section 904(a). That limit is now $45 (foreign source GILTI inclusion of $50 minus interest expense of $5) times the effective U.S. tax rate of 21%, or $9.45. Thus, only $9.45 of FTC is allowed, and there is U.S. tax of $10.50 minus $9.45, or $1.05. Note that this loss of credits has the same tax cost ($1.05) as would the allowance of the full FTC and the disallowance of the $5 of foreign source interest deductions. The same result would arise for any other deductions allocable to the GILTI inclusion.

Members of an affiliated group, whether or not they file a consolidated return, must allocate and apportion interest expense of each member as if all members of the group were a single corporation.[38] A similar rule applies for purposes of allocating and apportioning certain other expenses that are not directly allocable or apportioned to any specific income producing activity.[39] For affiliated groups filing a consolidated return, all foreign taxes

acquired, constructed or improved with proceeds of qualified nonrecourse indebtedness, (ii) interest expense is directly allocated to certain investments funded with amounts borrowed in connection with certain integrated financial transactions and (iii) third party interest expense must be directly allocated to certain separate foreign tax credit limit categories in certain circumstances where the U.S. shareholder's debt is much greater than its CFCs' debt. Temp. Treas. Reg. § 1.861-10T(a), (b), (c), Treas. Reg. § 1.861-10(e).

[38] Section 864(e)(1), Temp. Treas. Reg. § 1.861-11T. Foreign corporations are excluded from an affiliated group for this purpose. Treas. Reg. § 1.861-11(d)(1).

[39] Section 864(e)(6), Temp. Treas. Reg. § 1.861-14T.

paid by group members are aggregated, and a single Section 904 limit is calculated for the group.[40]

IV. Discussion and Recommendations

A. Purpose of the GILTI Regime

As can be seen from the description above, the GILTI regime creates a tax system for the United States that is a hybrid between a territorial system and a world-wide system. Like a world-wide system, a significant amount of income of a U.S. shareholder that is earned through CFCs is subject to immediate U.S. tax if the foreign tax rate is insufficient. Moreover, gains on a sale of CFC stock are taxable if they exceed previously taxed income in the CFC. While the territorial system in most countries does not tax foreign operating income at all, the GILTI regime taxes GILTI income at a significantly lower rate than domestic income. Moreover, NDTIR is permanently exempt from U.S. tax, and dividends from foreign subsidiaries are exempt from U.S. tax.[41]

In addition, to the extent that GILTI is a world-wide tax system, it results in yet another hybrid between (1) a flat minimum domestic and foreign tax rate on a U.S. shareholder's non-NDTIR GILTI inclusions earned through CFCs[42] (the "**flat-rate theory**"), and (2) the imperfect adding of the GILTI regime onto the existing tax regime for foreign source income, particularly Subpart F income (the "**add-on theory**").

The strongest evidence that Congress intended the flat-rate theory is that the Conference Report arguably contemplates no GILTI tax if the foreign tax rate is at least 13.125%,[43] although this may have merely been intended as an illustrative rate.[44] Other factors that are consistent with this theory (although with the add-on theory also) are the ability to offset tested income of some CFCs with tested losses of other CFCs, and the fact

[40] Treas. Reg. § 1.1502-4(d).

[41] In the case of a U.S. shareholder that is not a domestic corporation (and assuming no Section 962 election), the GILTI regime creates a system that is even closer to a worldwide tax system. GILTI inclusions are subject to tax at the same rate as other ordinary income because neither the Section 250 deduction nor foreign tax credits are available. The discussion in this Part IV.A assumes the applicable U.S. shareholder is a domestic corporation.

[42] This approach is similar to the approach taken for pass-through income in Section 199A, where a deduction of a fixed percentage of specified categories of pass-through income results in a reduced tax rate on that type of income.

[43] Conference Report at 626-7 ("Since only a portion (80 percent) of foreign tax credits are allowed to offset U.S. tax on GILTI, the minimum foreign tax rate, with respect to GILTI, at which no U.S. residual tax is owed by a domestic corporation is 13.125 percent....Therefore, as foreign tax rates on GILTI range between zero percent and 13.125 percent, the total combined foreign and U.S. tax rate on GILTI ranges between 10.5 percent and 13.125 percent.").

[44] The quoted language is under the heading "Illustration of effective tax rates on FDII and GILTI". *Id.* at 626.

that the GILTI FTC limitation is determined on a world-wide basis rather than a country-by-country basis.

Moreover, the flat rate theory is arguably more consistent with the tax rate on FDII. Aside from the deemed return on QBAI, which is fully taxable under FDII and exempt under GILTI, the FDII rules are designed to lower the U.S. tax rate on FDII export income to a rate that is approximately the rate the taxpayer could achieve by engaging in activities through a CFC. FDII income would not normally generate significant foreign tax credits except for withholding taxes on royalties from non-treaty jurisdictions. As a result, Congress could have considered the statutory FDII rate to be close to the final worldwide rate.

Thus, if Congress had not believed it was adopting the flat-rate theory, it arguably should have realized that the effective world-wide tax rate on GILTI will often be much higher than the rate on FDII, and it would not have been necessary to lower the rate on FDII as much. The fact that Congress did reduce the rate on FDII as much as it did arguably indicates that it believed the rate on GILTI inclusions would usually be 13.125% or not much higher. On the other hand, FDII is also reduced by allocable deductions such as interest and research and development,[45] so arguably Congress intended both the FDII rate and the GILTI rate to be higher than 13.125%.

Other elements of the GILTI regime support the add-on theory because they can cause a much higher tax rate on the net world-wide income of the CFCs owned by a U.S. shareholder. Under this view, the add-on theory is in effect a "minimum tax theory", namely that Congress intended the world-wide effective tax rate on GILTI to be no less than 10.5%, but U.S. tax could apply even if the foreign rate is more than 13.125%. For example, a tested loss in a CFC can cause a loss of FTCs and NDTIR exclusion, and neither unused tested losses nor unused FTCs can be carried over.[46] All interest expense of a shareholder's CFCs not reflected in tested income of a Related CFC is in substance first allocated to tax-exempt NDTIR, rather than being allocated between taxable income and exempt NDTIR. The Section 250 deduction of the U.S. shareholder is limited to its taxable income. All of these restrictions would have to be reconsidered as a legislative matter if the flat-rate theory was to be implemented.

As to the placement of GILTI FTCs in a separate FTC basket, on its face this is a neutral factor, since even a system for taxing GILTI at a fixed tax rate might prohibit cross-crediting of FTCs arising on non-GILTI income. On the other hand, by placing the FTC limitation in Section 904, Congress intentionally or unintentionally adopted the add-on theory, because it thereby incorporated numerous limitations on GILTI FTCs that can give rise to a combined U.S. and foreign tax rate on CFC income that is well in excess of 13.125%.

[45] Section 250(b)(3)(A)(ii).

[46] We propose in Part IV.C.3(a) that unused tested losses should be allowed to carry over.

In many cases the statute is clear and Treasury would not have discretion to change a specific rule even if it wished to. However, regulations will be needed to resolve many ambiguities and unanswered questions under the statute. The resolution of many issues depends upon whether one believes that the intent of Congress was, as much as possible, to create a uniform maximum tax rate of 13.125% on foreign income, or, alternatively, to (imperfectly) lay the GILTI rules on top of the existing rules for foreign income.

There is no definitive way to resolve this dual nature of the GILTI regime. To the extent the statute provides flexibility for interpretation, we believe that regulations should give significant weight to the theory that Congress intended to create a flat tax at a 13.125% rate, even if the statute itself does so imperfectly. Many of our suggestions for regulations in this Report, such as allowing carryovers of CFC losses and modifying the existing rules for allocating expenses to FTCs, reflect this view. We also suggest some legislative changes to further achieve this result.

B. Aggregation of Members of a Consolidated Group

This section discusses the extent to which members of a consolidated group should be treated as a single corporation for purposes of the various GILTI calculations.

1. In General

Under Sections 951A and 78, each U.S. corporation must calculate its own GILTI inclusion based on its own Related CFCs. However, a consolidated group is treated as a single entity for many purposes of the Code, and in a typical group there will be more than one, and perhaps many, members that are U.S. shareholders of CFCs. It is important for guidance to state the extent to which a consolidated group is to be treated as a single corporation for purposes of the various GILTI calculations.

The statute itself provides no specific guidance. The statute[47] and the legislative history suggest similarity between Subpart F income and GILTI,[48] and consolidation principles do not apply to calculating Subpart F inclusions. However, the GILTI rules are different from Subpart F in many critical respects, and we discuss below the extent to which we believe that consolidation principles should apply to GILTI.

2. The Section 250(a) Deduction

Consider a consolidated group where a single member (M1) has a single Related CFC with tested income. Because consolidation principles do not change the location of items of income and deduction, the GILTI inclusion would be income of M1, and the Section 250 deduction would be a deduction of M1. However, Section 250(a)(2) limits the

[47] Section 951A(f)(1)(A) lists the Code sections for which GILTI is to be treated in the same manner as Subpart F income.

[48] For example, in describing the Senate Amendment, the Conference Report at 641 says: "a U.S. shareholder of any CFC must include in gross income for a taxable year its global intangible low-taxed income ("GILTI") in a manner generally similar to inclusions of subpart F income".

deduction to the taxable income "of the domestic corporation". The question is whether this refers to M1's separate taxable income or to the taxable income of the group as a whole. If more than one member of the group had a Related CFC, the issue would be whether to count the entire taxable income of the group and the entire Section 250(a)(1) deduction of the group. There is no relevant analogy to Subpart F, since income inclusions under Subpart F do not depend in any way on taxable income of the U.S. shareholder.

We believe that regulations should provide that the Section 250(a)(2) limitation is determined on the basis of the taxable income of the group as a whole. We have several reasons for this conclusion.

First, placing such importance on a particular member's taxable income would require the IRS to police the allocation of income among group members, such as intercompany pricing for transactions between group members. Separately determined taxable income of a member is rarely relevant from a nontax point of view, and so taxpayers would be incentivized to take aggressive positions with few (if any) nontax economic consequences. These issues rarely arise today.

Second, looking at the single member's taxable income would be a trap for unwary taxpayers, who would not expect this result. Well-advised taxpayers could easily avoid it, as discussed below.

Third, if the separate taxable income of the member-shareholder is the relevant test, it will be trivial for taxpayers to avoid ever having the carve-back apply. No matter how big the overall loss of the consolidated group, the CFC could be held by a member with no other items of income or deduction. In that case, the GILTI inclusion would by itself create sufficient taxable income to support the full Section 250(a)(1) deduction without the carve-back. Even in the unusual case where this was not practicable, it would not generally be difficult to locate a CFC in a corporation that was not expected to have a taxable loss without regard to the GILTI inclusion.

Fourth, in a consolidated group, losses of one member can freely be used against income of another member, and (as long as the members remain in the group), the location of losses is generally irrelevant. Consistent with this policy, it is difficult to see why the carve-back should apply if the group as a whole has positive taxable income, solely because the member that is the U.S. shareholder has a tax loss on a stand-alone basis. Likewise, if the group as a whole has a tax loss, it is difficult to see why the carve-back should *not* apply merely because the particular member that is the U.S. shareholder has positive taxable income.

Note that if the member has a loss but the group as a whole has positive taxable income, even if a Section 250 deduction is allowed, the carve-back would prevent the deduction from creating a loss in the member that could not be used by the group on a current basis. Therefore, even aside from Section 172(d)(9), the loss created by the deduction could not be carried forward outside the group even if the stock of the member was sold.

Finally, consolidated groups determine their income on a group-wide basis, and it is rarely relevant to determine taxable income on a member-by-member annual basis. It could be a considerable administrative burden for a group to have to separately calculate the taxable income of every member that had a Related CFC solely for purposes of GILTI and FDII.

We believe that Treasury has regulatory authority under Section 1502 to reach the result we propose. That section specifically authorizes consolidated return regulations "that are different from the provisions of chapter 1 that would apply if such corporations filed separate returns." This provision was adopted in 2004, and the legislative history makes clear that it authorizes regulations to treat members of a group as a single taxpayer or as separate taxpayers, or a combination of the two approaches.[49]

We note that Section 5 of Notice 2018-28[50] applies the interest deduction limits of Section 163(j) on a consolidated basis. Those limits are based on the adjusted taxable income of the taxpayer and are analogous to the limits on the deduction under Section 250(a)(2). To be sure, the Notice relies in part on the legislative history of Section 163(j) that specifically supports the conclusion of the Notice. While there is no similar legislative history concerning Section 250, we believe the implicit logic of the Section 163(j) legislative history applies equally to Section 250.

3. Section 904 Limit on the Deemed Paid Foreign Tax Credit

Under the existing consolidated return regulations,[51] the Section 904(a) limit on foreign tax credits is determined on a consolidated basis. This is consistent with the calculation of taxable income on a consolidated basis, as discussed above. We believe that regulations should confirm that this principle continues to apply to the calculation of the limitation on the GILTI basket under Sections 904(a) and (d).

The foregoing discussion applies equally here. A separate company limitation for the GILTI basket would necessarily require a company-by-company calculation of notional taxable income and U.S. tax liability, neither of which is relevant today. In fact, for purposes of allocating research expenses, as well as most other expenses (other than interest) that are not directly allocated or apportioned to any specific income producing activity, an affiliated group is treated as a single corporation,[52] and a member-by-member allocation would be necessary solely for purposes of GILTI.

These special rules for GILTI calculations would result in enormous administrative complexity, a trap for the unwary taxpayer, and a very large tax planning opportunity for

[49] *See* Staff of the Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in the 108th Congress*, JCS-5-05 (2005) at 415.

[50] 2018-16 IRB (April 2, 2018).

[51] Treas. Reg. § 1.1502-4(d).

[52] Section 864(e)(6); Treas. Reg. §§ 1.861-14T and 1.861-17(a)(3)(i).

taxpayers. In fact, no matter how large the overall group losses or how many deductions the group had that might be allocated to GILTI inclusions, a group could avoid a Section 904 limitation by having a CFC be held by a member with no losses and with no expenses that might be allocated to foreign source income.

4. The Amount of the GILTI Inclusion

A more complex question is whether all members of a consolidated group should be considered a single U.S. shareholder for purposes of calculating a single GILTI inclusion for the group. If the answer is yes, then, since each Section 951A inclusion creates its own FTC inclusion percentage, the group would also have a single inclusion percentage. The result would generally be the same as if all the Related CFCs of all members of the group were owned by a single group member.

For the reasons stated below, we believe that regulations should adopt this approach. As discussed above, we believe that Section 1502 provides clear authority for such regulations. Treating all group members as a single member is referred to below as the "**aggregation approach**", while treating each member as having its own separately computed GILTI is referred to as the "**nonaggregation approach**".

(a) Why it matters

The aggregation approach can be either beneficial or harmful to taxpayers, depending on the situation. The reason is that aggregating or not aggregating particular CFCs with other CFCs in calculating GILTI can have a significant effect in determining the benefits that the group will receive from tested losses, QBAI return, and FTCs.

There are at least six distinct ways in which aggregation can be better or worse for taxpayers. The examples that follow illustrate these situations. In the examples, CFC1 is owned by group member M1, and CFC2 is owned by group member M2. If aggregation applies, M1 and M2 are together referred to as M. Unless otherwise indicated, there is no FTC or QBAI return. Charts and more detailed calculations for certain of these Examples are provided in Appendix 1.

(i) *Tested income can be offset by tested loss of another CFC*

Absent FTCs or QBAI return, aggregation is generally better for taxpayers when CFC1 has tested income and CFC2 has a tested loss. This is because tested income and tested loss can offset each other when they are included in a single GILTI calculation.

> <u>Example 6(a) (tested income and tested loss; aggregation is taxpayer-favorable)</u>. Assume CFC1 has \$100 of tested income, and CFC2 has \$100 of tested loss. Under aggregation, M has a \$0 Section 951A inclusion. Under nonaggregation, M1 has \$100 of tested income and Section 951A inclusion,

and M2 obtains no benefit from the tested loss of CFC2. The group is better off under aggregation.

However, if there is interest expense in a CFC with tested losses and QBAI return in a CFC with tested income, nonaggregation may be better for the taxpayer.[53]

> Example 6(b) <u>(tested income and tested loss, interest expense offsets QBAI return; nonaggregation is taxpayer-favorable)</u>. CFC1 has \$100 of tested income and \$100 of QBAI return. CFC2 has \$100 of interest expense and \$50 of tested loss. Under nonaggregation, neither M1 nor M2 has any Section 951A inclusion. Under aggregation, the CFC2 interest expense of \$100 offsets M's NDTIR from CFC1, so M has a Section 951A inclusion of \$50.

(ii) *Tested income can be offset by excess QBAI return of another CFC*

If a Related CFC has QBAI return in excess of its tested income, such excess will reduce the Section 951A inclusion of its shareholder arising from other Related CFCs. This provides a benefit of aggregation.

> <u>Example 7 (excess QBAI return of one CFC offsets tested income of another CFC; aggregation is taxpayer-favorable)</u>. Assume CFC1 has \$100 of tested income and no QBAI return, and CFC2 has \$10 of tested income and \$100 of QBAI return. Absent aggregation, M1 has a Section 951A inclusion of \$100, and M2 has no inclusion. With aggregation, M has a Section 951A inclusion of \$10.

(iii) *Tested loss offsets tested income but also reduces the inclusion percentage*

As illustrated in Example 6(a), a tested loss of one CFC has the benefit of offsetting tested income of other CFCs in the same aggregation group. However, a tested loss also reduces the inclusion percentage for FTCs paid by other CFCs in the same aggregation group. Aggregation can help or hurt the taxpayer depending on whether the tested loss offsets tested income of a high-taxed or low-taxed CFC.

> <u>Example 8(a) (base case with aggregation: tested loss offsets high- and low-taxed tested income)</u>.

[53] This example assumes that interest expense in a Related CFC with tested losses reduces the U.S. shareholder's NDTIR from other CFCs with QBAI return. *See* discussion in Part IV.D.6.

Assume (1) CFC1 has $100 of tested income net of foreign taxes and a foreign tax rate of 13.125%, (2) CFC2 has $100 of tested income and foreign tax of $0, and (3) the group also owns CFC3 with a $100 tested loss. With aggregation, the Section 951A inclusion is $100 and the inclusion percentage is 50%, regardless of who owns CFC3.[54]

Example 8(b) (no aggregation, tested loss only offsets high-taxed income; result is worse for taxpayers than aggregation). Same facts as Example 8(a), but assume CFC3 is owned by M1. Absent aggregation of M1 and M2, M1 has no Section 951A inclusion and an inclusion percentage of 0%. M2 has a Section 951A inclusion of $100 and no FTC. The result is worse than under aggregation because the tested loss of CFC3 is "wasted" when used against high-taxed income in CFC1.[55]

Example 8(c) (no aggregation, tested loss only offsets low-taxed income; result is better for taxpayers than under aggregation). Same facts as Example 8(a), but assume CFC3 is owned by M2. Then, M1 has a Section 951A inclusion of $100 and a 100% inclusion percentage, so no tax is due. M2 has no inclusion, and no tax. Full use has been obtained for both the tested loss in one GILTI group, and the FTC in a different GILTI group.

(iv) *NDTIR reduces the Section 951A inclusion, which then reduces the FTC inclusion percentage*

When NDTIR reduces the Section 951A inclusion, the result is a *pro rata* cutback of FTCs based on the reduction of the Section 951A inclusion, without regard to which CFC had QBAI return. If one CFC has QBAI return and the other does not, and tax rates on the CFCs are different, the single calculation of the inclusion percentage under

[54] The Section 951A inclusion is equal to CFC1's $100 of tested income, plus CFC2's $100 of tested income, minus CFC3's $100 of tested loss, or $100. The inclusion percentage is the $100 Section 951A inclusion, divided by the sum of CFC1's $100 of tested income and CFC2's $100 of tested income, or 50%. A portion of CFC1's foreign taxes is available to M for use as a FTC because the inclusion percentage is 50%.

[55] None of CFC1's foreign taxes is available as an FTC because M1 has no inclusion under Section 951A. M2 has an inclusion under Section 951A but no FTCs because CFC2 paid no foreign taxes.

aggregation can be better or worse for taxpayers than the separate calculations of the inclusion percentage under nonaggregation.

In the three examples below, the FTCs are half utilized under aggregation (Example 9(a)), fully utilized under one fact pattern involving nonaggregation (Example 9(b)), and not utilized at all under another fact pattern involving nonaggregation (Example 9(c)).

> <u>Example 9(a) (base case with aggregation; NDTIR reduces inclusion percentage).</u> Assume (1) CFC1 has $100 of tested income net of foreign taxes, and no QBAI return, and (2) CFC2 has $100 of tested income net of foreign taxes, and $100 of QBAI return. Also assume that either CFC1 or CFC2 has a foreign tax rate of 13.125%, and the other has a 0% rate. Under aggregation, M has $200 of tested income, a Section 951A inclusion of $100 ($200 minus $100 of NDTIR), and an inclusion percentage of 50%.
>
> <u>Example 9(b) (no aggregation; lower foreign tax on QBAI return; result is taxpayer-favorable compared to aggregation).</u> Assume the same facts as Example 9(a), but with the foreign taxes being imposed on CFC1. Under nonaggregation, M1 has a Section 951A inclusion of $100 and an inclusion percentage of 100%, while M2 has a Section 951A inclusion of $0. This allows for full usage of FTC on the non-exempt income in CFC1, while aggregation "wastes" half of the FTC on the QBAI return in CFC2.
>
> <u>Example 9(c) (no aggregation; higher foreign tax on QBAI return; result is taxpayer-unfavorable compared to aggregation)</u>. Same facts as in Example 9(a), but the foreign taxes are imposed on CFC2. Under nonaggregation, M1 has a $100 Section 951A inclusion, with no FTC offset, and M2 has no Section 951A inclusion. This is worse for taxpayers than the aggregation case because the FTC in CFC2 is totally "wasted".

(v) *Interest expense reduces NDTIR of the U.S. shareholder unless paid to a Related CFC of the same U.S. Shareholder*

Gross interest expense of a CFC reduces NDTIR of the U.S. shareholder unless the corresponding interest income is taken into account in determining the U.S. shareholder's net CFC tested income. This can make aggregation or nonaggregation more favorable depending on the facts.

Suppose CFC1 has interest expense to a third party and no QBAI return, and CFC2 has no interest expense but has QBAI return. Under aggregation, the interest expense of CFC1 will reduce M's NDTIR. Without aggregation, there will be no reduction in M2's NDTIR, so aggregation is worse for the group.

Alternatively, suppose CFC1 has QBAI return and pays interest to CFC2. With aggregation, the interest will have no effect on the group's net CFC tested income or NDTIR. Without aggregation, the interest will reduce M1's NDTIR and net CFC tested income, and increase M2's net CFC tested income. Total net CFC tested income is the same in both cases, but aggregation avoids the reduction in NDTIR and is better for the group in this fact pattern.

(vi) *Investment adjustments in stock of M1 and M2 will differ depending on aggregation or nonaggregation*

Part IV.D.7 discusses issues that arise in making stock basis adjustments to M1 and M2 under the consolidated return regulations. Aggregation or nonaggregation may have different effects on allocating the GILTI inclusions to M1 and M2, even if the total inclusion is the same in both cases. These differences in stock basis could be favorable or unfavorable to the group depending on its future plans to dispose of stock of M1 or M2.

(b) Discussion

These examples illustrate some of the ways in which aggregation of members of a group in calculating GILTI helps taxpayers in certain circumstances and hurts taxpayers in others. As a policy matter, we do not believe the substantive tax results in these examples should differ so dramatically depending on where in a group a particular CFC is held. The statute already provides for a single calculation of the GILTI inclusion for all Related CFCs held by a single group member. Logically, the rule should also apply to all Related CFCs held by all members of a group.

It is often quite arbitrary where in a group a particular CFC is held, and it would be quite unusual for significant tax consequences to depend upon the location of the CFCs within a group. At a minimum, this would create an enormous trap for the unwary taxpayer who simply assumes that it would not make a difference where a particular CFC is held within a group.

Moreover, if regulations do not provide for mandatory aggregation for all Related CFCs held by members of a group, the result will be an effectively elective regime. In many if not most cases, it will make little or no business difference to taxpayers where in a group any particular CFC is held.[56] As a result, in the absence of mandatory aggregation,

[56] An exception might be CFCs that are regulated entities, which may be required by law to be held within or outside of specified structures.

taxpayers can be expected to obtain aggregation for whichever CFCs it is desirable, by having the relevant CFCs held by a single group member, and to avoid aggregation for whichever CFCs it is desirable, by having individual CFCs each held by a separate group member.

Elaborate computer programs would likely be designed to determine, on an annual basis, the groupings and non-groupings of CFCs that will minimize the overall tax liability of the group for the following year. Likely the only reason a well-advised group would not reach the optimal structure every single year would be if their predictions for the following year were inaccurate. Query whether the use of such a computer program would even violate any anti-abuse rule, given the rather arbitrary nature and murky purpose of some of these rules.

For example, a group could restructure today to cause every member with a Related CFC that it directly holds to transfer it to a single newly-formed U.S. group member ("**CFC Master Holding**") in a series of transfers that qualify for non-recognition of gain and loss under Section 351. Aggregation of all the Related CFCs would therefore apply absent further action.

At the end of this year, the group would determine whether separate treatment of any CFC (along with its CFC subsidiaries) would likely be favorable for next year. If so, CFC Master Holding would transfer each of those CFCs to a new separate wholly owned U.S. subsidiary of CFC Master Holding (each, a "**CFC Subsidiary Holding**"). If a separate grouping of two or more CFCs was desirable, those could be contributed together to a separate CFC Subsidiary Holding.

At the end of each year thereafter, the group would make a new determination for the following year. Depending on the results, any CFC Subsidiary Holding can either be retained as such or else liquidated into CFC Master Holding in a transaction that qualifies for nonrecognition of gain and loss under Section 332. Any CFC already held by CFC Master Holding could either be retained there, or transferred to a new CFC Subsidiary Holding or to an existing CFC Subsidiary Holding. The result is a practical election on an annual basis whether each CFC (along with its own CFC subsidiaries) will be treated on a separate or aggregated basis for GILTI purposes, and what the aggregation groups will be for the year.

In reality, this type of structuring would often have little or no business purpose. While existing or newly created anti-abuse doctrines or rules might be employed to attempt to stop the most blatant structuring, such doctrines or rules will be extremely difficult to enforce for a multinational corporation with hundreds if not thousands of CFCs.[57] A lot of pressure will also be put on the ability to make retroactive check the box elections, in order to retroactively combine or separate out companies based on results that are different than the expected results.

[57] None of this restructuring would be affected by Section 367, since the stock of the CFCs remains within the U.S. consolidated group.

As a policy matter, these transactions do not carry out the purposes of the statute and we are not aware of any other reason why they should be permitted. Thus, the statute should not be allowed to distort taxpayer behavior and incentivize these transactions. Moreover, we are not aware of any policy reason why taxpayers should have adverse tax consequences solely because they hold CFCs through multiple members for good business reasons.

More broadly, there is no reason that consolidated groups should obtain significantly different tax results under GILTI depending on where CFCs are held within the group. Indeed, given the statutory aggregation among CFCs owned by a single group member, the single entity principle of consolidated returns supports aggregation among CFCs owned by different group members.

We acknowledge that Section 951A reflects a general similarity between GILTI and Subpart F, and that there is no aggregation of group members in Subpart F. Each U.S. group member calculates its own Subpart F inclusion solely by reference to the CFCs for which it itself is a U.S. shareholder. However, under Subpart F, the U.S. shareholder takes account of each CFC separately, without regard to any other CFCs of which it is a U.S. shareholder. As a result, it would not make a difference whether all group members were aggregated.

On the other hand, the GILTI calculation for a single member of the group already involves considerable aggregation of the tax attributes of the Related CFCs of that member, and it is a logical extension of that procedure to extend the aggregation to CFCs owned by all group members. As a result, we do not find the Subpart F analogy persuasive.

The administrative aspects of aggregation do not appear to add undue complexity. It is true that the group would often have a different Section 951A inclusion than the sum of the separate Section 951A inclusions in the absence of aggregation, but this is the proper result. The overall inclusion would logically first be allocated to members in proportion to the net CFC tested income that each member would have from its own Related CFCs in the absence of aggregation. This method would disregard members' NDTIR that would reduce their respective Section 951A inclusions on a stand-alone basis. However, it is consistent with the second step of the process based on Section 951A(f)(2), which allocates a member's own Section 951A inclusion (as determined in the first step) among its own Related CFCs with positive tested income in proportion to such income.

Alternatively, the overall inclusion could be allocated to members in proportion to the separate Section 951A inclusions or GILTI inclusions they would have had in the absence of aggregation, although the second step would still be on the basis of tested income. A number of issues under the basis adjustment rules of Treas. Reg. § 1.1502-32 would also arise and are discussed in Part IV.D.7.

In principle, aggregation could be applied to CFCs held by U.S. members of a controlled group that do not file a consolidated return. We do not recommend the expansion of aggregation in this manner, except perhaps as an anti-abuse rule if a principal purpose of having multiple owners of multiple CFCs is to avoid the purposes of the GILTI rules. We note in this regard that Section 5 of Notice 2018-28 states that Treasury does not anticipate that affiliated groups not filing a consolidated return would be aggregated for purposes of Section 163(j).

Even setting aside the question of the government's authority to aggregate more broadly, we think aggregation among consolidated group members is correct because these members are already treated as a single entity for most tax purposes. This is not true for each member of a controlled group that does not file a consolidated return. As a result, there is less policy justification for aggregation. Moreover, mandatory aggregation would be difficult to justify, and elective aggregation does not seem justified. The mechanics of aggregation would also be very difficult to apply, since each U.S. shareholder would have its own taxable income and other tax attributes.

If aggregation among consolidated group members is required, consideration should also be given to whether the same rule should apply to CFCs held by a partnership where a specified percentage of the partnership is owned by group members. For example, if a CFC is held by a partnership and two group members are each a 50% partner, the issue is whether the group's overall GILTI calculation should be made as if the CFC were held directly by group members, or whether the partnership should be respected and the usual rules for partnerships holding CFCs (discussed below) should apply.

In the absence of a look-through rule, it would be possible for a group to take particular CFCs out of its aggregation groups by putting them into a partnership that is wholly or largely owned by group members. Treasury could either adopt an automatic look-through rule, or it might conclude that existing anti-abuse rules such as economic substance and partnership anti-abuse are adequate to police this structure.[58]

C. Deductions Allowed in Calculating Tested Income

1. The Issue

Assume that all the gross income of a CFC is included in tested income. The threshold question is which expenses of a CFC should be allowed as a deduction in calculating tested income.

The statute provides that tested income is "gross income" determined without regard to certain specified items,[59] less deductions (including taxes) "properly allocable to such gross income under rules similar to the rules of section 954(b)(5) (or to which such

[58] In our recent report on Section 163(j), we recommended that a partnership among members of a consolidated group be respected as such, although a minority supported the view that aggregate principles should apply. *See* NYSBA Tax Section, "Report on Section 163(j)", Report No. 1393, March 28, 2018 (the "**Report on Section 163(j)**"), Part III.G.5. Arguably Section 951A presents a better case for aggregation because, as noted in that Report, Section 163(j)(4)(A)(i) specifically says that Section 163(j) is to be determined at the partnership level and does not distinguish a partnership among group members.

[59] Section 951A(c)(2)(A)(i).

deductions would be allocable if there were such gross income)".[60] Section 954(b)(5) contains the same reference to deductions "properly allocable" to Subpart F income. However, it refers to the method to allocate known deductions to different categories of income, not the method to determine whether an expense is properly counted as a deduction.[61]

In the absence of guidance from either the statute or the legislative history, we consider three possible methods for determining which expenses of a CFC should be allowed as a deduction from its gross income:

(1) The "**modified taxable income method**". All costs that would be allowable as a deduction to a U.S. corporation would be allowed, except as specifically identified otherwise by Treasury. The CFC must in effect file a hypothetical U.S. tax return reporting taxable income and loss, with any specified adjustments, but only for gross income that is tested income and deductions allocable to tested income.

(2) The "**Subpart F method**". All costs of the type deductible for Subpart F purposes would be allowed. Allowed deductions are generally amounts deductible under U.S. generally accepted accounting principles ("**GAAP**") for a domestic corporation, unless the use of those principles would have a "material effect" as compared to a calculation under U.S. tax principles.[62] This calculation incorporates by reference the rules for determining e&p of the CFC.[63]

(3) The "**modified Subpart F method**". The Subpart F method would apply, but with the disallowance of particular deductions specified in regulations that are disallowed for U.S. tax purposes.

[60] Section 951A(c)(2)(A)(ii).

[61] Treas. Reg. § 1.954-1(c)(1)(i)(B) refers to allocating expenses under the principles of Sections 861, 864, and 904(d). It appears the drafters of the Act intended Section 954(b)(5) principles to apply for purposes for allocating deductions, rather than determining deductibility: "For purposes of computing deductions (including taxes) properly allocable to gross income included in tested income or tested loss with respect to a CFC, the deductions are allocated to such gross income following rules similar to the rules of section 954(b)(5) (or to which such deductions would be allocable if there were such gross income)." Conference Report at 644.

[62] Treas. Reg. § 1.952-2(b)(1), (c)(2).

[63] *Id.* These rules are in Treas. Reg. § 1.964-1. *See also* Proposed Treas. Reg. § 1.163(j)-8, which provides rules for applying Section 163(j) to a foreign corporation that has "effectively connected income", or "ECI". Arguably this regulation contains a negative inference that Section 163(j) must not apply to a foreign corporation unless it has ECI.

Under any of these methods, foreign taxes are permitted as deductions in calculating tested income if they are "properly allocable" to gross Section 951A inclusions.[64] The question of what taxes are properly allocable to Section 951A inclusions is discussed in Part IV.E.1(a).

2. Choice of Method

Each of these methods could produce very different outcomes, depending on the particular facts. For example, a nondeductible fine or penalty,[65] a payment under a hybrid instrument,[66] a loss on a sale to a related party,[67] an interest deduction that exceeded the limits under Section 163(j), and a nondeductible business entertainment or meal expense[68] would likely be allowed under the Subpart F method and the modified Subpart F method absent a regulatory exception, but not under the modified taxable income method. "Interest" expense on an instrument treated as debt for GAAP purposes but not for U.S. tax purposes because of its riskiness might even be allowed under the same circumstances.[69]

(a) The modified taxable income method

We believe that the modified taxable income method is the preferable method as a theoretical matter. Under either of the theories of GILTI discussed above, GILTI is in substance a partial world-wide tax system, with nonexempt income of a CFC effectively taxed at a reduced rate of U.S. tax (in the case of a corporate U.S. shareholder) or at the regular rate of U.S. tax (in the case of all other U.S. shareholders in the absence of a Section 962 election and Section 250 deduction).

Moreover, "gross income", the initial component of tested income, is based on U.S. tax principles.[70] It would be most logical for the second step, namely the calculation of deductions allocable to gross income, to be calculated in the same manner so that taxable income for GILTI purposes is the same as for U.S. tax purposes generally. We note that

[64] Section 951A(c)(2)(A)(ii).

[65] Section 162(f).

[66] Section 267A.

[67] Section 267.

[68] Section 274.

[69] Under the modified taxable income method, if the CFC makes a locally deductible payment under a hybrid instrument to the U.S. shareholder, there would not be a deduction from tested income, but the payment would be a dividend payment out of previously taxed GILTI inclusion and not taxable in the U.S. As a result, both the local tax deduction and the reduced GILTI rate would apply to the income underlying the hybrid payment.

[70] Section 951A(c)(2)(A)(i) refers to "gross income", which is necessarily used in the tax rather than accounting sense.

the Subpart F rules use a consistent method for calculating gross income and deductions, because it is taxable income (not merely deductions) that is determined on a GAAP basis unless the result has a material effect as compared to the use of U.S. tax principles.[71]

We also do not see a policy justification for deductions not allowed to a U.S. corporation to be allowed to a CFC in calculating tested income. Such a rule would invite "deduction shifting", since a U.S. corporation could shift nondeductible expenses to a CFC and in effect obtain a deduction at the GILTI tax rate. For example, if Section 163(j) did not apply to a CFC, the U.S. shareholder could avoid the limitations of that section (at the cost of a reduced 10.5% tax benefit) by having its existing debt assumed by the CFC or new borrowings incurred by the CFC. To be sure, such shifting of debt could have significant business consequences, and the application of Section 163(j) might not eliminate the incentive for shifting debt to CFCs.[72] Nevertheless, we do not believe taxpayers should have an incentive to make such shifts.

We acknowledge that Section 6 of Notice 2018-28 states that Section 163(j) does not prevent the application of disallowed deductions to reduce e&p, and arguably the same reasoning would disregard Section 163(j) in calculating GILTI. However, we do not think the situations are analogous. Earnings and profits is a measure of economic income or loss, many disallowed deductions reduce e&p, and in particular interest is a true cost regardless of its deductibility. As a result, the position in the Notice makes sense. On the other hand, Section 163(j) is specifically designed to prevent income stripping, and the fact that interest deductions disallowed under Section 163(j) reduce e&p is not a justification for allowing excessive interest expense to strip income out of CFCs with tested income.

Under this method, Treasury would be given the authority to specify particular variances from U.S. taxable income that would apply. This might be done for administrative convenience, such as not requiring an add-back to tested income for disallowed travel and entertainment expenses.

A disadvantage of the modified taxable income method is that it would require a corporate group to create a separate hypothetical U.S. Federal income tax return for each CFC in the group. This could be extremely difficult, since local finance officials in the CFCs are likely unfamiliar with U.S. tax principles.[73] Moreover, even minor variances from U.S. taxable income (as adjusted) could result in audit adjustments.

This difficulty in calculation might be reduced under the Subpart F method or the modified Subpart F method. Those methods begin with U.S. GAAP income, and a U.S.

[71] Treas. Reg. § 1.952-2(b)(1), (c)(2).

[72] Since there is no aggregation of CFCs for Section 163(j) purposes, debt could be incurred by particular CFCs with high levels of tested income, even if the Related CFCs in the aggregate had little tested income.

[73] We also note that if U.S. tax principles are to be used in calculating the tested income of CFCs, logically other U.S. tax principles should also apply, such as allowing aggregation of Related CFCs of a U.S. shareholder as if they filed a U.S. consolidated tax return.

group with CFCs is likely already computing its GAAP income by taking into account the income of its CFCs. On the other hand, these methods would require a determination in each case that the result was not materially different than the result under the modified taxable income method, so some knowledge of U.S. tax principles would be required in any event. In reality, the difficulties in calculation are inherent in the decision by Congress to impose a current U.S. tax on the income of CFCs.

Another disadvantage of the modified taxable income method is that it would result in tested income being calculated on a different basis than Subpart F income. This is literally consistent with Section 951A(c)(2)(A), which defines tested income as gross income not taken into account in determining Subpart F income, minus deductions allocable to such gross income under rules similar to the rules for allocating deductions under Subpart F. This language should prevent a double inclusion of gross income, or a double deduction of the same item. However, Congress may not have contemplated Subpart F and tested income being calculated on a different basis. Moreover, if deductions were allowed for one purpose but not the other, both taxpayers and the IRS would have incentives to shift deductions between the categories.

(b) The Subpart F method

The Subpart F method imports Subpart F principles into the GILTI calculations. This is consistent with the general similarity between GILTI and Subpart F. Moreover, tested income is defined in substance as total taxable income reduced by Subpart F income,[74] and it would be peculiar to determine the total on a different basis than the subtraction.[75]

However, we believe that the differences between these two regimes are sufficiently great that the existing application of the Subpart F method does not strongly support the extension of that method to GILTI. GILTI is not based on or limited to e&p, so arguably consistency between Subpart F income and GILTI was not viewed by Congress as important. Moreover, GILTI involves a vastly greater amount of potential income inclusions than Subpart F.[76] Thus, the rule for Subpart F should not be applied to GILTI without an independent policy justification.

In considering whether such policy justification exists, we note that under pre-2018 law, tax on the earnings of CFCs was deferred until e&p generated by the CFC was repatriated in the form of dividends (or deemed dividends under Section 1248 upon a sale

[74] Section 951A(c)(2)(A).

[75] The Tax Section recently asked Treasury to allow items arising under Section 987 to be determined on a basis similar to GAAP profit and loss rather than U.S. taxable income. NYSBA Tax Section Report No. 1386, *Report on Notice 2017-57: Alternative Rules for Determining Section 987 Gain or Loss*, Jan. 22, 2018.

[76] On the other hand, the prevalence of Subpart F income may increase if taxpayers create it to avoid unfavorable aspects of GILTI. This would make disparities between Subpart F income and GILTI more meaningful than at present, and planning opportunities would arise to take advantages of such disparities.

of the stock of the CFC). Subpart F represented an exception to deferral for particular categories of income,[77] and it was logically limited to the same e&p that would eventually be taxed on payment of a dividend. Moreover, the calculation of e&p is relatively similar to the calculation of GAAP income, so it made sense to use GAAP income (which would already be known) as a surrogate for e&p as long as the differences were not too great. To the extent that the GAAP calculation resulted in less Subpart F income than the e&p calculation, the difference was a timing difference for income inclusion.

By contrast, tested income and GILTI are not based on e&p. If tested income of a CFC is understated under U.S. tax principles, there is a permanent exemption of income of the CFC (calculated under U.S. tax principles) from the U.S. GILTI tax. This result does not seem consistent with the intent of Congress in imposing a tax on GILTI without regard to the e&p of the CFC.

As between the modified taxable income method and the Subpart F method, the former will usually be less favorable to taxpayers because of deductions disallowed for U.S. tax purposes but allowed for GAAP purposes. However, it will sometimes be more favorable to taxpayers. For example, in cases where U.S. tax depreciation is faster than GAAP depreciation, there will be less tested income in earlier years.

We do not believe the Subpart F method should be adopted, because we believe that it is inferior to the modified Subpart F method for the reasons described below.

(c) The modified Subpart F method

In light of the practical concerns raised by general adherence to U.S. tax principles under the modified taxable income method, and the policy concerns raised by disregarding U.S. tax principles under the Subpart F method, we believe the modified Subpart F method is superior to the Subpart F method and is a realistic alternative to the modified taxable income method. The modified Subpart F method would give Treasury the flexibility, for example, to apply the Section 163(j) limits on interest deductions. Permitting departures

[77] The Senate Finance Committee made the following comment regarding the 1962 bill that enacted Subpart F: "Under [then] present law foreign corporations, even though they may be American controlled, are not subject to U.S. tax laws on foreign source income. As a result no U.S. tax is imposed with respect to the foreign source earnings of these corporations where they are controlled by Americans until dividends paid by the foreign corporations are received by their American parent corporations or their other American shareholders. The tax at that time is imposed on the American shareholder with respect to the dividend income received, and if this shareholder is a corporation it is eligible for a foreign tax credit with respect to the taxes paid by the foreign subsidiary. In the case of foreign subsidiaries, therefore, this means that foreign income taxes are paid currently, to the extent of the applicable foreign income tax, and not until distributions are made will an additional U.S. tax be imposed, to the extent the U.S. rate is above that applicable in the foreign country. This latter tax effect has been referred to as 'tax deferral.'" The committee went on to describe the ways in which the House bill had sought to eliminate deferral only for "tax haven" devices, and the committee's amendments were "designed to end tax deferral on 'tax haven' operations by U.S. controlled corporations". S. Rep. No. 1881, 87th Cong., 2d Sess., *reprinted at* 1962-3 C.B. 703, 784-785.

from the Subpart F method in certain circumstances is also consistent with our position below that carryovers of losses of a CFC should be allowed.

Under the modified Subpart F method, taxpayers would begin with the same type of analysis with respect to each CFC that is already conducted for Subpart F purposes. They would then refer to a list formulated by Treasury of specific deductions that are disallowed to U.S. corporations and would also be disallowed in calculating GILTI regardless of their treatment for GAAP purposes

This method would limit adjustments to GAAP income to the elimination of those deductions that Treasury believes are most important to disallow for GILTI purposes. In particular, it would minimize the need to make minor add-backs such as (if Treasury agreed) for disallowed travel and entertainment expenses.

Under this method, we propose to continue the rule in the existing Subpart F regulations that the result could not be materially different than the calculation of taxable income for U.S. tax purposes. This would prevent abuse of the modified Subpart F method for GILTI purposes, just as for Subpart F purposes today.

Ultimately, a significant disadvantage of this method is that it involves dealing with three different tax systems. First, GAAP income must be determined as in the Subpart F method. Then, adjustments to GAAP income as required by Treasury guidance must be made. Finally, the result must be compared to U.S. taxable income with specified adjustments (the modified taxable income method) to see if the differences are material. On top of this, the statute specifically requires that the tax basis of assets for purposes of the QBAI calculation be determined quarterly under the alternative depreciation system of Section 168(g).[78] It is not clear that this process is any simpler than beginning with the modified taxable income method in the first place. It would also be peculiar for an asset to have a GAAP basis for calculating tested income and a Code-based tax basis for calculating QBAI.

(d) Conclusion

We recommend that Treasury adopt either the modified taxable income method or the modified Subpart F method. These methods are similar. The former starts with taxable income and allows Treasury to make adjustments to bring the result closer to GAAP income. The latter starts with GAAP income and allows Treasury to make adjustments to bring the result closer to taxable income. The choice of method depends upon whether, in the end, the desired result is closer to GAAP income or closer to taxable income. We do not take a position on this issue.

3. Loss and Interest Carryovers

(a) Carryover of operating losses

[78] Sections 951A(d)(1), (d)(3)(A).

(i) In general

Under any of the foregoing methods of determining tested income, the question arises as to whether losses can be carried forward. Consider a U.S. shareholder with a single CFC that has no QBAI return, a tested loss in year 1, an equal amount of tested income in year 2, and no foreign tax liability. Absent a loss carryover, the shareholder would have a net GILTI inclusion and resulting tax liability in year 2, in the absence of any economic income over the two year period. This result is unfair, and inconsistent with the flat-rate theory of GILTI, assuming the flat-rate theory is intended to apply over time as opposed to only in years with profits.

As a result, to the extent a U.S. corporation would be entitled to carry over a loss or deduction to a future year, we believe the same should be true under GILTI. Moreover, we believe that rules similar to the existing rules for NOL carryovers should apply. We believe this should be true under any of the methods for determining tested income described above that might be adopted for GILTI purposes.[79]

The Subpart F regulations provide that net operating losses are not taken into account in calculating taxable income for Subpart F purposes.[80] However, Subpart F income is limited to current year e&p of the applicable CFC[81] and is reduced for certain prior year e&p deficits of the same CFC from Subpart F activities.[82] In some cases, e&p deficits of other CFCs in the same ownership chain may also be used.[83] As a result, in at least some cases, an NOL carryover under such a system is not needed to prevent net Subpart F income from arising in year 2 if there is a loss in year 1 and income in year 2. Moreover, Subpart F losses are not likely to arise very often, so the rule for Subpart F should not as a policy matter determine the rule for GILTI, where tested losses are likely to arise much more frequently.

We also acknowledge that under any method of allowing carryovers, the amount of the carryover is based in part on the tested loss of a CFC. Under any of the methods of determining tested loss, the tested loss might be greater than the NOL that would arise for a domestic corporation. However, because of the restrictions on those methods, the tested loss could not be materially greater. Moreover, given that the full amount of the tested loss

[79] We do not recommend that rules similar to the e&p deficit rules apply in calculating tested income (as an alternative to loss carryovers). Many of the complexities described below relating to loss carryovers arise because of the aggregation principles inherent in the GILTI calculations, and many of the same complexities would arise in this alternative system.

[80] Treas. Reg. § 1.952-2(c)(5)(ii).

[81] Section 952(c)(1)(A), Treas. Reg. § 1.952-1(e).

[82] Section 952(c)(1)(B).

[83] Section 952(c)(1)(C).

is respected as an offset to current year tested income of other CFCs, it should logically be available in full to determine the carryover to future years.

We describe below two alternative methods to implement a system to allow the carryover of unused tested losses, one at the CFC level and the other at the shareholder level. The first method would allow a tested loss of a CFC to carry over at the CFC level to offset future tested income of the CFC, similar to an NOL carryforward of a domestic corporation. As discussed below, this gives rise to extremely complex issues because the income inclusion occurs at the shareholder rather than the CFC level, and the amount of the inclusion is affected by factors arising from other CFCs. As a result, while this approach may be the more theoretically correct one, the resulting complexities make it questionable as a practical matter.

The alternative approach is to "push out" an unused tested loss of a CFC to the shareholder and permit the shareholder to use it to reduce its GILTI inclusions in future years. We prefer this approach because it avoids many, but far from all, of the complexities of loss carryovers at the CFC level.

Both approaches raise the question of whether they could be implemented by regulation, or if legislation would be required. We take no position on this issue,[84] but we urge that Treasury either adopt our preferred method by regulation, or if it does not believe it has the authority, that legislation be adopted to implement this method.

(ii) Carryover at the CFC level

Under the existing rules, if a Related CFC has a tested loss, all or part of that tested loss is available to shelter tested income of the U.S. shareholder from Related CFCs.[85] To the extent the loss is in fact utilized in this manner, it obviously should not carry over to future years of the CFC.

We would apply this rule even if the U.S. shareholder did not obtain any tax benefit from the use of the tested loss to shelter tested income, either because the tested income had high FTCs or because the shareholder had NDTIR. For example, suppose CFC1 has a tested loss of $100, and CFC2 has tested income of $100. In addition, either CFC2's income is non-NDTIR income taxed at a high foreign tax rate, or else all of CFC2's income is NDTIR.

In either case, the shareholder has no GILTI tax even without regard to the tested loss of CFC1. However, both NDTIR and foreign tax credits are determined at the

[84] One issue under the existing statute for allowing losses to carry over at the CFC level is the rule that tested income of a CFC for a taxable year is gross income of the CFC for that year less deductions properly allocable to that gross income. The question is whether a tested loss carried over from a prior year, representing expenses in prior years that were allocable to gross income in prior years, can be considered properly allocable to gross income of the current year.

[85] Section 951A(c)(1) states that the U.S. shareholder's *pro rata* shares of tested income and tested losses of all Related CFCs for the current year are aggregated to determine net CFC tested income.

shareholder level, and in fact can arise from CFCs other than CFC1. Moreover, the application of a tax benefit principle would not be consistent with the normal rule that a loss is absorbed when it offsets taxable income, even if the taxpayer would not have been taxed on the taxable income for a reason such as high FTCs. Application of tax benefit principles would also be enormously complex and require a CFC to obtain far more information from its shareholder. As a result, we believe that a tested loss should be treated as "used" by the shareholder, and unavailable for carry forward by the CFC, whenever it offsets tested income of the shareholder, without regard to a "tax benefit" analysis at the shareholder level.

So far, this approach appears to be fairly straightforward. However, considerable complexity quickly arises.

First, rules would need to address how to determine which tested losses allocable to a particular U.S. shareholder are used to offset tested income of that shareholder. The shareholder might have multiple Related CFCs with tested income and tested loss.

The issue would only arise if the shareholder has a net tested loss, since only in that case are some tested losses from Related CFCs not utilized to offset tested income of other Related CFCs. In that case, the net tested loss at the shareholder level should logically be allocated to the various Related CFCs with tested losses in proportion to the tested loss of each Related CFC. A carryover of tested loss by each Related CFC would then be allowed to the extent of such allocation. This calculation would be done separately for each U.S. shareholder of a CFC with a tested loss.

Second, if there are multiple unrelated U.S. shareholders of a CFC, it would be necessary for the CFC to determine the extent to which its tested losses were actually used to offset the tested income of each U.S. shareholder. Perhaps a rule could be adopted that unless the CFC could provide proof that its loss was not utilized by a U.S. shareholder, the loss would be deemed to have been so utilized and could not carry over.

Third, suppose some but not all U.S. shareholders of a CFC can use their share of a tested loss in year 1.[86] The non-users would include, for example, all U.S. persons that are not U.S. shareholders of the CFC, all U.S. shareholders that do not have tested income from other CFCs, and all non-U.S. individual and corporate shareholders that directly hold stock in the CFC. The unused portion of the tested loss is the portion allocable to the shareholders in the non-user group.

It would be extraordinarily complicated to allocate the losses carried over to year 2 solely to the non-users in year 1. As a result, whatever portion of the loss is carried over will potentially benefit all U.S. shareholders in future years on a *pro rata* basis, not only the non-users in year 1. This will result in a partial double benefit to the shareholders that

[86] For simplicity, disregard shareholders who can use part but not all of their share of the tested loss.

used their share of the loss in year 1, at the expense of the non-users in year 1 who can use the loss in a later year.[87]

For example, suppose a CFC has a tested loss of $100 in year 1, and the CFC is owned 50% by a U.S. corporation and 50% by a non-U.S. corporation.[88] If the U.S. corporation can use $50 of tested losses in year 1, then $50 of tested losses would carry over to year 2. The U.S. corporation would obtain 50% of the benefit of this $50 carryover if either (i) the CFC had $50 of tested income in year 2, or (ii) the CFC had no tested income in year 2 but the U.S. corporation had $25 of unrelated tested income in year 2.

In either case, the U.S. corporation obtains 75% of the benefit of the $100 tested loss in year 1. This result might be considered particularly surprising, if, say, the non-U.S. corporate shareholder owned 100% of the U.S. corporate shareholder. In that case, 75% of the tax benefits would be shifted to the 50% U.S. shareholder. The same allocation of 75% of the tax benefits to a related U.S. party would arise if a U.S. individual owned a U.S. corporation, each owned 50% of the CFC, the CFC had a tested loss of $100 in year 1, and either the U.S. individual or the U.S. corporation, but not both, could use $50 of tested losses in year 1.

The results can be even more extreme. In the example, assume the U.S. corporation can use unlimited tested losses, the other shareholder cannot use any tested losses, and the CFC has $0 tested income in each year after year 1. As above, the U.S. shareholder uses $50 of tested losses in year 1. Then, of the $50 that carries over to year 2, the U.S. shareholder uses its $25 share. Then, the remaining $25 of tested loss carries over to year 3, the U.S. shareholder uses $12.50 of that loss, and so on literally forever.

One possible way to avoid these results in some cases would be to limit the carryover of tested losses of a CFC to losses allocable to U.S. corporate shareholders that could not use their share of the tested losses, or to U.S. individuals that could not use their share and were not related to a U.S. corporate shareholder. This would prevent the shifting of the benefit of tested losses from non-U.S. persons to U.S. persons, or among individuals and related U.S. corporations.

However, this approach could give uneconomic results for U.S. shareholders that could not use their share of the loss in year 1. They would obtain no benefit in year 1 and might receive only a *pro rata* share of a reduced tested loss in year 2.

Consider the example above with a 50% U.S. corporate shareholder and 50% non-U.S. corporate shareholder. If the U.S. corporate shareholder could use $50 of the $100 tested loss in year 1, no tested loss would carry over and the result seems correct. However,

[87] The shifting of tested losses among possibly unrelated shareholders would also raise complex basis and e&p issues similar to those discussed in Part IV.D.7 where the shareholders are related.

[88] Fifty percent U.S. ownership is used for simplicity. The CFC might be a CFC because the non-U.S. corporation has a U.S. subsidiary, or because the U.S. corporation owns 50.01% of the stock or holds stock with over 50% of the vote.

if the U.S. corporate shareholder could not use any of the tested loss in year 1, only its $50 share of tested loss would carry over, and the U.S. corporate shareholder could obtain the benefit of only $25 of that amount in year 2.

This result seems unfair. However, arguably it is justifiable on the ground that the U.S. corporate shareholder is in no worse a position than if the other shareholder was another U.S. corporate shareholder that could use its $50 share of the tested loss in year 1.

Fourth, under current law, NOL carryforwards to a taxable year can offset only 80% of taxable income for the year.[89] Tested loss carryforwards should likewise be limited to offsetting only 80% of tested income in future years. However, consider the case where in the future year the CFC has QBAI return:

> <u>Example 10(a): Carryover of tested loss to year with QBAI return</u>. A U.S. shareholder owns 100% of a single CFC, and the CFC has a tested loss of $100 in year 1. In year 2, the CFC has $100 of tested income, of which $20 is QBAI return. Absent the loss carryover, the shareholder would have a Section 951A inclusion of $80.

If the loss carryover is allowed in the amount of 80% of the year 2 tested income, the shareholder's net CFC tested income will be $100 minus $80, or $20, and its Section 951A inclusion will be $20 of net CFC tested income minus $20 of NDTIR, or $0. Thus, the loss carryover eliminates 100% of the Section 951A inclusion.

The elimination of 100% of the Section 951A inclusion for year 2 is arguably inconsistent with the purpose of the 80% limitation for domestic corporations. That rule does not allow a carryover to year 2 to eliminate 100% of the taxable income in year 2. Under this theory, the carryover should be limited to 80% of the Section 951A inclusion in year 2.

On the other hand, allowing a carryover of $80 only reduces tested income in year 2 by 80%, consistent with Section 172(a). Moreover, tested income is determined on a completely separate basis than are NDTIR and Section 951A inclusions. As a result, if the goal is to reduce the Section 951A inclusion to the U.S. shareholder by no more than 80%, it is impossible even in theory to determine at the CFC level how much of a carryover should be allowed. For example, another CFC held by the same U.S. shareholder might have QBAI return that offsets the tested income of this CFC, or might have interest expense that offsets the QBAI return of this CFC. If the CFC has more than one U.S. shareholder, then any loss carryover allowed at the CFC level will likely result in different percentage reductions to each U.S. shareholder's Section 951A inclusion.

[89] Section 172(a).

The allowance of the loss carryover equal to 80% of tested income in year 2, without regard to QBAI return, is helpful to the taxpayer in Example 10(a). However, it can also be very adverse to taxpayers.

> Example 10(b): Carryover of tested loss to year with QBAI return. Same facts as Example 10(a), but in year 2, the CFC has $100 of tested income, of which all $100 is QBAI return. Even without the loss carryover, the Section 951A inclusion is $0. If $80 of the loss carryover is allowed in year 2, it has been absorbed with no tax benefit to the U.S. shareholder.

The avoidance of the 80% limitation in Example 10(a), and the wasting of loss carryovers in Example 10(b), would not arise if the loss carryover is limited to 80% of the excess of tested income over QBAI return in the carryover year. In that case (i) the carryover utilized in Example 10(a) will be 80% of ($100 minus $20), or $64, (ii) tested income and net CFC tested income will be $36, (iii) the Section 951A inclusion will be $36 minus $20, or $16, and (iv) $36 of the $100 of tested loss from year 1 will be carried forward to year 3. The Section 951A inclusion is reduced by 80%, arguably the correct result. No carryover would be utilized in Example 10(b), and the entire $100 carryover would be available in future years.

However, as discussed above, this limitation on carryovers could reduce the Section 951A inclusion by either more or less than 80% if the U.S. shareholder had other CFCs whose attributes were included in the Section 951A calculation. Moreover, the structure of the statute seems to contemplate that tested losses will be absorbed with no tax benefit in a situation such as Example 10(b) where they shelter QBAI return. It would be peculiar (and an opportunity for tax planning) if loss carryovers gave a more favorable result.

Finally, a rule for carryovers would normally treat a carryover in the same manner as a loss realized in the subsequent year.[90] However, this principle does not resolve the present issue. The ability to use carryovers to offset only 80% of current-year income necessarily means that a carryover is not as beneficial as a current year loss. Rather, the issue here is 80% *of what*, *i.e.*, tested income or tested income reduced by QBAI return.

Fifth, even in the absence of QBAI return, the 80% limit on carryovers raises uncertainties if the U.S. shareholder has more than one Related CFC. For example, as illustrated in Examples 6 and 7 above, the shareholder's Section 951A inclusion is determined by reference to net CFC tested income and NDTIR, which take into account

[90] *See, e.g.*, the discussion of Example 12 in Part IV.3.C(2) below, where we state that carryovers of disallowed interest under Section 163(j) to a year with QBAI return should not be treated more favorably than interest expense actually incurred in the later year. The distinction is that Section 163(j) treats current and carryover interest the same in limiting the deduction to a percentage of adjusted taxable income of any taxable year, while Section 172(a) only limits NOL carryovers to a percentage of taxable income in the carryover year.

not only the tested income and QBAI return of a particular Related CFC, but also the tested income and losses, QBAI return or interest expense of other Related CFCs.

> Example 11. NOL carryover to year in which tested income is offset by tested loss of another CFC. In year 1, CFC1 has a tested loss of $100 that is not used by its 100% U.S. shareholder. In year 2, CFC1 has tested income of $100, and the U.S. shareholder also owns CFC2 that has a tested loss of $20. Assume there is no NDTIR. The Section 951A inclusion aside from the loss carryover is $80.

If the loss carryover to year 2 is allowed to offset 80% of the $100 of tested income of CFC1, then CFC1 will have tested income of $20 in year 2 and the Section 951A inclusion will be reduced from $80 to $0 as a result of the carryover. Arguably this is inconsistent with the 80% limitation on loss carryovers, although it can be argued that the carryover is at the CFC1 level and any attributes of CFC2 are irrelevant. Allowing this result would also put a premium on shifting tested income from CFC2 to CFC1 in year 2 (and, depending on the rule adopted in Example 10, shifting QBAI return from CFC1 to CFC2 in year 2), in order to maximize the utilization of the loss carryover.

Alternatively, a rule could be considered that all loss carryovers from all Related CFCs of a particular U.S. shareholder should only be allowed to offset 80% of the net Section 951A inclusion of the particular U.S. shareholder, taking into account all tested income, tested loss, and NDTIR of that shareholder. This rule would be simple when there was a single U.S. shareholder.

However, this rule would not work when there were multiple U.S. shareholders with different Section 951A inclusions from different CFCs. The reason is that only a single specified amount of the carryover can be used to offset tested income of CFC1 in year 2, and that reduction in tested income would flow through *pro rata* to all shareholders. That *pro rata* amount would normally cause a different percentage reduction of the Section 951A inclusion for different U.S. shareholders with different holdings in other CFCs.

Sixth, if carryovers of tested loss are allowed, presumably Section 382 would apply to limit loss trafficking just as it does to domestic losses. This would introduce another layer of complexity, particularly among CFCs with multiple non-affiliated owners.

Finally, the allowance of carryover of tested losses at the CFC level might be quite disadvantageous to taxpayers in some situations, especially if the law is changed in the future so that NOL carryovers can offset 100% of taxable income. If this rule was applied to allow tested losses of a CFC to offset 100% of tested income of the CFC in future years, the benefits of FTCs and QBAI return of the CFC in the future year would be eliminated, just as they are today for a CFC with no positive tested income. Such a result could be much worse for taxpayers than the disallowance of the loss carryover, since the FTCs and

QBAI return in a particular CFC could be more valuable than the tax cost of the tested income in the CFC.[91]

This issue would not arise or would be less significant under the current rule limiting the reduction in tested income by 80%, to 20% of tested income. This would always leave *some* positive tested income, which would allow full retention of FTCs and QBAI return of the CFC. However, the FTC inclusion percentage could be reduced because of the reduction in positive tested income, *e.g.*, because the QBAI return would be a greater percentage of the total positive tested income.

(iii) Carryover at the US shareholder level

We consider now the alternative approach of having tested losses arising from a CFC carry over at the shareholder level. As a reminder, tested losses of a CFC are taken into account in reducing the U.S. shareholder's income inclusion under Section 951A(a). A U.S. shareholder's Section 951A inclusion is the excess (if any) of the shareholder's net CFC tested income for the year over its NDTIR for the year.[92] Net CFC tested income is the excess (if any) of the aggregate of its *pro rata* shares of its Related CFCs' tested income over the aggregate of its *pro rata* shares of its Related CFCs' tested losses.[93]

We propose that in the first instance, all tested losses of a CFC move up to the U.S. shareholder and be taken into account by the U.S. shareholder, whether or not this gives the shareholder a net negative tested loss. These tested losses then become tax attributes of the U.S. shareholder, and are treated just like other tax attributes for all purposes, such as Section 381. The possible consequences to the U.S. shareholder's tax basis in the CFC are briefly discussed in Part IV.D.7.

Then, the question is how the tested losses that move up to the shareholder are "absorbed" in the current year and affect the amount of the carryover to future years (or are absorbed in future years and unavailable for further carryover).

The following example illustrates two methods for calculating carryovers. Assume a U.S. shareholder has two CFCs ("**CFC1**" and "**CFC2**"), CFC1 has $100 of tested income and $150 of QBAI return. CFC2 has $100 of tested loss. Under the statute, the U.S. shareholder has $0 tested income and $150 of NDTIR. As will be seen below, the two approaches give carryovers from year 1 of $0 and $150.

Under one approach (the "**tested loss carryover approach**"), $100 of tested losses would be absorbed by the $100 of tested income, and there would be no carryover of tested loss. More generally, the carryover amount would be the "**net CFC tested loss**", which

[91] Presumably losses from pre-2018 years would not carry over into 2018 because the expenses giving rise to the losses were not attributable to tested income in those years.

[92] Section 951A(b)(1).

[93] Section 951A(c)(1).

would be defined in the same manner as net CFC tested income, except tested losses of some CFCs could exceed tested income of other CFCs. Likewise, in future years, the carryover would reduce, and be reduced by, the net CFC tested income, subject to the 80% limit. This approach is consistent with carrying over tested losses at the CFC level, since as discussed above tested losses would logically offset future tested income of the CFC without any adjustment for QBAI return in the future year.

The alternative approach (the "**shareholder calculation carryover approach**") applies the entire calculation at the shareholder level. If the Section 951A formula for inclusion would result in a negative number, aside from the prohibition of a negative result, that amount could be carried over, just like any excess of taxable expenses over taxable income. In the example, the Section 951A formula would result in minus $150 in year 1 (net tested income of $0 and NDTIR of $150), and this could be carried over.

This approach allows NDTIR not only to offset net CFC tested income, but also allows NDTIR to create its own carryover if it exceeds net CFC tested income. Specifically, the carryover of the negative amount in the GILTI formula is equal to net CFC tested income minus NDTIR, to the extent this number is negative and without regard to whether it exceeds aggregate tested losses of loss CFCs for the year. This approach, like the tested loss carryover approach, does not provide any benefit from shifting income and deduction among CFCs, since only net CFC tested income (or loss) is relevant.

This approach in effect treats NDTIR as exempt income earned on tangible assets, whether or not that is true in fact. It assumes that, say, a CFC with $100 of tested income and $150 of QBAI return *really* had a $50 tested loss on intangible assets and $150 of income on tangible assets, whether or not that is true as a factual matter. The shareholder obtains "credit" for the deemed $50 loss on intangible assets by being allowed a loss carryover of $50.

On the other hand, even aside from carryovers, the statute does a poor job of treating NDTIR as exempt income, such as by not providing any current year tax benefit for NDTIR when tested loss equals tested income. Moreover, this discussion began with the idea that tested losses of a CFC should be allowed to carry over if they are not utilized currently by the shareholder. It is a considerable leap from that position to the idea that the Section 951A calculation should be allowed to become negative and result in a loss carryover even in the absence of a net CFC tested loss. As a result, this approach would be a more significant conceptual change from the existing statute.[94]

[94] We considered a third, intermediate, approach under which NDTIR would offset tested income from CFCs with positive tested income, freeing up such amount of tested losses from CFCs with tested losses to be used currently against remaining tested income or to carry over. Only tested losses could carry over. However, this approach would allow the benefit of NDTIR to increase through the shifting of income and deduction within the group. In fact, if income and deduction items were shifted so that CFCs with positive tested income had total tested income equal to NDTIR, the group would achieve the result of the shareholder calculation carryover approach.

We turn now to a separate issue. Either of the approaches for allowing a loss carryover at the U.S. shareholder level would raise a number of questions.

First, a U.S. shareholder could have a regular NOL carryover and a GILTI NOL carryover (aside from any Section 163(j) carryover from its own activities). GILTI NOLs would not offset non-GILTI income, just like a negative GILTI inclusion for the current year cannot offset non-GILTI income of the shareholder. However, non-GILTI loss carryovers should be available to offset GILTI inclusions, just like current non-GILTI losses can offset GILTI inclusions.

As a result, an ordering principle would be needed to establish which losses are used first. For example, current year losses are typically used before loss carryforwards. However, if the current year has a GILTI inclusion and a non-GILTI loss, and there is a GILTI loss carryforward, arguably the carryforward should be used first since it is of more limited use. Likewise, loss carryovers are usually utilized earliest year first. However, if there is a GILTI inclusion in the current year, arguably all GILTI carryovers should be used before any non-GILTI carryovers, for the same reason.

Second, the GILTI loss carryover (however defined) would presumably be subject to the same 80% limit for use against future GILTI income as are regular NOLs. There is no reason that these carryovers should be exempt from the rule. Suppose that there is both a GILTI inclusion and non-GILTI income in the year, and sufficient carryovers of both types. The question is whether each type of carryover should be limited to offsetting 80% of its respective income type.

The alternative would be an aggregate limitation on carryovers equal to 80% of total income, with a preference given to the GILTI carryovers. For example, if there was $100 of GILTI inclusion and $100 of non-GILTI income and sufficient carryovers of both types, the net result could be either (1) $20 of GILTI inclusion and $20 of non-GILTI income, or (2) $0 of GILTI inclusion and $40 of non-GILTI income.

Third, having GILTI and non-GILTI carryovers would raise issues under Section 382. Suppose a corporation had $100 of each type of carryover, and a Section 382 event occurred that limited annual use of NOLs to $20. There are at least three possibilities:

- The aggregate limit of $20 would be available for any $20 of carryovers, and if the usual priority was for GILTI carryovers, that priority would continue to apply until the entire $20 was used up.

- The annual limit of $20 would be divided up *pro rata* between GILTI and non-GILTI carryovers based on their relative size.

- The annual limit of $20 would be divided between GILTI and non-GILTI carryovers based on the relative value of the assets generating GILTI inclusions and other assets.

The third alternative is supported by the fact that the Section 382 limit is equal to a percentage of the value of the stock of the shareholder at the time of the change in ownership.[95]

Yet another issue arises because under Notice 2003-65,[96] the Section 382 limit is adjusted by "recognized built in gain and loss". The question arises if the second or third alternative in the preceding paragraph is used. In those cases, the Notice 2003-65 amount could be calculated separately to adjust the GILTI and non-GILTI carryovers, or it could be done for the corporation as a whole and then allocated between the two carryovers in the same manner as the rest of the NOL limitation.

We note that while these issues appear to be complicated, in reality they are primarily design choices. Once the choice is made by regulations or legislation, the rules appear to operate relatively simply, in contrast to the operational effects of carrying over losses at the CFC level.

(b) Section 163(j) carryovers

We discuss in Part IV.C.2 the method for determining the taxable income of a CFC. Under our proposal, Treasury would have the authority to determine whether Section 163(j) applies to a CFC. If the limitations of Section 163(j) apply, we believe that all of Section 163(j) should apply, including the carryover of unused interest deductions in the same manner as for a domestic corporation. As in the case of tested loss carryovers, we urge that either regulations or legislation provide for Section 163(j) carryovers.

We have the following reasons for this conclusion. The interest deductions that are disallowed currently under Section 163(j) are for interest that would reduce tested income if it was allowed. A taxpayer should not be in a worse position if an interest deduction is disallowed under Section 163(j) than if the interest deduction was allowed and created a tested loss that was permitted to be carried over. Moreover, absent a carryover rule, a CFC could have plenty of tested income over a period of two or more years, but because the income is bunched into a few of the years, interest deductions would be permanently disallowed. This result is unfair to taxpayers, a trap for the unwary, and an incentive to engage in nonproductive activities to equalize income over a period of years.

In addition, a carryover is necessary to mitigate the consequences of "phantom income" or "phantom tested income" that can arise from a Section 163(j) disallowance for interest paid between related parties. Suppose a CFC ("**CFC1**") pays interest to a related CFC ("**CFC2**") and the interest deduction is disallowed under Section 163(j). Then, CFC2 has an increase in tested income from the receipt of the interest payment, but CFC1 does not have a reduction in tested income. The group has net positive tested income, which

[95] Section 382(b)(1).

[96] 2003-2 C.B. 747.

may result in a Section 951A inclusion, without any cash profit.[97] Similarly, if a CFC pays interest to its U.S. shareholder and the interest deduction is disallowed under Section 163(j), the U.S. shareholder has taxable interest income but the CFC does not have a reduction in tested income.[98]

Of course, this result could also arise for an interest payment between two related but nonconsolidated U.S. corporations. In that case, however, the interest disallowed under Section 163(j) can be carried forward to reduce future tax liability. A carryover at the CFC level would ameliorate the same risk in the GILTI regime.

Although we recommend applying loss carryovers at the U.S. shareholder level, we recommend applying Section 163(j) carryovers at the CFC level. This is most consistent with the language of Section 163(j)(2), which treats the carried over amount as paid or accrued in the succeeding taxable year.

Moreover, many of the difficulties that arise in the context of a carryover of tested losses at the CFC level do not arise in the context of Section 163(j) carryovers. The reason is that tested loss is determined at the CFC level but used at the U.S. shareholder level, while both Section 163(j) limitations and carryovers of disallowed interest deductions are determined and used at the CFC level. As a result, there is no need to reduce carryovers that have been used by shareholders, and no possibility of some shareholders receiving a double benefit from a carryover. Attempting to apply Section 163(j) carryovers at the U.S. shareholder level would introduce unnecessary complexity.

We note that the Code already applies Section 382 to Section 163(j) carryovers,[99] so this limitation is already built into the system and should apply equally to domestic and foreign corporations. In contrast to tested losses, no regulations or statutory amendment would be required to achieve this result.

As in the case of the 80% limit for NOL carryovers, there is a question as to how the 30% limit on Section 163(j) carryovers should apply to the tested income of the CFC that also has QBAI return in the carryover year. Consider the following variation on Example 10(a) above.

> <u>Example 12: Carryover of Section 163(j) deduction to year with QBAI return</u>. A U.S. shareholder owns 100% of a single CFC, and the CFC has an excess Section 163(j) deduction of $100 in year 1. In year

[97] Alternatively, the interest income might be foreign personal holding company income to CFC2, which could give rise to a better or worse result depending on the group's FTC position. *See* L.G. "Chip" Harter and Rebecca E. Lee, *A Brave New World—The Application of code Sec. 267(a)(3)(B) to Expenses Accrued by Controlled Foreign Corporations*, CCH Int'l Tax. J. May-June 2008, at 5.

[98] In the absence of a rule allowing carryovers in these cases, relief could only be provided by a rule treating non-consolidated affiliates as a single corporation.

[99] Section 382(d)(3), added by the Act.

2, the CFC has $100 of tested income, of which $30 is QBAI return. Absent the loss carryover, the shareholder would have a Section 951A inclusion of $70.

If the carryover is limited to 30% of tested income, or $30, then tested income is reduced to $70. Then, the U.S. shareholder's NDTIR is reduced by the $30 of allowed interest, namely to $0, since interest expense first reduces NDTIR until NDTIR is reduced to $0.[100] As a result, the U.S. shareholder's Section 951A inclusion is still $70, and the $30 interest carryover is absorbed but provides no tax benefit.

Arguably the allowed carryover should be increased by $21, to $51, to reduce the Section 951A inclusion by 30%, to $49. However, if the interest expense of $100 had actually been incurred in year 2, $30 would be allowed under Section 163(j), tested income would be $70, NDTIR would be $0, and the Section 951A inclusion would be $70. Under Section 163(j)(2), a carryover is to be treated the same as, not better than, interest actually incurred in year 2. Moreover, interest expense and QBAI return in another related CFC of the same U.S. shareholder can affect the Section 951A inclusion of the U.S. shareholder. As a result, any Section 163(j) limitation based on QBAI return of the particular CFC with carryovers will have varying effects on the Section 951A inclusion depending on the attributes of the other CFCs and, in the case of a CFC with more than one U.S. shareholder, will have varying effects for different U.S. shareholders.

The combined effect of (1) limiting current or carryover interest expense to 30% of tested income, and (2) disallowing any benefit of the interest expense to the extent of NDTIR, is a rather extreme result. However, this clearly is the result under the statute if the interest expense was incurred in the current year. It would not even help materially if regulations limited the Section 163(j) current or carryover amount to 30% of the excess of tested income over QBAI return of the particular CFC, since the allowed deduction would still reduce NDTIR before providing any tax benefit.

The Section 163(j) carryover also raises the question of how to deal with a situation similar to that raised in Example 11.

<u>Example 13: Section 163(j) carryover to year in which tested income is offset by tested loss of another CFC.</u> In year 1, CFC1 has a Section 163(j) carryover of $100 to year 2. In year 2, CFC1 has tested income of $100, and the U.S. shareholder also owns CFC2 that has a tested loss of $70. The Section 951A inclusion aside from the carryover is $30.

If the carryover to year 2 is allowed to the extent of 30% of the $100 of tested income of CFC1 in year 2, then tested income of CFC1 will be $70 and the Section 951A

[100] Section 951A(b)(2)(B).

inclusion will be $0. The reduction in Section 951A inclusion from $30 to $0 is arguably not consistent with the intent of the 30% limitation in Section 163(j).[101]

On the other hand, it can be argued that the result is correct, since the Section 163(j) limit is properly determined at the level of the particular CFC. Moreover, attempting to limit the carryover that is used by CFC1 to 30% of the Section 951A inclusion for year 2 would raise the same issues discussed in the previous examples if the U.S. shareholder had other CFCs with interest expense, QBAI return, etc., or if CFC1 had more than one U.S. shareholder.

D. Other Computational Issues for GILTI Inclusions

1. Order of GILTI versus Section 956 Inclusions

Regulations should confirm that tested income of a CFC is determined before Section 956 inclusions.

It is clear from the Code that Subpart F income is determined before Section 956 inclusions.[102] Treasury Regulations confirm this result.[103] Moreover, the definition of tested income specifically excludes Subpart F income,[104] so Subpart F income must be determined before tested income can be determined.

Section 951A(f)(1)(A) states that Section 951A inclusions are to be treated as Subpart F inclusions for purposes of Section 959. Therefore, since Subpart F inclusions come before Section 956, tested income should also come before Section 956. Under this interpretation, which we refer to as "**GILTI First**", the U.S. shareholder would first report a GILTI inclusion, and this inclusion would create a PTI account.[105] Investment by the CFC in U.S. property under Section 956 would give rise to incremental income inclusions only to the extent it exceeded the PTI account and there was additional e&p available. This

[101] Under this theory, the carryover is limited to 30% of the Section 951A inclusion of $30, so the allowed carryover is $9, net tested income of CFC1 is $91, and the Section 951A inclusion is $91 less $70, or $21.

[102] Subpart F income is included under Section 951(a)(1)(A) and Section 956 amounts are included under Section 951(a)(1)(B). Section 956 inclusions under Section 951(a)(1)(B) are specifically limited by Section 959(a)(2), which states that e&p attributable to PTI is not included in income again either as a Subpart F inclusion or a Section 956 inclusion. Section 959(f)(1) says that amounts that would be Section 956 inclusions are attributable to PTI to the extent of prior Subpart F inclusions. By contrast, Section 951(a)(1)(A) includes no similar PTI-based limitation for Subpart F inclusions. As a result, Subpart F income causes a Subpart F inclusion, which creates PTI and (assuming the income is not distributed) thereby limits Section 956 inclusions to the extent of that PTI.

[103] Treas. Reg. § 1.959-1(a).

[104] Section 951A(c)(2)(A)(i)(II).

[105] Sections 951A(f)(1)(A), 959. We assume for simplicity that the CFC has a single U.S. shareholder and that there is no Subpart F income.

result avoids any double inclusion of income of the CFC into the income of the U.S. shareholder.

By contrast, if Section 956 inclusions were determined before tested income is calculated ("**Section 956 First**"), any Section 956 income inclusion (up to e&p) would first create a PTI account. Then, since tested income is not reduced by Section 956 inclusions and (crucially) is not limited to e&p, tested income would be determined completely without regard to the Section 956 inclusion. This would result in a double inclusion of the income of the CFC into the income of the U.S. shareholder.

To be sure, each inclusion would create its own PTI account and basis increase.[106] As a result, the second inclusion in income might provide a tax benefit to the U.S. shareholder on a future distribution from the CFC or on sale of the CFC stock. However, this benefit might be far in the future, and the benefit could be in the form of a future capital loss with a tax benefit of less than the current cost of ordinary income. In any event it would be quite anomalous for $1 of earnings to create $2 of PTI and $2 of basis increase.

We do not believe Congress intended these results. Consequently, we believe that GILTI First is more consistent with both the plain meaning of the statute and the intent of Congress.

In principle, it would be possible for "Section 956 First" to apply, with tested income being reduced for Section 956 inclusions. However, actual distributions do not reduce tested income, so it would be inconsistent for deemed distributions from Section 956 inclusions to do so.

Moreover, in some cases taxpayers will prefer Section 956 inclusions and in other cases they will prefer tested income, in part because of very different FTC rules. This modified version of "Section 956 First" would effectively create an elective regime where well-advised taxpayers could choose between Section 956 and tested income by having CFCs making (or not making) loans to U.S. shareholders or otherwise investing in U.S. property. On the other hand, the same rule would create a trap for the unwary for less well advised taxpayers.

We observe that in applying GILTI First, a U.S. shareholder's income inclusion is based first on the CFC's Subpart F income (which is limited to e&p), then on its tested income and NDTIR (which are not based on e&p), and finally by Section 956 (which is limited to e&p). This ordering is not intuitive, but for the reasons described above, it seems most consistent with the language and purpose of the statute.

2. GILTI and Subpart F Inclusions in a Year When CFC Stock is Sold

When stock of a CFC is sold in the middle of a taxable year, in some cases the Subpart F income and GILTI inclusions allocable to the selling shareholder for the pre-sale portion of the year of the sale are permanently eliminated from the U.S. tax base. These

[106] Sections 951A(f)(1)(A), 959 and 961(a).

results arise because of the enactment of Section 245A.[107] We discuss ways in which legislation or regulations could prevent these results. However, we do not take a position on whether any such legislation or regulations should be adopted.

(a) Background

The Section 951A inclusion applies only to a U.S. shareholder of a CFC that owns (directly or indirectly through a foreign entity) stock in the CFC on the last day of the taxable year of the CFC that it is a CFC (the "**last CFC date**").[108] The same rule applies to a Subpart F inclusion.[109] The U.S. shareholder's Section 951A inclusion is based on its *pro rata* share of the CFC's tested income for the CFC's taxable year.[110] The U.S. shareholder's *pro rata* share of tested income, tested loss, and QBAI is determined "under the rules of section 951(a)(2) in the same manner as such section applies to subpart F income".[111]

Assume that a U.S. shareholder owns X% of the CFC stock on the last CFC date, and the CFC is a CFC for Y% of the year. Under Section 951(a)(2), the U.S. shareholder's *pro rata* share of the Subpart F income for the year is equal to:

- X% times Y% times the Subpart F income for the entire year, including periods after the last CFC date, *see* Section 951(a)(2)(A), *minus*

- actual dividends paid by the CFC during the tax year to other holders of the stock (or deemed dividends under Section 1248(a) on a sale of the stock by another holder), but not in excess of the product of (i) X% (the ownership percentage), (ii) the Subpart F income for the year, and (iii) the percentage of the year that the U.S. shareholder did not own the stock, *see* Section 951(a)(2)(B).

In other words, the *pro rata* share of the U.S. shareholder on the last CFC date is first determined as if the U.S. shareholder had held the stock for the entire period of the year through the last CFC date. That amount is then reduced by dividends to another holder of the same stock during the year, but only to the extent those dividends do not exceed the Subpart F income attributable on a *pro rata* basis to the period that the U.S. shareholder did not own the stock.

[107] The Tax Section is preparing a separate report on Section 245A.

[108] Section 951A(e)(1) and (2). This rule is also expressly stated in the Conference Report at 645.

[109] Section 951(a)(1).

[110] Section 951A(a), (b)(1)(A) and (c)(1)(A).

[111] Section 951A(e)(1). This section is written in a rather peculiar way because it refers separately to tested income, tested loss, and QBAI, but since these three items are in effect combined to determine the Section 951A inclusion, we assume it is intended to apply the *pro rata* rule to the Section 951A inclusion.

As will be seen below, these rules worked well under the prior law rules for Subpart F. However, they can now allow Subpart F income and tested income allocable to a U.S. shareholder for the portion of the taxable year before the shareholder sells its stock to avoid being a Subpart F or GILTI inclusion or ever being included in U.S. taxable income to anyone.

(b) Fact patterns and results

(i) *Sale of a CFC from one Section 958(a) U.S. Shareholder to another Section 958(a) U.S. Shareholder*

Consider first the case where a CFC is a CFC throughout the year and has 100% U.S. shareholders throughout the year that are subject to Subpart F or GILTI inclusions, *i.e.*, they are shareholders under Section 958(a) ("**Section 958(a) U.S. Shareholders**"). Assume in all cases that the relevant CFCs have no PTI as of the beginning of the year in question, there is no gain in the CFC stock on January 1 of the year in question, the U.S. shareholder's holding period for the CFC stock satisfies the Section 245A holding period requirement,[112] the U.S. shareholder holds no other CFCs and none of the relevant CFCs has any QBAI return.

> <u>Example 14(a) (CFC with Section 958(a) U.S. shareholders throughout the year)</u>: A U.S. shareholder (US1) owns the CFC. During the year, the CFC has $1000 of earnings. On June 30, the CFC pays a dividend of $500 to US1, and immediately thereafter US1 sells the stock to another Section 958(a) U.S. shareholder (US2) at no gain or loss. US2 continues to own the stock until the end of the year, so the last CFC date is December 31.

Consider first this fact pattern under prior law, and assume that the $1000 of earnings is all Subpart F income. US1 did not have any Subpart F inclusion because it was not a shareholder on the last CFC date. Thus, it did not have any PTI account, and the $500 dividend it received was taxable at ordinary rates. US2 had Subpart F income of $1000 under Section 951(a)(2)(A), but this was reduced by $500 under Section 951(a)(2)(B). Thus, the total inclusion was $1000, the full amount of Subpart F income for the year.

The same result would arise if there had been no dividend, but US1 had sold the stock of the CFC to US2 on June 30 for a gain of $500. Then, the gain would be a deemed dividend under Section 1248 subject to the same rules. Section 951(a)(2)(B) is essential in these cases to avoid double taxation of $500 of Subpart F income, since otherwise $500 would be taxed to US1 and $1000 would be taxed to US2.

[112] *See* Section 246(c).

Consider now the same fact pattern under current law. Just as under prior law, US1 does not have a Subpart F inclusion or PTI account, US1 has dividend income of $500, and US2 has Subpart F income of $1000 minus $500, or $500. However, now the dividend of $500 received by US1 is eligible for the 100% dividends received deduction under Section 245A. Likewise, if US1 sold the stock at a $500 gain without taking out the dividend, new Section 1248(j) provides that the deemed dividend under Section 1248 is eligible for the Section 245A deduction.

In either of these cases, US2 would obtain a PTI account of $500 by the first day of the CFC's next taxable year and could withdraw that amount tax free under Sections 959(a) and (e). As a result, in both the dividend and Section 1248 cases, $500 of Subpart F income permanently goes untaxed. Section 951(a)(2)(B), which was originally intended and needed to avoid double taxation of Subpart F income, is now eliminating even a single level of taxation of Subpart F income.

Since the Section 951A rules incorporate the Subpart F rules, the same results arise if income of the CFC is tested income rather than Subpart F income. Again, since US1 is not a shareholder on the last CFC date, it does not have a Section 951A inclusion. US2's *pro rata* share of tested income is $1000 minus the distribution or deemed distribution to US1 of $500, or $500. US1 has a taxable dividend or deemed dividend of $500 and a Section 245A deduction of $500. The CFC has $1000 of tested income for the year, but only $500 of it is taxable (to US2).

These results arise even if US2 is related to US1 (assuming no Section 304 transaction). In addition, an even more taxpayer-favorable result arises if the sale is near the end of the taxable year of the CFC, and so there will be tax benefits to deferring a sale until that time of year. In some cases it might also be possible for US1 to change the taxable year of the CFC to be the 12-month period ending shortly after the sale, to fix the amount of income in the previous portion of the year that would not be taxed under Subpart F or Section 951A.

This elimination of tax on Subpart F income or GILTI inclusions arises because Section 951(a)(2)(B) reduces the Subpart F inclusion (and because of the cross-reference in Section 951A(e)(1) to Section 951(a)(2), the tested income) regardless of whether the dividends to prior shareholders are subject to U.S. tax. In particular, the elimination of tax arises because Section 951(a)(2)(B) applies to dividends paid in the year of sale even if the dividends are eligible for the Section 245A deduction to the shareholder.[113]

(ii) *Sale of CFC stock from a Section 958(a) U.S. Shareholder to a Non-U.S. Shareholder; CFC ceases to be a CFC*

We now consider how existing law applies when the CFC ceases to be a CFC on the sale date.

[113] If the distribution to US1 is not taxable because of a preexisting PTI account, such as on account of a prior Section 965 inclusion, it is not a dividend covered by Section 951(a)(2)(B).

<u>Example 14(b) (CFC for only part of year).</u> A Section 958(a) U.S. shareholder (US1) owns the CFC on January 1. During the year, the CFC has $1000 of earnings. On June 30, the CFC pays a dividend of $500 to US1, and immediately thereafter US1 sells the stock to a non-U.S. shareholder (F1) at no gain or loss on the stock. F1 continues to own the stock until the end of the year. Assume no attribution rules apply, so the last CFC date is June 30.

In this case, US1 is a Section 958(a) U.S. shareholder on the last CFC date. As a result, US1 has Subpart F income or a Section 951A inclusion, and PTI, equal to the Subpart F income or tested income for the year, or $500, as well as a Section 250 deduction if the income is tested income. Section 951(a)(2)(B) never applies, since there is no prior shareholder of the relevant stock. The $500 dividend to US1 is out of PTI, and so there is a single inclusion of $500 of Subpart F income or a net Section 951A inclusion of $250. The statute reaches the correct result without regard to Section 951(a)(2)(B). The same result arises if there is no dividend on June 30, but instead the stock is sold at a gain of $500. There is still a Subpart F inclusion of $500 on June 30 and Section 1248(d)(1) excludes such amount from being taxed again under Section 1248.

However, there is one further issue. Section 951A(e)(3) states that for purposes of Section 951A, "a foreign corporation shall be treated as a controlled foreign corporation for any taxable year if such foreign corporation is a controlled foreign corporation at any time during such taxable year." This rule was apparently intended to conform the Section 951A rules to the repeal of the rule that had been in Section 951(a) and that had prevented the application of Subpart F to a corporation that was a CFC for less than 30 days during the year.

Yet it is possible to read this provision as stating that in Example 14(b), the CFC is treated as a CFC for the entire year even though it has no actual or constructive U.S. owners in the second half of the year. We do not think this result was intended, since it would make meaningless the rules in Section 951 that look to the last day of the year on which the CFC is a CFC. Such last day would always be the last day of the taxable year. We recommend that regulations clarify that this provision is merely stating that there is no minimum period of time for a CFC to qualify as a CFC in order for it to be a CFC during its qualification period.

(iii) *Sale of CFC Stock from a Section 958(a) U.S. Shareholder to a non-U.S. Shareholder; CFC remains a CFC*

We now turn to another case where, as in Example 14(a), the CFC remains a CFC until the end of its tax year.

<u>Example 14(c) (CFC for whole year, taxable Section 958(a) U.S. shareholder for only part of</u>

year). U.S. shareholder (US1) owns the CFC on January 1. During the year, the CFC has $1000 of earnings. On June 30, the CFC pays a dividend of $500 to US1, and immediately thereafter US1 sells the stock to a buyer (F1) at no gain or loss. Assume F1 continues to own the stock until the end of the year, and the CFC remains a CFC through the end of the year.

Suppose the prior Subpart F rules apply, the income was Subpart F income, and there was no Subpart F inclusion for the year to any U.S. taxpayer because there was no U.S. taxpayer with Section 958(a) ownership on December 31, the last CFC date. This fact pattern would have arisen, for example, if F1 was a U.S. partnership with all foreign partners.[114] While the partnership would have the Subpart F inclusion as a U.S. shareholder on the last CFC date, none of its partners would be subject to U.S. tax. Section 951(a)(2)(B) was irrelevant because it merely reduces a Subpart F inclusion. However, US1 had a taxable dividend of $500 on June 30, which was taxable because US1 had no PTI. The same is true if there was no dividend and US1 sold the stock on June 30 at a gain of $500, since Section 1248(a) would apply to the gain.

Now assume these facts arise in 2018, and the income is either Subpart F income or tested income. The CFC will remain a CFC following the sale to F1 far more often under current law than before the Act. The reason is that the Act repealed Section 958(b)(4), which prevented a U.S. corporation from being considered a U.S. shareholder by virtue of attribution from a related foreign person.[115] Now, the CFC will continue to be a CFC through the end of the year even if F1 is a foreign corporation, as long as F1 has at least one U.S. subsidiary, since the subsidiary will constructively own the CFC stock owned by F1.

As before, there is no Subpart F or Section 951A inclusion, because the last CFC date is December 31 and there is no Section 958(a) U.S. shareholder on that date.[116] Section 951(a)(2)(B) is irrelevant because it merely reduces a Subpart F (and now a Section 951A) inclusion. The dividend to US1 is included in its gross income since the CFC has e&p and there is no PTI. However, the dividend is eligible for the Section 245A deduction, so there is no net income inclusion. The same is true if there was no dividend and the stock

[114] This fact pattern would also have arisen as to, say, 49% of the stock of the CFC if US1 sold 49% of the stock of the CFC to a foreign corporation and retained the rest. The CFC would have remained a CFC throughout the year with a 51% U.S. shareholder, but there would have been no Subpart F inclusion on December 31 as to the 49% purchased interest.

[115] The scope of the repeal of Section 958(b)(4) is discussed in Part IV.G.3.

[116] Even if the CFC remains a CFC because F1 has a U.S. subsidiary that is a U.S. shareholder for determining CFC status, the subsidiary is not a U.S. shareholder under Section 958(a) and therefore has neither a GILTI inclusion (Section 951A(e)(2)) nor a Subpart F inclusion (Section 951(a)(1)).

was sold at a gain of $500, since Section 1248(j) treats the Section 1248(a) gain as a dividend for purposes of Section 245A.

Thus, the Subpart F income or tested income allocable to US1, the selling U.S. shareholder of the CFC with Section 958(a) ownership, has permanently avoided U.S. tax by being converted into a tax-free dividend.[117] Moreover, no interpretation or amendment of Section 951(a)(2)(B) will change this result, since there is no inclusion of Subpart F or tested income that is being reduced by that provision. As before, the goal of US1 would be to sell the stock shortly before the end of the tax year of the CFC, and either take out a tax-free dividend shortly before the sale or else recognize a corresponding tax-free dividend under Section 1248.

As noted above, this permanent elimination of tax on Subpart F income and Section 951A inclusions will be more common in light of the repeal of Section 958(b)(4), since there will now be many more situations where a CFC remains a CFC even though it does not have a taxable Section 958(a) U.S. shareholder. However, the issue is conceptually distinct from such repeal, since the issue could arise even if Section 958(b)(4) were fully restored. For example, as in the discussion of prior law above, the same issue would arise (a) if the sale of 100% of the stock was to a U.S. partnership to the extent the partnership had foreign partners that would not be required to report their share of partnership income, or (b) as to 49% of the tested income of a CFC, if a 51% direct U.S. shareholder retained its stock for the entire year, and a 49% direct U.S. shareholder sold its stock in the middle of the year to a non-U.S. person.

(iv) *Sale of stock of second tier CFC where ownership of top CFC does not change*

Similar issues arise when a first tier CFC receives a dividend from, or sells the stock of, a second tier CFC during a taxable year, where the ownership of the first tier CFC does not change. This transaction is identical as an economic matter to the situation in Examples 14(a), (b), and (c) if the first tier CFC is a shell company, and if the buyer of the CFC stock is the same in each case. The result is in substance the same as in the previous situations.

The different fact patterns discussed above are now discussed in this lower-tier CFC context. In the examples, a U.S. shareholder ("**US1**") directly owns all the stock of a top tier CFC ("**CFC1**"), CFC1 directly owns all the stock of the lower tier CFC ("**CFC2**"), and CFC1 has no income or assets other than the stock of CFC2. As before, assume in all cases that the relevant CFCs have no PTI as of the beginning of the year in question, there is no gain in the CFC stock on January 1 of the year in question, the U.S. shareholder's holding

[117] The converse situation would arise in Example 14(c) if F1 owned the stock in the first part of the year and sold it (without a distribution) to US1 on June 30. US1 would have a Subpart F or tested income inclusion on December 31 equal to the CFC's income for the entire year, and it is doubtful that an offset would be allowed under Section 951(a)(2)(B). The offset is only allowed for an amount included in gross income under Section 1248, and a non-U.S. person such as F1 would not have any gross income under Section 1248 or otherwise. A pre-sale dividend to F1 would avoid this problem.

period for the CFC stock satisfies the Section 245A holding period requirement,[118] the U.S. shareholder holds no other CFCs and none of the relevant CFCs has any QBAI return.

> Example 14(d) (Second Tier: CFC2 has Section 958(a) U.S. shareholders throughout the year): During the year, CFC2 has $1000 of earnings. On June 30, CFC2 pays a dividend of $500 to CFC1, and immediately thereafter CFC1 sells the stock of CFC2 to a Section 958(a) U.S. shareholder ("**US2**") at no gain or loss on the stock. US2 continues to own the stock until the end of the year, so the last CFC date for CFC2 is December 31.

Consider first this fact pattern under prior law, and assume that the $1000 of earnings is all Subpart F income. US1 did not have any Subpart F inclusion from CFC2 because it was not a shareholder on the last CFC date. US2 had Subpart F income of $1000 from CFC2 under Section 951(a)(2)(A), but this was reduced by $500 under Section 951(a)(2)(B). However, US1 would have an additional $500 of income either when CFC1 received the dividend as Subpart F income (*i.e.*, if the same country exception did not apply), or (if not Subpart F income initially) when CFC1 paid the cash to US1 or when US1 sold the stock of CFC1. Thus, the total inclusion was $1000, the full amount of Subpart F income for the year.

The same result would have arisen if there had been no dividend, but CFC1 had sold the stock of CFC2 to US2 on June 30 for a gain of $500. Under Section 964(e)(1), CFC1 would have a deemed dividend as if Section 1248(a) applied, and the foregoing results would be unchanged. Note that Section 951(a)(2)(B) is essential in these cases to reduce US2's Subpart F inclusion from $1000 to $500, since otherwise $500 would be taxed to US1 and $1000 would be taxed to US2.

Now consider the effects of the Act. The Act added new Section 964(e)(4), which provides that when CFC1 sells the stock of CFC2, the Section 1248(a) amount created by Section 964(e)(1) is Subpart F income to CFC1, is includible in the income of US1, and is eligible for the Section 245A deduction in the same manner as if the Subpart F income were a dividend from CFC1 to US1.

Return now to Example 14(d) under current law, and assume the $1000 of income of CFC2 is Subpart F income or tested income. The dividend to CFC1 would not be Subpart F income or tested income in CFC1's hands.[119] CFC1 could pass on the dividend

[118] *See* Section 246(c).

[119] Under Section 951A(c)(2)(A)(i)(IV), a dividend from a related party is not tested income. The dividend might be exempt from Subpart F income to CFC1 under Section 954(c)(3) (same country exception) or Section 954(c)(6) (look-through rule). Note that the look-through rule does not apply if the underlying income is Subpart F income, but there is no exclusion if the underlying income is tested income. At least if the underlying income is Subpart F income and the same-country exception does not apply, CFC1 would apparently be entitled to the Section 245A deduction, *see* Conference Report at 599 n. 1486.

to US1, and US1 would be eligible for the Section 245A deduction. If instead CFC1 sells the CFC2 stock at a gain of $500, under Section 964(e)(4), US1 will have a deemed Subpart F inclusion that is eligible for the Section 245A deduction.[120] In addition, in either case, US2 will continue to have $1000 of Subpart F income or Section 951A inclusion that is reduced, under Section 951(a)(2)(B), by an actual dividend of $500 paid by CFC2 to CFC1, or by "any gain included in the gross income of any person as a dividend under section 1248". If CFC2 paid an actual dividend of $500, US2's CFC inclusion would be $500, and the clear intent is that the same result arises if CFC1 sold the stock for gain of $500.[121]

These results are similar to the results today under Example 14(a) when the stock of a first tier CFC is sold in the middle of the year to another U.S. shareholder. Here, if CFC2 has $1000 of tested income, the Section 951A inclusion reported for the year is $500. Likewise, if CFC2 has $1000 of Subpart F income, the Subpart F inclusion for the year is $500. In both the GILTI and Subpart F cases, the Act has conformed the results of the sale of stock of a second tier CFC to the results of a sale of a first tier CFC.

Next, consider the analog to Example 14(c), where CFC1 sells the stock of CFC2 to F1 and CFC2 continues as a CFC until the end of the year. Regardless of whether the $500 is paid up as a dividend or the stock is sold at a gain of $500, the results to CFC1 and US1 are the same as in the second preceding paragraph. Moreover, there is no U.S. shareholder that pays tax on any Subpart F income or Section 951A inclusions on the last CFC date. Just as in Example 14(c), $500 of Section 951A inclusion or Subpart F income attributable to US1 has avoided U.S. tax, and just as in that example, the reason has nothing to do with Section 951(a)(2)(B).

Finally, consider the results under the Act if the CFC2 income is either GILTI or Subpart F, CFC1 sells the stock of CFC2 to a non-U.S. person, and the CFC ceases to be a CFC. This is the analog to Example 14(b) but in the context of a sale of a second tier subsidiary. Now, US1 is a U.S. shareholder of CFC2 on the last CFC date. As a result, US1 has Subpart F income or a Section 951A inclusion of $500 on that date, regardless of whether the $500 is paid up as a dividend or the stock is sold at a gain of $500. The non-U.S. purchaser of CFC2 is not a U.S. shareholder and has no inclusion. As a result, the total inclusion is $500, just as in Example 14(b), and the result conforms to the amount of Subpart F income or GILTI allocable to the selling shareholder.

(c) Discussion

It is clear from the foregoing that on a sale of a first tier or second tier CFC in the middle of a taxable year, the Subpart F income or Section 951A inclusion attributable to the selling shareholder for the pre-sale portion of the taxable year of sale will now permanently avoid tax because of Section 245A.

[120] Note that Section 964(e)(4) applies "notwithstanding any other provision of this title".

[121] Section 964(e)(4) does not say that CFC1's gain on the sale of the CFC2 stock is "included in the gross income of any person" as a Section 1248 dividend, but the intent is clear.

Absent a stock sale, it is clear that the payment of a dividend eligible for Section 245A does not reduce the amount of Subpart F income or Section 951A inclusion for the year. The policy question is whether a dividend eligible for Section 245A should reduce the amount of the inclusion if it occurs in the year the stock of a first-tier or second-tier CFC is sold.

On the one hand, it can be argued that Congress did not intend to allow for such an easy avoidance of Subpart F income or Section 951A inclusion. In addition, the fact that the Act conforms the treatment of a first and second tier subsidiary does not mean that it intended to allow such avoidance in either case. Moreover, such an avoidance of tax on a Section 951A inclusion is inconsistent with the theory that GILTI is a flat tax on foreign earnings. This result also allows for considerable tax planning to reduce the taxation of GILTI or Subpart F income. For example, a sale can occur near the end of the year to maximize the amount of excluded income, and the sale can be made to a U.S. or non-U.S. affiliate in a manner that avoids Section 304.

On the other hand, arguably Congress was not concerned about these results. The Act adds both Section 951A and Section 964(e)(4), and both sections refer to Section 951(a)(2). Moreover, the new rule in Section 964(e)(4), combined with new Section 245A, expands the scope of tax free treatment of GILTI and Subpart F income to second tier subsidiaries. Arguably Congress must have determined that the operation of Section 951(a)(2), in conjunction with Section 245A, was consistent with its intent or at least not important enough to fix. In addition, if Congress was satisfied with the operation of Section 951(a)(2) and Section 245A when the sale of stock was to a Section 958 U.S. shareholder, presumably it was satisfied with the equivalent result when the sale was to a non-Section 958 U.S. shareholder.

Moreover, Section 951(a)(2)(B) arguably allowed the elimination of Subpart F income in the year of a sale even before the Act. Return to Example 14(b), where the CFC ceased to be a CFC on June 30. Assume in addition that the CFC paid F1 a dividend of $500 on December 31. US1 is a U.S. shareholder on the last CFC date. Under a literal reading of Section 951(a)(2)(B), US1 has a Subpart F inclusion of (i) $500 (*pro rata* share of Subpart F income for the full taxable year of the CFC) minus (ii) $500 (distribution to F1 not in excess of F1's share of Subpart F income for the year), or $0. At least one Technical Advice Memorandum from 1995 confirms this result.[122] No legislative or regulatory action has been taken to change this result.

We take no position on whether these results should be changed by legislation or, if there is authority to do so, regulations. However, we point out some possible approaches if a change is desired.

First, Section 245A could be amended to provide that when stock of a CFC is sold during a taxable year, and the CFC continues to be a CFC after the sale, dividends paid on that stock out of Subpart F income or Section 951A inclusions for that year are not eligible

[122] TAM 9538002 (May 16, 1995).

for Section 245A. However, this would be a basic structural change to the Subpart F and GILTI rules, as well as Section 245A, and would create other complexities.

Second, Section 951(a)(2)(B) could be modified to reduce a Subpart F inclusion only for distributions not eligible for Section 245A. This approach would result in inclusion for the full amount of Subpart F income or GILTI for the year of the stock sale if the CFC continued to be a CFC with a continuing Section 958(a) U.S. shareholder. However, it would not result in full inclusion if the CFC continued as a CFC without a Section 958(a) U.S. shareholder. Moreover, it could be viewed as unfair to the Section 958(a) U.S. shareholder that buys the stock, since it would have a Section 951A inclusion of $1000 (without reduction for the $500 distribution to the seller eligible for Section 245A) even though it only held the stock for half the year. This is penalizing the buyer because of the under-taxation of the seller.

Third, a new rule could apply on any sale of stock by a U.S. shareholder where the tax year does not end and the CFC remains a CFC, regardless of the buyer. In that event, the taxable year of the CFC would be deemed to end, with respect to the sold stock only, on the sale date. This would result in full inclusion to the seller for the year of the sale, as in Example 14(b), regardless of whether the buyer was a Section 958(a) U.S. shareholder.

The notional ending of the tax year could, like today, result in a *pro rata* allocation of income for the full year to the periods before and after the sale date, as opposed to a factual determination of income before and after the sale date. However, if the closing of the tax year applied for all purposes, it would result in short tax years for the sold stock. This would exacerbate the tax detriments under GILTI that arise from tax years with tested losses, and the fact that FTCs do not carry over.

3. Relationship between Section 163(j) and Section 250

As indicated in Part III.E.3 of the Section 163(j) Report, regulations should address the relationship between Section 163(j) and Section 250. Notice 2018-28, relating to Section 163(j), is silent on this question. A taxpayer could first apply the Section 250(a)(1) deduction in determining "adjusted taxable income" under Section 163(j)(8), then determine allowed interest deductions under Section 163(j), and then apply the Section 250(a)(2) limitation of the Section 250 deduction to taxable income. However, a reduction in deductions under Section 250(a)(2) would "retroactively" increase "adjusted taxable income" under Section 163(j)(8), which would require re-calculating allowed interest deductions under Section 163(j), which, in turn, would require re-calculating the reduction in deductions under Section 250(a)(2), and so on and so forth. When Section 250(a)(2) applies, simultaneous equations might be required in order to replicate the effect of this iterative process.

4. Limit on Section 250 Deduction

Regulations should clarify that, for purposes of the limit on the Section 250 deduction under Section 250(a)(2), "taxable income of the domestic corporation" includes all income, including Subpart F, Section 951A, Section 78, and FDII inclusions, determined without regard to the Section 250(a)(1) deduction.

In addition, regulations should clarify whether the Section 250(a)(2) carve-back applies to the Section 78 gross-up amount for a Section 951A inclusion. For example, assume the U.S. shareholder has no income or loss except for a Section 951A inclusion of $50, a Section 78 gross-up amount of $20, and a current NOL of $60. Tentative taxable income before Section 250 is $10. Section 250(a)(2) might require the $70 base for the 50% Section 250(a)(1) deduction to be reduced to either:

(a) $10, *i.e.*, the total Section 951A and Section 78 inclusions of $70 are reduced by the excess of such inclusions ($70) over tentative taxable income ($10), a reduction of $60, resulting in a Section 250 deduction of $5, or

(b) $30, *i.e.*, the Section 951A inclusion of $50 is reduced by the excess of such inclusion ($50) over tentative taxable income ($10), a reduction of $40, to $10, but there is no reduction in the Section 78 amount of $20, resulting in a Section 250 deduction of $15.

Under alternative (a), the Section 250 deduction reduces the tentative taxable income by 50%, from $10 to $5. Under alternative (b), the Section 250 deduction eliminates all of the tentative taxable income and results in a loss of $5. Section 172(d)(9) would prevent this loss from being carried forward.

The two methods give the same result if the loss (after reduction for non-GILTI income) exceeds the sum of the Section 951A and Section 78 inclusions. In that case, any Section 250 deduction will only result in a loss that cannot be carried over because of Section 172(d)(9). The two methods also give the same result if the loss is no greater than the Section 951A inclusion, since the reduction of the Section 951A inclusion itself by the loss will give the same result as if both inclusions are reduced by the loss. The two methods only give different results if, as in the example, the loss is greater than the Section 951A inclusion but less than the sum of the two inclusions.

The uncertainty in the statute arises because under Section 250(a)(2)(A), the reduction in the GILTI amount taken into account under Section 250(a)(1) is equal to the excess of the GILTI amount "otherwise taken into account by the domestic corporation under [Section 250(a)(1)]" over the tentative taxable income of the corporation. Section 250(a)(1)(B) refers separately to the GILTI inclusion under Section 951A and the Section 78 gross-up attributable to such inclusion. It is not clear whether the reference in Section 250(a)(2)(A) is only to the Section 951A inclusion, or whether it is also intended to include the Section 78 gross-up. However, Section 250(a)(2)(B)(ii), which allocates the carve-back between GILTI and FDII, tracks the language of Section 250(a)(1)(B)(i) and implies that only the Section 951A inclusion and not the Section 78 gross-up can be cut back by Section 250(a)(2).

5. Allocation to Preferred Stock

We consider now the proper allocation of tested income to a U.S. shareholder that holds preferred stock of a CFC. Section 951A(e)(1) states that a U.S. shareholder's *pro rata* share of tested income of a CFC is determined under the rules of Section 951(a)(2). The regulations under Section 951(a)(2) determine how to allocate Subpart F income among classes of stock of a CFC.

Under those regulations, if preferred stock has a fixed term and all dividend arrearages accrue and compound at a rate at least equal to the applicable Federal rate at the time of issuance ("**fixed yield preferred stock**"), the stock is not allocated any Subpart F income in excess of accrued and unpaid dividends (referred to here as the "**fixed allocation method**").[123] However, stock that is subject to discretionary distributions, specifically including preferred stock that is perpetual or that does not provide for the compounding of dividend arrearages, is allocated Subpart F income under a different method (referred to here as the "**proportionate allocation method**").[124] Under that method, there is first an initial allocation to accrued and unpaid dividends, and any remaining Subpart F income is then allocated to each class of stock, including the preferred stock, in proportion to the fair market value of all classes of stock of the CFC.[125] The regulations do not contain any special rule for convertible preferred stock, although preferred stock with a participating dividend is subject to the proportionate allocation method.[126]

Regulations should determine the application of these rules to allocations of tested income to a U.S. shareholder holding preferred stock. If the stock is nonconvertible fixed yield preferred stock, we believe that the fixed allocation method that applies for Subpart F purposes should apply. Such stock is not entitled at any point in time to more income than its accrued dividends to date, and there is no logical reason to allocate to it a greater amount of tested income.

Contrary to the Subpart F regulations, the same logic applies to stock that would be nonconvertible fixed yield preferred stock except that it does not provide for compounding of dividend arrearages. If anything, this stock should be allocated *less* rather than more Subpart F income or tested income than fixed yield preferred stock, since the present value of its future fixed dividends will be lower than in the case of fixed yield preferred stock.[127]

[123] Treas. Reg. §§ 1.951-1(e)(3)(i) (unless an exception applies, when there are multiple classes of stock, the *pro rata* share of each class for Subpart F purposes is based on proportion of the distributions that would be made to each class if all e&p for the year was distributed on the last day of the year); -1(e)(4)(ii) (an exception that applies the proportionate allocation method described below in the text does not apply to fixed yield preferred stock).

[124] *Id.*

[125] Treas. Reg. §§ 1.951-1(e)(3)(ii)(A); -1(e)(4)(ii).

[126] Treas. Reg. § 1.951-1(e)(6) Ex. 5.

[127] The Tax Section made the same point in commenting on the proposed regulations that led to these final regulations. See NYSBA Tax Section, Report No. 1079, *Report on Proposed Regulations Regarding*

As a result, we believe that in determining tested income allocable to nonparticipating, nonconvertible preferred stock that would be fixed yield preferred stock except for the lack of compounding of dividend arrearages, the allocation should at least not exceed the allocation under Subpart F for fixed yield preferred stock. We believe this change could be made by regulations, at least if the regulations under Subpart F are changed accordingly.

Turn now to convertible preferred stock that, absent the conversion feature, would be eligible for the fixed allocation method. It does not appear that the conversion feature causes it to be subject to the proportionate allocation method under the Subpart F regulations. Nevertheless, if the fixed allocation method applies to such stock, it would be possible to avoid Section 951A inclusions on tested income. The stock will be allocated tested income equal to the dividend paid or (apparently) accruing on the stock.[128] However, the dividend rate will be below the market rate on comparable nonconvertible preferred stock to reflect the conversion feature. In fact, assuming a purchase price at the face amount of the preferred stock, the greater the initial value of the conversion feature, the lower the dividend rate.

As a result, there may be no tested income allocated to any U.S. shareholder to reflect the "bargain" element of the dividend rate. In addition, when the stock is converted, it will represent a percentage interest in the CFC's existing assets, including PTI for which the holder has never been allocated tested income.

Taxpayers could take advantage of these rules to defer or eliminate tax on tested income. For example, a U.S. shareholder could purchase convertible preferred stock of a CFC, or exchange its common stock for convertible preferred stock with the same value. The common stock might be held by an unrelated U.S. or non-U.S. person, or by the foreign parent of the U.S. shareholder.[129] An individual U.S. shareholder might also own convertible preferred stock, with a wholly owned corporation owning common stock.

It would be possible to treat convertible preferred stock as subject to the proportionate allocation method because of its conversion feature. Alternatively, at least when the stock is "in the money", it could be treated as converted. However, any such rule could lead to widely varying results from year to year. In any event, regulations should clarify the result in these cases.

6. Interest Expense of CFC with Tested Loss

It is not clear whether the gross interest expense of a CFC with a tested loss reduces NDTIR of the shareholder. Section 951A(b)(2)(B) reduces NDTIR by interest expense

The Determination of a Shareholder's "Pro Rata Share" Under Section 951 (Feb. 11, 2005), at 20-21 (expressing concern that an uneconomically high allocation of Subpart F income to such preferred stock could lead to abuse).

[128] Treas. Reg. § 1.951-1(e)(3)(i). *See also* Treas. Reg. § 1.951-1(e)(3)(ii) (clause (i) applies to preferred stock entitled to a fixed return).

[129] This assumes no previous inversion transaction. *See* Treas. Reg. § 1.7701(l)-4T.

taken into account under Section 951A(c)(2)(A)(ii) in determining net CFC tested income, and the tested loss of a CFC reduces net CFC tested income. However, while tested losses are calculated under Section 951A(c)(2)(B)(i) by taking into account expenses described in Section 951A(c)(2)(A)(ii), strictly speaking, the expense is taken into account under Section 951A(c)(2)(B)(i) rather than Section 951A(c)(2)(A)(ii) in reducing net CFC tested income.[130]

First, assume the CFC with the tested loss and interest expense does not have any notional QBAI return. For example, suppose CFC1 has $100 of tested income and $100 of QBAI return, so there is no Section 951A inclusion for income from CFC1 on a stand-alone basis. CFC2 has $100 of interest expense, $1 of tested loss, and no notional QBAI return. The question is whether the shareholder's NDTIR of $100 from CFC1 is offset by the interest expense in CFC2, so there is net CFC tested income of $99 and a Section 951A inclusion of $99.

Next, even if the interest expense in CFC2 reduces the shareholder's NDTIR in this situation, consider the above fact pattern where CFC2 also has $100 of notional QBAI return. The notional QBAI return of CFC2 does not increase the shareholder's NDTIR, because CFC2 has a tested loss. The question now is whether the shareholder's NDTIR of $100 from CFC1 is still offset by the interest expense in CFC2, even though the $100 of notional QBAI return in CFC2 is disregarded in determining the shareholder's NDTIR. If so, there would be a Section 951A inclusion of $99, the net CFC tested income from CFC1 and CFC2, with no NDTIR.

This would be a very anomalous result, and quite adverse to the taxpayer. Logically, even if interest expense in a CFC with tested losses such as CFC2 is generally required to offset NDTIR, the interest expense should *first* offset the notional QBAI return in CFC2 itself. After all, the purpose of the reduction of NDTIR for interest expense is a presumption that the debt on which the interest is paid was used to buy an asset generating QBAI return. If CFC2 has its own assets that generate notional QBAI return, there is no logical reason for that return to be ignored, and for the interest expense of CFC2 to offset the QBAI return of CFC1 without regard to the notional QBAI return of CFC2.

Regulations should clarify this point.

[130] The House bill took account of all QBAI in determining NDTIR, without regard to whether a CFC had tested income or tested loss, and it was therefore logical to reduce NDTIR by interest expense of all CFCs. The Senate amendment took into account only QBAI used in the production of tested income but did not reduce NDTIR by any interest expense of CFCs. The conference agreement adopted the Senate amendment with modifications, including reducing QBAI for interest expense taken into account "under [section 951A(c)(2)(A)(ii)] in determining the shareholder's net CFC tested income....". However, because the Senate provision was not amended to also take into account QBAI in a CFC with tested loss, it is not clear whether the amendment was intended to only account for interest expense of a CFC with tested income.

7. Tax Basis and E&P Issues

A number of issues concerning tax basis and e&p are raised by the GILTI rules. We only mention these briefly, since many of these issues will be discussed in a more extensive report that the Tax Section will be submitting on the subject.

Outside of consolidation, suppose US1 owns all of CFC1 and other CFCs. Assume no NDTIR, and that in year 1, CFC1 has tested income and the other CFCs break even. US1's tax basis in CFC1 will increase by the Section 951A inclusion, which is CFC1's tested income. Now suppose that in year 2, CFC1 has a tested loss equal to its year 1 tested income, but US1 has another CFC with an equal amount of tested income, so there is no Section 951A inclusion in year 2.

Regulations should clarify whether US1 still has a PTI account of $100 in US1 based on the year 1 Section 951A inclusion, even though CFC1 has no net tested income over the two year period. The existence of such a PTI account would be consistent with the fact that US1's tax basis in CFC1 is apparently not reduced in year 2 notwithstanding the tested loss of CFC1 in year 2. There may be additional consequences arising from the fact that CFC1's loss in year 2 has saved US1 tax on the tested income of CFC2 in year 2.

Next, suppose US1 holds CFC1 and CFC2, CFC1 has tested income of $100, and CFC2 has a tested loss of $100. Section 951A(f)(2) states that if the Section 951A inclusion is less than the sum of the positive tested incomes of the shareholder's CFCs, the inclusion is allocated to the CFCs in proportion to the positive tested income of each CFC. Here, there is no Section 951A inclusion, no basis adjustment to the stock of CFC1 or CFC2, and no PTI is created. However, a dividend of $100 from CFC1 would apparently be eligible for the 100% deduction under Section 245A, and $100 of gain on the sale of the CFC1 stock would be exempt under Section 1248(a). Regulations should confirm these results.

Moreover, on this fact pattern, CFC2's loss has saved US1 $10.50 of GILTI tax, but there is apparently no adjustment to the tax basis of either CFC or to the e&p of the CFC with tested income. A similar issue arises if CFC2 has positive tested income but generates NDTIR in excess of that income, thereby offsetting tested income of CFC1 and causing US1 to save GILTI tax. The basis results in these examples can be uneconomic because the formula under Section 951A(f)(2) can cause a Section 951A inclusion to be allocated to a CFC that generated little or none of the actual Section 951A inclusion amount.

Finally, suppose that under our proposal in Part IV.C.3(a), the tested loss (and possibly QBAI return) of a CFC is shifted to the U.S. shareholder for carryover to future years of the shareholder. Logically there should be a basis decrease at the time of the shift, since the tested loss attribute has permanently left the CFC at that time. Regulations should clarify this point if the statute or regulations adopt this proposal for carryovers.

Many issues also arise under the consolidated return investment adjustment rules. Suppose one member (M1) owns the stock of another member (M2), and M2 has a Section 951A inclusion of $100 and a related Section 250 deduction of $50. Regulations should confirm that M1's stock basis in M2 increases by M2's Section 951A inclusion and is not reduced by M2's related Section 250 deduction. This result is supported by the rule for the dividends received deduction for dividends received by M2, by the analogous rule for partnerships discussed below that is contemplated by the Conference Report, and by the fact that the Section 250 deduction is intended as a rate reduction on GILTI inclusions rather than an economic deduction involving out of pocket costs.

Failure to give M1 a $100 basis increase in M2 would eliminate the benefit of the reduced GILTI tax rate when M1 sells the stock of M2, since M1 would then have a $50 capital gain on a sale attributable to the Section 250 deduction.

Additional issues arise under the investment adjustment regulations if, as we propose, members of a group are treated as a single corporation for purposes of GILTI inclusions and Section 250 deductions. As a result of such aggregation, members with Related CFCs may have different PTI accounts in those CFCs than in the absence of aggregation (although as discussed above, mismatches arise even in the absence of aggregation).

For example, suppose CFC1 and CFC2 are owned by different members M1 and M2, CFC1 has tested income, CFC2 has an equal amount of tested loss, and therefore there is no GILTI inclusion for the group.

For example, it is not clear if there is any tiering up or shifting of basis in the stock of M1 and M2, as there would be if CFC1 and CFC2 were domestic members of the group and the CFC2 losses were used to shelter CFC1 income. It is also not clear if any account is taken of the fact that CFC2's loss results in a loss of the Section 250 deduction for the group. The same issues arise if CFC1 has tested income, CFC2 has $1 of tested income and large QBAI return, and there is little or no GILTI inclusion as a result of the offset for NDTIR.

Finally, in a consolidated return context, the foregoing fact patterns raise questions as to how e&p is to be allocated among members of the group. Our forthcoming report will discuss both basis and e&p issues.

Additional issues also arise in the partnership context. As contemplated by the Conference Report, regulations should confirm that a corporate partner's outside basis in its partnership interest is increased by the GILTI inclusion of income to the partner, but not reduced by the Section 250 deduction. Such a reduction would mean that the deduction would represent a deferral, rather than a permanent decrease, in the tax rate on GILTI income to the corporate partner.

In addition, suppose a U.S. person is a partner in a partnership that owns a CFC, and the partner has a GILTI inclusion. Regulations should clarify whether there is an adjustment to the tax basis of the partnership in the CFC. Regulations should also address the more complex issues that can arise when interests in a CFC are held through tiered partnerships.

E. Foreign Tax Credit Issues

1. Determination of Allowed FTC

(a) Tracing versus proration

If a CFC has tested income, the foreign taxes paid by the CFC are entitled to the deemed paid FTC for GILTI purposes if they are "tested foreign income taxes". This means they must be "properly attributable to the tested income of such foreign corporation taken into account by such domestic corporation under Section 951A."[131] If the CFC has both tested income and other income, the Conference Report[132] indicates that regulations should apply principles from Treas. Reg. § 1.904-6. That regulation applies tracing if different categories of income are subject to foreign taxes imposed on different tax bases, but a *pro rata* rule based on net income if two categories of income are subject to the same foreign tax regime. We support regulations under GILTI that incorporate this aspect of the existing regulation.[133]

Once foreign taxes are determined to be attributable to tested income, regulations should clarify that it is not necessary to trace the taxes to particular dollars of tested income, as long as the items of tested income are included in the foreign tax base. For example, the CFC as a whole might have tested income, but foreign taxes might be paid by a branch or disregarded subsidiary that would have a tested loss on a stand-alone basis.

> <u>Example 15(a): Two divisions of a single CFC</u>. Assume a CFC has two divisions, A and B. Division A generates $100 of tested income, while division B generates $99 of tested loss in a business whose income would be tested income. As a result, the CFC has $1 of tested income. Assume that income of division B is subject to foreign income tax, notwithstanding the tested loss under U.S. tax principles.
>
> <u>Example 15(b): Disregarded subsidiary of a CFC</u>: Same facts as Example 15(a), but the CFC transfers division B to a newly-formed legal entity and "checks the box" to cause the entity to be disregarded.

[131] Section 960(d)(3).

[132] Conference Report at 628 (describing House bill), 630 (stating that conference agreement follows House bill).

[133] See Part IV.E.2(f), where we suggest modification of the regulation where tax is imposed on an item of income that is not included in the U.S. tax base.

As noted above, the FTC allowance is for FTCs "properly attributable" to tested income. As a result, it could be argued that in both of these cases, the foreign taxes borne by division B should not be eligible for the FTC. This position is arguably supported by the rule that if division B was a separate CFC, its foreign taxes would not be creditable to the U.S. shareholder.

We believe, however, that regulations should confirm that the FTC is available for foreign taxes borne by division B. The statute does not provide for any "tracing" of particular taxes to particular dollars of tested income. Rather, a CFC has a single specified amount of tested income, which is taken into account by the shareholder in determining its Section 951A inclusion. Income and loss of all the assets of the CFC that can generate tested income go into the calculation of its tested income, even if some groups of assets standing alone generate a loss for U.S. tax purposes. We therefore believe that all the foreign taxes of the CFC are attributable to "the tested income" of the CFC. This position is consistent with the fact that Section 960(d)(3) (requiring that the foreign taxes be "properly attributable to the tested income") is written in a broader fashion than the item-by-item approach of Section 960(a) (requiring that the foreign taxes be properly attributable to "any item of income under Section 951(a)").

Moreover, if a CFC has an overall tested loss, no tracing is *allowed* to *permit* FTCs for taxes paid on profitable activities of the CFC. Since tracing is disallowed in that case, tracing should not be *required* so as to *disallow* FTCs for unprofitable activities of a CFC that has overall tested income. This is a matter of policy rather than administrative convenience (although we note that item by item tracing would often be very burdensome and impracticable). Thus, we believe tracing should not be required even in Example 15(b), where tracing might be relatively simple.

(b) Timing differences

Tested income will often arise in the same taxable period as the foreign taxes that are attributable to that tested income. However, timing mismatches can arise in a number of situations, including (a) tested income arises in the current year under U.S. tax principles, but the corresponding income inclusion (and therefore tax accruals) occurs in an earlier or later year under foreign tax principles, *e.g.*, because of different depreciation schedules or different taxable years under U.S. and foreign tax law, or (b) audit adjustments.

The first question in these situations is whether foreign taxes can qualify as tested foreign income taxes if they accrue in a year that is different than the year that the underlying income is included in tested income for U.S. tax purposes. Timing differences do not disqualify a tax for the foreign tax credit for purpose of the non-GILTI baskets.[134]

[134] Treas. Reg. § 1.904-6(a)(1)(iv) (stating that timing differences do not change the basket in which a foreign tax is allocated); Rev. Rul. 74-310, 74-2 C.B. 205 (total foreign taxes of CFC imposed on profit on contract is eligible for Section 902 credit, even though timing of income was different under U.S. principles; requirement that foreign taxes be "attributable to" U.S. accumulated profits is satisfied).

As noted above, a tested foreign income tax must be "properly attributable to the tested income of such foreign corporation" taken into account by the U.S. shareholder under Section 951A. The concern is that the reference to "the tested income" means "the tested income" *for the year in which the foreign tax accrues*.

Regulations should confirm that the reference to "the tested income" of the CFC is not so narrow, and that a foreign tax is a tested foreign income tax as long as the underlying income giving rise to the foreign tax is included in the tested income of the CFC for *any* year.[135]

We believe this interpretation is fully consistent with the language of the statute. Moreover, a contrary rule would require the tracing of every item of tested income to every item of foreign tax, to make sure they arose in the same taxable year. This would not be administrable and would result in large amounts of foreign taxes being disqualified as tested foreign income taxes because of minor timing differences between U.S. and foreign law. As noted above, this would also be inconsistent with the law for foreign taxes allocable to non-GILTI baskets, where timing differences are disregarded.

Assume now that a foreign tax qualifies as a tested foreign income tax. Such a tax is creditable in the year it is paid or accrued by the CFC.[136] Normally this would be the taxable year that the liability arises under foreign law, namely the year that the underlying income is taken into account for foreign tax purposes. In the case of timing differences, this year would be different than the year that the CFC had the underlying tested income. This could result in loss of the benefit of the FTC altogether, because there is no carryover or carryback of GILTI credits, even to the year in which the underlying tested income arises.

Relief from this timing mismatch is provided under certain circumstances by Section 905(c)(2)(B), as amended by the Act. That section provides that if accrued foreign taxes are not paid within two years after the end of the taxable year to which the taxes relate, or are refunded after being paid, then they are taken into account in the taxable year to which they relate. Previously the section provided that taxes in this situation were taken into account when paid. The scope of the old provision was not clear,[137] and many of the uncertainties remain.

Nevertheless, the provision is directed primarily at the situation where an audit adjustment causes foreign taxes to accrue in an earlier year, but payment does not occur until the close of the audit. Regulations should confirm that Section 905(c)(2)(B) applies to audit adjustments relating to tested income under these circumstances, and clarify the

[135] If a foreign corporation is a not a CFC in 2018 but is one in 2019, regulations should clarify whether a foreign tax payable in 2019 on 2018 income is a tested foreign income tax, given that the definition of tested income refers to income of CFCs. Section 951A(c)(2)(A).

[136] Section 960(d)(1)(B).

[137] *See* Alan Fischl, Elizabeth Nelson, and Anisa Afshar, *Section 905(c) Mysteries*, J. Int'l Tax, July 2017 at 22.

application of that provision. This is especially important because of the lack of carryovers and carrybacks of GILTI credits.

In cases where Section 905(c)(2)(B) does not apply, the Code does not provide relief from timing mismatches. Relief may not be needed for routine mismatches that cancel each other out from year to year, or even for routine annual audit adjustments that are settled quickly after a tax return is filed.

However, consider the case of an extraordinary item that involves a timing mismatch for U.S. and foreign income inclusion. Section 905(c)(2)(B) will not apply because the tax will accrue for U.S. tax purposes at the time the foreign tax accrues for foreign purposes and is paid, even though the tested income is reported for U.S. purposes in a different year.

Given the lack of carryovers and carrybacks of GILTI FTC, a disparity between the year the tested income is reported and the year that the FTC arises may give rise to significant amounts of FTCs that become unusable. We urge that the principles of Section 905(c)(2)(B) be extended to timing differences arising from the inclusion of items in the U.S. and foreign tax base in different years. The extension could be limited to non-routine items, although this would be difficult to define. An automatic rule that is as broad as possible would be preferable to a facts and circumstances test. In any event, regardless of the scope of the new rule, it should apply without regard to the two-year minimum deferral period in Section 905(c)(2)(B), because the lack of a carryover means that even a single-year timing difference could easily result in a loss of any benefit from FTCs.

We believe that this rule is justifiable because the restriction on carryovers and carrybacks of FTCs was presumably intended to prevent taxes paid in high-tax years from being used to shelter income earned in low-tax years. There is no indication it was intended to cause a loss of the benefit of FTCs as a result of inclusion of income in different years for U.S. and foreign tax purposes.

We recognize that applying an expanded version of Section 905(c)(2)(B) on an item-by-item basis will be administratively difficult. However, we do not see any alternative that would be consistent with the rule that there is no carryover of GILTI FTCs. We believe that the result after applying Section 905(c)(2)(B) should be the same, but no better and no worse, than if the tested income arose in the same year that the foreign tax was paid.

The proposed extension of the principles of Section 905(c)(2)(B) could be limited to GILTI, on the theory that GILTI is in effect a new world-wide tax system and so all preexisting rules should be reconsidered for GILTI. Alternatively, uniform rules under Section 960 could be considered for all foreign income. The reason is that the additional new baskets and lack of GILTI carryover mean that the use of FTCs and carryovers on an overall basis is now much more restricted than before.

(c) Withholding tax on distribution of PTI

Regulations should confirm that if there is withholding tax on a distribution of PTI arising from tested income, 100% rather than 80% of the withholding tax is allowed as a credit under Section 901, and that the FTC is not cut back by the inclusion percentage. Both limitations are imposed by Section 960(d)(1), which applies to tested foreign income taxes, *i.e.*, taxes paid by the CFC on the CFC's tested income. These taxes are imposed on the U.S. shareholder rather than the CFC.[138]

2. Section 904 Issues

(a) Expense allocation

Section 904(d) creates a separate limitation basket for GILTI. As illustrated in Examples 5(a) through 5(c) above, if expenses of the U.S. shareholder are treated as foreign source expenses allocated to the GILTI basket, and if the foreign tax rate is at least 13.125%, expenses of this type cause U.S. tax to be payable on a Section 951A inclusion no matter how far above 13.125% the foreign tax rate is. As shown in Example 5(c), for every $1 of such allocated expenses, foreign source income is reduced by $1, and this reduces the FTC limit by $.21. This in turn increases the U.S. tax liability by $.21, no matter how much the foreign tax rate exceeds 13.125%. If the foreign tax rate is less than 13.125%, any allocated expenses will first increase the effective foreign tax rate (determined under U.S. principles taking the expense allocations into account) to 13.125%, and thereafter any additional $1 of allocated expenses will result in the same $.21 increase in U.S. tax liability.

This section discusses the statutory basis for the allocation of expenses, the ability of Treasury not to allocate any expenses to GILTI, the policy issues concerning allocating or not allocating expenses to GILTI, and possible modification of existing regulations for allocating expenses to GILTI.

Section 904(d)(1)(A) states that Section 904(a) and certain other sections shall be applied separately to Section 951A inclusions. Section 904(a) limits foreign tax credits based on taxable income from foreign sources, so the Section 951A limitation is based on taxable income in the Section 951A basket. Under Sections 861(b), 862(b), and 863(a), taxable income in a category is based on gross income in the category reduced by expenses "properly apportioned or allocated" to such gross income under regulations. Moreover, under existing regulations, the expenses of the U.S. shareholder must be divided between US-source and foreign-source, and then the foreign-source expenses are further divided among the applicable limitation baskets.[139]

In light of this statutory structure, if Treasury determines that no expenses of the U.S. shareholder are "properly allocable" to income in the GILTI basket, Treasury could

[138] Logically the same rule should apply to withholding tax on a distribution from a subsidiary CFC to a parent CFC, since the U.S. shareholder takes account of tested income of the lower tier CFC, and the distribution to the upper tier CFC creates PTI rather than tested income to the upper tier CFC.

[139] *See generally* Section 861 and Treasury Regulations thereunder.

issue regulations that no allocation of expenses to that basket should be made. Presumably such a determination would be based on the flat-rate theory of GILTI discussed above that the rules are intended as a flat tax of 13.125% on foreign income. As noted above, the Conference Report seems to contemplate no GILTI tax if the foreign tax rate is at least 13.125%. This statement is correct only if there are no allocations of U.S. deductions to the GILTI basket for purposes of determining FTC limitations. Moreover, there are other situations where the usual rules for allocating expenses are modified.[140]

On the other hand, arguments can be made that such an interpretation by Treasury would be inconsistent with the structure and purpose of the statute. First, such an interpretation is inconsistent with the notion that the statement in the legislative history is illustrative rather stating a definitive rule. Arguably the allocation of deductions to foreign income is integral to the structure of the FTC rules, and it should take more than this ambiguous statement in the legislative history to override that basic structure.

Second, the statute is most logically read to require that every expense should be allocable to some item of gross income. Therefore, Treasury would have to conclude that expenses otherwise allocable to Section 951A inclusions under the principles of the existing regulations are instead allocable as a matter of law to domestic income or other foreign source income. It is difficult to see how such expenses become "properly allocable" to such other income solely as a result of the enactment of the Act, since there is no more connection between such expenses and such other income after the Act than there was before. Such a nonallocation to Section 951A inclusions is in contrast to other situations where regulations create an exception to allocations of expenses to foreign income, since such exceptions are based on specific fact patterns where an allocation is likely not "proper" as a factual matter.

Third, the statute clearly contemplates a loss of GILTI FTCs in other situations,[141] so perhaps Congress was not concerned about a loss of FTCs in the context of expense allocations. In fact, when Congress desired to change the normal rules for allocations of expenses to categories of income, it has stated so explicitly.

- Section 864(e) contemplates an allocation of interest expense among assets, with a specific exception in Section 864(e)(3) that prevents an allocation of expenses to tax exempt assets (and the income they produce) and the deductible portion of dividends eligible for the DRD.

- New Section 904(b)(4), discussed below, is a special rule for allocating expenses when dividends from a CFC are eligible for Section 245A.

[140] *See, e.g.*, Treas. Reg. § 1.861-10T, relating to special rules for allocating interest expense.

[141] For example, FTCs are lost if the foreign taxes are paid by a CFC without tested income, and tested losses of one CFC (or NDTIR of the shareholder) can reduce the shareholder's resulting FTC allocation percentage for FTCs paid by a CFC with tested income.

- New Section 965(h)(6) turns off allocation of deductions attributable to dividends from a CFC in determining the net tax liability under Section 965.

There is no comparable special rule for the GILTI basket, arguably indicating an intent by Congress that no special expense allocation rules were intended for the GILTI basket. In fact, Section 904(b)(4) by its terms disregards deductions allocable to income from stock of a CFC other than amounts includible in income under Sections 951(a)(1) or 951A(a). This exception clearly implies an understanding that deductions might be allocable to Section 951A inclusions. Similarly, since shareholder level deductions clearly reduce FDII, to the extent FDII and GILTI are considered parallel systems, shareholder deductions should likewise be allocable to GILTI.

In any event, we do not believe as a policy matter that there should be a complete exclusion of shareholder expenses from the GILTI basket.

Such a complete exclusion means that expenses that would be properly allocable to Section 951A inclusions under existing principles should instead *automatically* be treated as properly allocable to other foreign or domestic source income. Yet such expenses reduce U.S. taxable income no matter how they are allocated for FTC purposes. To the extent expenses that are properly allocable to foreign income are in fact allocated to domestic income for FTC purposes, the overall effect is that FTCs are allowed to shelter U.S. tax on U.S. income. This effect also arises if these expenses are not allocated to any basket (a questionable interpretation of the statute in any event), because the full FTC is allowed as long as there is no reduction in foreign source income.

Section 904 was intended to prevent the FTC from having this effect. In addition, this reallocation of deductions encourages foreign countries to raise their tax rates at the expense of the U.S. fisc, because until the Section 904 limits are reached, 80% of the additional foreign tax is creditable.

If the taxpayer had non-GILTI foreign income, it would be possible to avoid all or part of this result by allocating the GILTI-related expenses to other baskets of foreign income, rather than to U.S. income. This may be taxpayer-favorable because it could allow GILTI FTCs to be used currently instead of being permanently lost, and FTCs in other baskets to be carried forward or backward instead of being used currently. However, it could be taxpayer-unfavorable if the taxpayer has, say, high-taxed foreign branch income and low-taxed GILTI, since there would be no effect on GILTI FTCs but the branch FTCs would have to be carried forward or backward rather than being used currently. In either case, it is difficult to see a logical reason for the reallocation of expenses to other baskets.

Moreover, there would be no justification for reallocating GILTI expenses to FDII of the shareholder. The argument for a flat rate of tax based on the Conference Report applies equally to FDII, and so it would be inconsistent with the flat rate theory to increase the effective tax rate on FDII in order to obtain a flat rate on GILTI.

Finally, allocation of GILTI expenses to other baskets of foreign income (with or without FDII) would have no effect if the taxpayer did not have any foreign income in other baskets, and no material effect if the taxpayer did have foreign income in the other baskets but such income was not subject to a material amount of foreign tax. Also, once the allocation eliminated all foreign source income in non-GILTI baskets, any additional expenses otherwise allocable to GILTI would have to be reallocated to GILTI or to U.S. source income.[142] This leads back to the original issue.

Despite these policy arguments against allocating *no* expenses to the GILTI basket, it is important to note that there are significant differences between the GILTI regime and the historic regime for taxing income of CFCs. For example, foreign tax credits in the GILTI basket cannot be carried forward or backward,[143] so the impact on taxpayers of limiting GILTI FTCs is much more severe than limiting non-GILTI FTCs. These limits on GILTI FTCs seem to undercut both theories of the nature of GILTI, since they cause worse results for taxpayers than either the Subpart F rules or the result under a flat rate of tax (at least if the flat rate of tax is intended to be based on true economic income over a period of years).

As a result, we believe that in light of these differences between GILTI and the preexisting tax rules for FTCs, even if expense allocations continue to apply to the GILTI basket under Section 904, the existing Section 861 statutory and regulatory framework should not necessarily be applied wholesale. Moreover, in light of the flat rate theory of GILTI, regulations should modify existing rules to minimize allocations to GILTI inclusions that are not economically justified. In fact, reconsideration might also be given to certain of the allocation rules for Subpart F income allocated to the general and passive FTC baskets.

For example, research expenses of a U.S. corporation are allocated to U.S. and foreign sources under various methods based on sales or gross income.[144] To the extent that gross income is the test, there was little allocation to CFCs in the past because most income of CFCs was not currently included in U.S. gross income. This result seems appropriate because research expenses of the U.S. shareholder increase the royalty or sales income of the shareholder, but the CFC does not benefit. In fact, the CFC would only have increased its income if the resulting intangibles were transferred to the CFC, which could

[142] Section 904(a) and (f)(5); Treas. Reg. § 1.904-4(c)(2)(ii). Allocations to U.S. source income would also create an overall domestic loss ("**ODL**") to the extent they exceeded U.S. source income.

[143] This means, for example, that if a U.S. shareholder has an NOL or NDTIR that offsets its GILTI inclusion for the year, the NOL or NDTIR is absorbed in the current year and the FTC on the GILTI inclusion provides no benefit in the current year and cannot be carried to a future year.

[144] *See* Treas. Reg. § 1.861-17.

not occur without gain recognition or Section 367(d) royalty income to the U.S. parent corporation.[145]

Now, CFCs will generate a significant amount of gross income to the U.S. shareholder as a result of GILTI inclusions. Moreover, the research expenses of the U.S. shareholder will not generally give rise to tested income to the CFC or GILTI inclusions to the shareholder for the reasons stated above.[146] Nevertheless, absent a change in regulations, the GILTI inclusions will result in an allocation of research expenses to the GILTI basket for purposes of Section 904. These allocations do not seem justified as a result of the enactment of the GILTI rules, and we believe these rules should be reconsidered by Treasury.

Likewise, interest expense of the U.S. shareholder is generally allocated to stock of a CFC based on the tax basis of the stock and the accumulated earnings of the CFC.[147] However, under Section 864(e)(3), no expenses may be allocated to stock that gives rise to income that is exempt, excluded, or eliminated from tax, including the portion of stock attributable to the dividends received deduction available under Section 243 or 245 for dividends on that stock.[148] It appears that this rule does not apply to stock of a CFC that gives rise to dividends eligible for the Section 245A deduction, because such dividends are initially included in gross income and the deduction is under a section not specified in Section 864(e)(3). Rather, stock giving rise to such dividends is apparently subject solely to Section 904(b)(4), discussed below. Regulations should confirm this conclusion.

Other allocation questions also arise. Allocations of some expenses such as interest are based on the tax basis of stock of a CFC. The stock may give rise to GILTI inclusions, dividends eligible for Section 245A, or Section 956 inclusions. The allocation each year could be based on the actual GILTI inclusions, Section 956 inclusions, and Section 245A eligible dividends paid during the year. Alternatively, the allocation could be based on GILTI inclusions, Section 956 inclusions, and QBAI return whether or not paid out as dividends during the year. Section 904(b)(4), discussed below, is inconclusive on this question because it contemplates that expenses might be allocable both to stock of a CFC and to exempt dividends paid by a CFC.

We note that the timing of Section 245A dividends is entirely discretionary and could be adjusted to achieve desired allocations each year. As a result, an annual allocation based on Section 245A dividends paid during the year would have little or no economic

[145] For intangibles developed by cost sharing, each of the U.S. shareholder and the CFC bore its own expenses, so this issue does not arise.

[146] An exception would be if royalty income from the CFC was considered a GILTI inclusion to the U.S. shareholder. We believe this should not be the case, as discussed in Part IV.E.2(e), but if this is the case, an expense allocation to such income would be appropriate.

[147] Section 864(e)(4); Treas. Reg. § § 1.861-9T(g), -12(c)(2); new Section 864(e)(2) (requiring use of tax basis rather than fair market value for allocating interest expense).

[148] *See also* Treas. Reg. § 1.861-8T(d)(2)(ii).

substance and would create considerable opportunity for tax planning. On the other hand, an allocation based on QBAI return could not take into account the possibility that such return could be paid out in the future as either Section 245A eligible dividends or as Section 956 inclusions. Regulations should clarify this question. In the examples that follow, we assume an allocation based on QBAI return rather than actual cash dividends, but the results would be the same in substance in either case.

Finally, in many situations the allocation of expenses is based on gross income, including in the preceding paragraph where the allocation to categories of income in the CFC is based on different types of income of the CFC. Consideration should be given as to whether these allocations should be based on net GILTI rather than gross GILTI. It can be argued that expenses give rise proportionately to gross income regardless of the different tax rates that might apply to different items of income. However, if the CFC has $100 of passive Subpart F income and $100 of gross GILTI income, an equal allocation of expenses to both items will have a far more adverse effect on the GILTI basket than on the passive basket. This result would exacerbate the negative effect of interest allocations on the GILTI basket. Consequently, it can be argued that a *pro rata* rule based on gross GILTI is unjustified in light of the flat-rate theory of GILTI.

(b) Section 904(b)(4)

Regulations should clarify the application of new Section 904(b)(4).

As background, FTCs are not available for dividends giving rise to a Section 245A deduction.[149] As a result, deductions allocable to such dividends, or to stock giving rise to such dividends, do not cause a tax detriment to the U.S. shareholder of a CFC, since a reduction in foreign source income under Section 904 does not matter when no FTCs are available anyway. It can logically be argued that deductions allocated to such dividends should remain so allocated, as opposed to being reallocated to other baskets, and other aspects of the Section 904 calculations should be unchanged.

After all, the logic that led to the initial allocation of expenses to each FTC basket is not changed as a result of the enactment of Section 245A. For example, if a U.S. shareholder borrows to buy stock in a corporation, the interest expense would logically be allocated to the stock (or not) regardless of whether the stock happens to give rise to taxable or tax-exempt dividends. This result would also be consistent with the general approach of Section 265 , which disallows deductions for expenses allocable to exempt income, and thereby increases taxable income for all purposes of the Code, but does not reallocate any deductions to or from exempt income (the "**no-reallocation approach**").

By contrast, Section 864(e)(3), discussed above, reallocates all expenses initially allocable to tax-exempt income and assets to other income and assets for FTC purposes. This reduces foreign source income in the baskets giving rise to taxable income, and therefore reduces the ability to utilize FTCs arising on taxable income. This approach might be based on the theory that in this situation, unlike under Section 265, the expenses

[149] Section 245A(d).

in question are still allowed to the U.S. shareholder as deductible expenses and therefore should still be allocated against taxable income.

Section 904(b)(4) was added by the Act as Section 904(b)(5) and later renumbered in a technical correction bill.[150] The heading is "Treatment of Dividends for which Deduction is Allowed Under Section 245A." Since the provision is within Section 904, the purpose is clearly to adopt a rule to deal with the allocation of deductions to dividends that are in substance exempt from tax.

The provision states that for purposes of the Section 904 limitations, the shareholder's foreign source income and entire net income are calculated without regard to (A) the foreign source portion of all dividends from the CFC ("**clause A**"), (B)(i) deductions allocable to non-GILTI, non-Subpart F income from stock of a CFC ("**clause B(i)**"), or (B)(ii) deductions allocable to stock of a CFC to the extent income from the CFC is non-GILTI, non-Subpart F ("**clause B(ii)**"). The identification of these clauses reflects the clause references in Section 904(b)(4).

This provision is similar to Section 864(e)(3) in that it does not deny a deduction for expenses at the shareholder level. On the other hand, on its face, it does not reallocate any expenses to other baskets, as does Section 864(e)(3). Rather, it provides a formula for calculating foreign source income and entire net income for purposes of the Section 904 limitations. As is discussed below, the formula appears to achieve the same result as the no-allocation approach.

Turning to the specifics of the formula, recall that the ratio of foreign source income in a basket to entire net income is multiplied by U.S. tax liability to obtain the FTC limit for the basket. Clause A disregards all foreign source dividends from a CFC. This rule is likely based on the fact that all dividends from a CFC will either be nontaxable PTI from GILTI or Subpart F, and taken into account previously for expense allocation purposes, or else from CFC exempt income and eligible for Section 245A.

Clauses B(i) and B(ii) require the disregard of all expenses allocable to the CFC in baskets other than GILTI and Subpart F. Since a CFC will never give rise to branch income to its U.S. shareholder, the reference can only be to the general basket. However, once those expenses are disregarded, the determination of foreign source income and entire taxable income must be recalculated for purposes of all baskets, including GILTI and Subpart F.

Since the formula disregards both exempt dividend income and expenses allocable to such income, the result is the no-reallocation approach. This increases the ability of the U.S. shareholder to use FTCs when the only foreign income of the U.S. shareholder is (1) dividends from a CFC eligible for Section 245A, and (2) Subpart F income or GILTI inclusions from a CFC.

[150] Pub. Law. 115-141, § 401(d)(1)(D)(xiii) repealed former Section 904(b)(4) as deadwood and renumbered Section 904(b)(5), added by the Act, as Section 904(b)(4), effective March 23, 2018.

Example 16(a) (Shareholder has no foreign income except CFC income). U.S. shareholder has:

- $700 of U.S. income offset by $500 of allocable expenses, for U.S. taxable income of $200

- $300 of net GILTI income from a CFC offset by $100 of allocable expenses, for GILTI basket income of $200

- $100 of expenses allocable to QBAI return of the CFC (general basket expenses).

World-wide taxable income is $300. Absent Section 904(b)(4), the foreign tax credit fraction for the GILTI basket would initially be $200 (GILTI income) divided by $300 (worldwide taxable income). However, since there is a $100 loss in the general basket, the GILTI fraction is reduced to $100/$300.[151]

Now applying Section 904(b)(4), clause A says to ignore dividends from the CFC. Regardless of whether any such dividends are paid, they would not be in taxable income (either because they are non-taxable distributions of PTI or because they are fully offset by Section 245A deductions) and so this condition is satisfied. Clauses B(i) and B(ii) say to disregard the $100 of expenses in the general basket in determining foreign source income and entire taxable income (because these expenses are allocable to QBAI return that will give rise to exempt dividends). In calculating the new GILTI limitation, those expenses are ignored in the numerator, meaning that they no longer reduce the $200 of net GILTI income to $100. Moreover, absent those expenses, entire taxable income increases from $300 to $400. As a result, the GILTI FTC fraction becomes $200 (net GILTI income) divided by $400 (entire taxable income with addback of expenses allocable to exempt dividends).

This $200/$400 FTC fraction is an improvement over the $100/$300 fraction that arises in the absence of Section 904(b)(4). In fact, this is the same result that would arise if the expense of $100 had simply not been incurred. Consequently, this result is the same as under the no-reallocation approach.

We now consider a case where the U.S. shareholder has other foreign source income in the general basket at least equal to the expenses in that basket that are allocable to exempt income. In that case, there is no negative balance in the general basket that would reduce the balances in the GILTI or Subpart F baskets. Section 904(b)(4) still reaches the same result as the no-reallocation approach. However, in this case the application of Section 904(b)(4) increases the limitation in the general basket, and

[151] Section 904(f)(5); Treas. Reg. § 1.904-4(c)(2)(ii).

decreases the limitations in the GILTI and Subpart F baskets. The following example illustrates these results.[152]

Example 16(b) (shareholder has other general basket income). A U.S. shareholder has:

- $100 of domestic source business income offset by $40 of allocable expenses,
- $600 of gross GILTI inclusion, offset by $300 of Section 250 deduction and $60 of allocable expenses,
- $50 of foreign source business income in the general basket, offset by $10 of allocable expenses, and
- $40 of expenses allocable to exempt CFC return of the CFC giving rise to dividends eligible for Section 245A.

On these facts, before applying Section 904(b)(4), the U.S. shareholder has:

- taxable income of $300 ($150 operating income, $300 net GILTI inclusion, $150 expense),
- U.S. source income of $60 ($100 of business income and $40 of expense),
- foreign source GILTI basket income of $240 ($300 inclusion minus $60 expense),
- foreign source general basket income of $0 ($50 of business income, $10 of expense allocated to such income, and $40 of expense allocated to exempt CFC return),
- tentative U.S. tax liability of 21% of $300, or $63.00, and
- a GILTI FTC limit of $63.00 (tentative U.S. tax) times $240 (foreign source GILTI inclusion) divided by $300 (world-wide taxable income), or $50.40.

These results would not change if income from the CFC was distributed, since the GILTI inclusion would be PTI, the exempt CFC return would give rise to gross income eligible for the Section 245A deduction, and as noted above Section 864(e)(3) would not apply. As a result, no taxable income or foreign source income would be created.

[152] Appendix 1 contains a table illustrating this example.

In this case, the expense of $40 that is allocated to QBAI return reduces the U.S. shareholder's foreign source income in the general basket from $40 to $0. As a result, unlike in Example 16(a), there is no "negative" balance in the general basket that reduces the GILTI fraction. However, the general basket fraction is reduced from $40 (general basket income outside the CFC) divided by $300 (worldwide income) to $0 divided by $300, or $0. Therefore, no FTCs on the direct foreign source income of $50 are available.

Consider now Section 904(b)(4). It requires disregarding the expenses of $40 allocable to QBAI return in calculating the shareholder's foreign source income and entire taxable income. Therefore, similar to the result in Example 16(a), general basket expenses are calculated without regard to the $40 deduction, so general basket income is increased from $0 to $40. Stopping there, the general basket FTC fraction is $40 (foreign source income) divided by $300 (world-wide income), and the GILTI basket is unaffected.

However, Section 904(b)(4) also requires that the shareholder's "entire taxable income" be determined without regard to the $40 of expense. As a result, the foreign source GILTI inclusion remains at $240. However, the denominator of the general basket fraction and the GILTI fraction, namely world-wide taxable income, is increased by the $40 of lost deductions, to $340.

The general basket FTC fraction is then $40/$340, which is higher than the $0/$300 result absent Section 904(b)(4). The GILTI FTC fraction is then $240/$340, or .71, which is lower than the initial fraction of $240/$300, or .80. The reason for the increase in the general basket fraction is that the increase in the numerator of that fraction by the $40 of exempt expense more than makes up for the increase in the denominator by the same amount. On the other hand, there is no increase in the numerator of the GILTI fraction, only a $40 increase in the denominator. This is in contrast to Example 16(a), where the increase in the numerator of the GILTI fraction (as a result of preventing the income in the basket from being offset by the exempt loss) more than made up for the increase in the denominator of the fraction by the same amount.

In both cases, the result is the same as under the no-reallocation approach. If the U.S. shareholder had not incurred the $40 of expense allocated to the exempt dividend income, entire taxable income would be $340 and the above results would follow.

It can be argued that the initial GILTI fraction of $240/$300 is the "correct" fraction, and that the reduction in the fraction to $240/$340 has the same substantive effect as reallocating part of the $40 of exempt expenses to the GILTI basket to reduce the GILTI fraction. However, if the GILTI fraction remains at $240/$300, the U.S. shareholder has a higher limitation in the GILTI basket than if there had not been any exempt income or expense. This is not consistent with the no-reallocation approach, with the principles of Section 265 or with the statutory directive to disregard the exempt expenses.

We also note that the maximum allowed GILTI FTC is the GILTI fraction multiplied by the tentative U.S. tax liability on world-wide income, and the latter number is reduced as a result of the tax deduction of $40 that was allocated to Section 245A dividends. As a result, the GILTI FTC basket is less than if the $40 had not been incurred and additional U.S. tax had been paid. However, this is a consequence of the allowance of the deduction, unlike the disallowance of deductions allocable to exempt income under Section 265. The deduction reduces the effective U.S. tax rate on worldwide income, and the result under Section 904(b)(4) is consistent with the purpose of Section 904 to limit the credit for FTCs to the effective U.S. tax rate on worldwide income.

Treasury should clarify in regulations whether the above results are correct, and if not, how Section 904(b)(4) should be applied instead.

(c) The Section 250 deduction

Regulations should confirm that the portion of the Section 250 deduction that is allocable to the GILTI inclusion is allocated and apportioned to the GILTI basket.[153] That portion of the deduction is clearly attributable to the foreign-source GILTI inclusion, since the deduction is a percentage of the gross income inclusion and is clearly intended merely to reduce the U.S. tax rate on that income.

If this portion of the Section 250 deduction was allocated and apportioned to the general limitation basket, foreign taxes on tested income at a rate in excess of 13.125% could in effect be used to shelter U.S. tax on U.S. income. Likewise, the allocation might cause a foreign tax on general basket income such as FDII income not to be fully creditable. These results are clearly at odds with Congressional intent.

(d) Section 78 gross-up

We recommend that regulations specify that the Section 78 gross-up for foreign taxes deemed paid under Section 960(d) is in the GILTI basket.

The issue arises for the following reason. Section 78 treats the gross-up amount as a dividend to the U.S. shareholder. However, the amount of foreign tax reduces the tested income of the CFC, and therefore neither the tax nor the gross-up gives rise to a Section 951A inclusion (which is based solely on tested income and QBAI return). Consistent with this, Section 250(a)(1)(B) specifically includes, in the amount eligible for the 50% Section 250 deduction, both the Section 951A inclusion and the Section 78 gross-up of the Section 951A inclusion. Moreover, while the Senate bill explicitly provided that the Section 78 gross-up was in the GILTI basket,[154] this provision was removed in the final bill. The foregoing could potentially indicate a conscious choice by Congress not to include the gross-up as an inclusion in the GILTI basket and to reach the "right" amount of the Section 250 deduction through a separately identified deduction.

[153] Likewise, the portion of the Section 250 deduction that is allocable to FDII is clearly attributable to FDII and should be allocated solely to the general basket or passive income basket. If the carve-back applies, the deduction should be allocated between GILTI and FDII based on the reduced amounts of each.

[154] *See* Conference Report at 644, describing the Senate Bill ("[T]he taxes deemed to have been paid [under new Section 78] are treated as an increase in GILTI for purposes of section 78...").

However, explicitly providing that the gross-up belongs in the GILTI basket might also have been deemed unnecessary. Section 78 does not specify the appropriate basket for gross-ups on other income, and regulations could address this point in the same manner that it is addressed under Subpart F.[155]

Moreover, it is not logical for the Section 78 gross-up to be in any basket other than the GILTI basket when the underlying income giving rise to the grossed-up taxes was tested income giving rise to an inclusion in the GILTI basket. If the Section 78 amount is not in the GILTI basket, this would reduce foreign source income in the GILTI basket and thus the FTCs allowed in that basket. In fact, reducing foreign source GILTI inclusion by excluding the Section 78 gross-up has a similar effect as reducing foreign source GILTI inclusion by allocating expenses of the U.S. shareholder to GILTI inclusion.

Unless some other items were also shifted out of the GILTI basket (see below), the result is that a blended foreign tax rate of 13.125% on pre-foreign tax tested income would not itself be sufficient to eliminate U.S. tax on such income even after taking the Section 78 gross-up into account. This is so even if no expenses of the U.S. shareholder were allocated to the GILTI basket. Even stranger, the higher the foreign taxes paid, the more pronounced this effect would be because more pre-foreign tax tested income would be shifted out of the GILTI basket. This seems inconsistent with the intent of Congress.

We assume that if a Section 78 gross-up is not included in the GILTI basket, it would be in the general basket.[156] In that case, other adjustments would logically follow.[157] In particular, since the foreign tax reduces tested income, we believe that regulations should provide that the portion of the FTC allocable to the Section 78 gross-up amount (a non-tested income amount) is also in the general basket. For example, suppose the CFC has $100 of income and pays $10 of foreign tax. This results in $90 of tested income, a Section 951A inclusion of $90, a Section 78 gross-up of $10, an FTC under Section 960(d) of $8 and a Section 250 deduction of $50. If the $10 of Section 78 gross-up is in the general basket, then an allocable portion of the Section 250 deduction and shareholder expenses should logically also be allocable to the general basket rather than the GILTI basket. Moreover, the portion of the FTC allocable to the Section 78 gross-up, *i.e.*, 80% of the tax

[155] Section 904(d)(3)(G), implemented by Treas. Reg. § 1.904-6(b)(3), specifies that amounts included in gross income under Section 78 and attributable to Subpart F income are treated as Subpart F income for purposes of the foreign tax credit limitations. Although the statute addresses only Subpart F income, Section 904(d)(7) delegates broad regulatory authority and the principles of the regulation could be extended to Section 78 amounts attributable to GILTI.

[156] Since tested income excludes Subpart F income, if there were no GILTI basket, all tested income (except for passive income that is not Subpart F income) would be in the general basket.

[157] *See discussion in* Elizabeth J. Stevens and H. David Rosenbloom, GILTI Pleasures, Tax Notes Int’l, Feb. 12, 2018, at 615.

imposed on $10 of general basket income, or $0.80, would logically also be in the general basket.[158]

However, when all of the underlying income of the CFC is tested income included under Section 951A, it would be extremely peculiar for the GILTI rules to give rise to two separate and parallel tax calculations and limitations, one in the GILTI basket and one in the general basket. Illogical pro-taxpayer and pro-government mismatches could arise. On the pro-taxpayer side, excess general basket FTCs could offset a low-taxed Section 78 gross-up of the Section 951A inclusion. In addition, excess FTCs could be created in the general basket that could carry over. On the pro-government side, excess GILTI FTCs from other CFCs could not offset a low-taxed Section 78 gross-up amount. In that case, GILTI FTCs could be wasted, and tax would be owed on the gross-up amount unless the taxpayer had excess FTCs in the general basket. This issue would be exacerbated if the FTCs proportionately allocated to the Section 78 gross-up income were not placed in the general basket. We do not believe that these results were intended by Congress.

(e) Interest, rent and royalty payments from a CFC to its U.S. shareholder

Regulations should confirm that interest, rent and royalties received by a U.S. shareholder from its Related CFC are not in the GILTI basket for Section 904(d) purposes.

We acknowledge that Section 904(d)(3)(C) states that interest, rents, and royalties paid by a CFC to a U.S. shareholder out of passive category income of the CFC retains its character as passive category income in the hands of the shareholder for Section 904 purposes. By analogy, this could allow these amounts paid out of tested income of a CFC to be in the GILTI basket for Section 904 purposes.

However, for the following reasons, we believe that these payments should not be in the GILTI basket.[159]

First, as a statutory matter, only Section 951A inclusions can give rise to taxes in the GILTI basket, and nothing in Section 951A turns these payments into Section 951A inclusions. Likewise, Section 904(d)(3) was not amended to include GILTI inclusions, and Congress did not include Section 904(d)(3) in the rather long list of sections for which GILTI was to be treated in the same manner as Subpart F income.[160]

[158] Under principles analogous to Treas. Reg. § 1.904-6(b)(3), the Section 78 gross-up would be in the GILTI basket if the underlying taxes were paid on income in the GILTI basket. Since tested income is only $90, logically only $9 of the foreign taxes were paid on that income, and the other $1 of foreign tax was paid on the $10 of pre-tax foreign income that was paid out in foreign taxes and thereby reduced tested income from $100 to $90. Of that $9 and $1 respectively, $7.20 and $0.80 are allowed as FTCs under Section 960(d) (assuming the inclusion percentage is 100%).

[159] Assuming these payments are not in the GILTI basket, foreign withholding taxes on these payments should likewise not be GILTI taxes and should not be subject to the 80% limit on GILTI credits.

[160] *See* Section 951A(f)(1)(A).

Second, rent or royalty income from a CFC to its U.S. shareholder would often be eligible for the FDII deduction. This is inconsistent with those payments being treated as GILTI inclusions.

Third, these payments are deductible for U.S. tax purposes. They reduce the tested income of the CFC, and reduce the U.S. shareholder's Section 951A inclusion in the same manner as payments made by the CFC to third parties. In addition, unlike dividends, these payments are normally deductible for foreign tax purposes and therefore reduce foreign tax liability. Increasing the GILTI basket by an expense that reduces foreign taxes is arguably contrary to the purpose of the FTC baskets.

Fourth, if these payments are in the GILTI basket, the U.S. shareholder of a CFC with high taxed income could use otherwise unusable FTCs to shelter these payments from U.S. tax.

> <u>Example 17 (Royalty income and FTC baskets).</u> Assume a CFC has $200 of gross income, a royalty deduction of $100 to the U.S. shareholder, tested income of $100 before foreign taxes, and foreign tax of $40 (40%). Assume the shareholder has no income other than this royalty income. Then, the shareholder has $100 of GILTI inclusion (including Section 78 gross-up), $50 of Section 250 deduction, and $100 of royalty income. Its tentative U.S. tax is $31.50 ($100 of royalty income, plus $50 of net GILTI, all multiplied by 21%).

If the royalty income is not in the GILTI basket, the Section 904(d) limit on GILTI credits is $10.50 ($50 GILTI inclusion, divided by $150 worldwide income, multiplied by $31.50 tentative U.S. tax). Therefore, the U.S. tax is $21 ($31.50 of tentative tax, less the allowed FTC of $10.50). This $21 is the full U.S. tax on $100 of royalty income.

If the royalty income is a GILTI inclusion for purposes of Section 904(d), the available FTC is 80% of $40, or $32. The Section 904(d) limit is $31.50 ($150 GILTI, divided by $150 worldwide income, multiplied by $31.50 tentative U.S. tax). Therefore, the shareholder can use $31.50 of its FTC to entirely eliminate the tentative U.S. tax of $31.50. As a result, no U.S. tax is owed on receipt of the royalty payment.

The CFC has effectively received the benefit in the foreign jurisdiction of having made a deductible royalty payment while, for U.S. FTC purposes, the U.S. shareholder has been able to treat the payment more like a non-deductible dividend payment. By adding the income to the GILTI basket it has offset the effect of the deduction taken into account in the calculation of tested income. While not actually a hybrid payment, this treatment appears to violate the principles behind anti-hybrid rules.

Finally, if these payments are in the GILTI basket, a U.S. shareholder with U.S. source income and with a high-taxed CFC would be incentivized to "sop up" the excess FTCs by converting its U.S. income into interest, rents or royalties from the CFC.[161] The result would be the conversion of U.S. taxable income to tax-free interest, rent or royalty income from the CFC.

(f) Basket for base differences

Current law, as amended by the Act, treats foreign taxes on items that are not income for U.S. tax purposes as in the basket for branch income.[162] This rule is the result of a technical error in the Act,[163] and if our suggestion below is not adopted, a statutory amendment should be adopted to restore the prior rule that such taxes are allocated to the general basket.

Allocation of residual taxes to the general basket made sense when the general basket contained most types of non-passive income. However, GILTI inclusions, and FTCs allocable to GILTI inclusions, are very significant today. The same is true for branch income.[164] An allocation of all these foreign taxes to the general basket could therefore have very unjustifiable and adverse results on taxpayers. As a result, we urge that legislation be adopted to provide for an allocation to one or more baskets based on a facts and circumstances test, *i.e.*, based on the basket that the item would be in if it were subject to U.S. tax. If this question was still unanswerable, the allocation could be made to the general basket as today.

For example, the GILTI basket should apply to a foreign income tax imposed on a particular item that is part of an ordinary business that generates tested income, but that is not viewed as income for U.S. tax purposes. In the same situation, the branch basket should apply if the item relates to an underlying business that is operated in a branch. Likewise, withholding tax on exempt PTI from GILTI inclusions could logically be placed in the GILTI basket (see discussion in Part IV.E.2(g)).

[161] For example, if the U.S. shareholder had assets earning $100 of U.S. source income, the shareholder could sell the assets to a third party and loan the proceeds to the CFC for debt paying interest of $100 per year. If the CFC could invest the proceeds and earn $100 on the purchased assets, just as the shareholder did, the foreign taxable income and tax would be unchanged. However, if the interest income to the parent was in the GILTI basket, then just as in Example 17, a sufficiently high foreign tax on the CFC would mean that the interest income would be tax-free to the parent.

[162] Section 904(d)(2)(H)(i).

[163] When Section 904(d)(2)(H)(i) was enacted, its cross reference to Section 904(d)(1)(B) was to general limitation income. The Act amended Section 904(d)(1)(B) to refer to the branch basket, but inadvertently neglected to change the cross-reference.

[164] Section 904(d)(1)(B).

We acknowledge that our proposal is arguably inconsistent with language in the Conference Report[165] indicating an expectation that taxes on items excluded from the U.S. tax base would be allocated to the general basket. However, this language is describing the current Code, and we are proposing legislation. Moreover, it is not clear that the drafters of the Conference Report were aware of the severe adverse consequences under the Act from base differences.

Finally, our position is supported by Section 951A(c)(2)(A)(ii), which allows a reduction in tested income for expenses (including taxes) properly allocable to gross income in the tested income category, or "to which such deductions would be allocable if there were such gross income". This language appears to contemplate a reduction in tested income for foreign taxes imposed on an item relating to tested income even if it is not in the U.S. tax base. It would be most logical for the amount of the deduction for foreign taxes attributable to tested income to be the same amount as the gross-up and FTC for foreign taxes attributable to tested income.

(g) Basket for withholding tax on PTI

If withholding tax applies to the distribution of previously taxed Subpart F income, the withholding tax appears to be in the same basket as the underlying income.[166] Regulations should provide that this treatment applies to withholding tax imposed on distributions by a CFC of previously taxed tested income attributable to GILTI inclusions.

Section 960(c)(1) increases the Section 904 limitation for the applicable FTC basket to account for such withholding tax in the taxable year in which a PTI distribution is made, to the extent there is excess limitation that was not used in prior years. However, Section 951A(f)(1)(A) does not incorporate the principles of Section 960. As a result, under existing regulations, the GILTI limitation for the year would not be increased by excess limitation from prior years.

We believe this "increase by excess limitation" rule should be extended to GILTI by regulations or a statutory amendment. Absent such a rule for GILTI, the FTCs from the GILTI withholding tax would often be unusable because of the lack of income inclusion from the distribution, and the lack of a carryback of FTCs to the year of the GILTI inclusion. Absent this rule, the FTC could only be used if the U.S. shareholder happened to have other low-taxed GILTI inclusions in the year of the PTI distribution.

[165] Conference Report at 628, describing the House Bill ("It is anticipated that the Secretary would provide regulations with rules for allocating taxes similar to rules in place [under Treas. Reg. § 1.904-6(a)] for purposes of determining the allocation of taxes to specific foreign tax credit baskets. Under such rules, taxes are not attributable to an item of subpart F income if the base upon which the tax was imposed does not include the item of subpart F income. For example, if foreign law exempts a certain type of income from its tax base, no deemed-paid credit results from the inclusion of such income as subpart F. Tax imposed on income that is not included in subpart F income, is not considered attributable to subpart F income." [footnote omitted])

[166] Treas. Reg. § 1.904-6(a)(1)(iv).

Even in a GILTI system without a general carryover of FTCs, if the tax on the underlying income is low enough to create excess limitation in the years that income is earned, there is no logical reason that the excess limitation should not be carried forward and made usable against withholding tax on GILTI inclusion when it is distributed. The Section 960(c)(1) rule applies to Subpart F income even though there is also a rule allowing FTC carryovers for Subpart F. There is no logical reason that the same rule should not apply to GILTI even in the absence of GILTI FTC carryovers.

On the other hand, existing Section 960(c)(1) involves the creation of a single cumulative excess limitation account that is drawn upon when needed. That approach appears to be inconsistent with the lack of carryover of GILTI FTCs, since it can put a GILTI taxpayer in a better position by receiving a PTI distribution in a later taxable year than in the year the tested income was earned. As a result, in applying Section 960(c)(1) to GILTI, logically the U.S. shareholder would be required to trace a particular distribution of PTI to particular tested income for a prior taxable year and excess limitation for the same year. Then, only excess limitation from that year would be allowed to shelter withholding taxes on the PTI distribution. We acknowledge that such a rule would be administratively burdensome.

(h) 2017 overall foreign or domestic loss

Regulations should clarify issues that arise under Section 904(f), relating to recapture of overall foreign loss ("**OFL**"), and Section 904(g), relating to recharacterization of ODL, where the respective loss occurred in 2017 or prior years. The question is how recapture or recharacterization of pre-2018 OFLs and ODLs, respectively, should be applied in 2018 and subsequent years. The issue arises because the calculations are done separately for each FTC basket,[167] and most or all income items that were in the pre-2018 general basket may now be in the GILTI and foreign branch baskets that did not exist pre-2018. Also, these sections were designed to reach a proper aggregate result for FTC limits across different tax years, and did not contemplate that a significant portion of FTCs taken into account in 2017 would be eliminated under Section 965(g).

(i) FTC transition issues

Regulations should clarify transition issues involving foreign tax credits that arise because the concept of tested income did not exist before 2018.[168] For example, should foreign taxes payable in 2018 for income of a CFC that accrued under foreign law in 2018 but accrued under U.S. law in 2017 be tested foreign income taxes? What if the foreign tax was payable in 2017 but the tested income accrued under U.S. law in 2018? How should a foreign tax deficiency or refund in 2018 for a foreign tax payable in 2017 or earlier

[167] Treas. Reg. § 1.904(f)-7; Section 904(g)(3).

[168] While not a GILTI question, regulations should also clarify whether excess foreign branch FTCs for 2018 can be carried back under Section 904(c) to 2017 (presumably to the general limitation basket), given that there was no foreign branch basket for 2017.

years be treated? The Tax Section expects to prepare a Report on FTC issues arising under the Act that will cover these and other topics.

F. U.S. Partnership as a U.S. Shareholder in a CFC

1. Possible Approaches for Applying GILTI

Suppose a U.S. partnership is a U.S. shareholder of a CFC.[169] It is not clear whether the GILTI calculations are to be made at the partnership level or the partner level. We believe the most logical alternatives are the following.

Under the "**Partnership Level Approach**":

(1) A partnership that is a U.S. shareholder of a CFC calculates its Section 951A inclusion just as any U.S. shareholder. The inclusion is based only on stock in the CFCs owned directly or indirectly under Section 958(a) by the partnership, but the rule applies even if the partnership owns less than 10% directly or indirectly and is a U.S. shareholder solely by reason of owning additional stock by attribution from its partners under Section 958(b).

(2) The partnership notionally calculates a Section 250 deduction equal to the specified percentage of the Section 951A inclusion, but without regard to the nature of its partners or the taxable income limit in Section 250(a)(2). The deduction has no substantial economic effect, and must be allocated to partners in the same manner as the inclusion.

(3) Each partner, whether or not it is itself a U.S. shareholder, includes its share of the Section 951A amount in gross income. Each partner claims the corresponding share of the Section 250 deduction to the extent it is eligible at the partner level. In particular, noncorporate partners do not get the deduction, and corporate partners are subject to the Section 250(a)(2) limit based on their own taxable income, other Section 250 deductions, and FDII deductions.

(4) Section 960(d) by its terms is applied at the level of a domestic corporation. As a result, tested foreign income taxes paid by CFCs owned by the partnership would flow through to each domestic corporate partner based on the Section 951A inclusion of each such partner, whether or not the partner is a U.S.

[169] A domestic partnership can be a U.S. shareholder of a CFC. Section 7701(a)(30); Treas. Reg. § 1.701-2(f) Example (3). This position was recently reaffirmed in Section 3.05(b) of Notice 2018-26, which treats a U.S. partnership that is a U.S. shareholder of a deferred foreign income corporation as the shareholder required to report the Section 965(a) inclusion amount, with partners in the partnership required to report their share regardless of whether they themselves are U.S. shareholders. If this rule was changed to apply look-through treatment to domestic partnerships in the same way it applies to foreign partnerships, many of the issues in this Report involving partnerships would be avoided. However, that proposal is beyond the scope of this Report.

shareholder.[170] The partner calculates its own inclusion percentage, Section 78 gross-up, and Section 904 limitations. A partner can use credits in the GILTI basket not only against the GILTI inclusion passed through from the partnership, but also against other GILTI inclusions from the same or other CFCs or from other partnerships owning CFCs, and *vice versa*.

Alternatively, under the "**Partner Level Approach**":

(1) If the partnership is a U.S. shareholder, tested income, tested loss, QBAI and interest expense of a CFC flow through the partnership directly to the partners and are treated as the partners' *pro rata* shares of such items for purposes of applying Sections 951A(c)(1)(A) and (B) and 951A(b)(2). The flow-through applies whether or not the particular partner is itself a U.S. shareholder.

(2) Each partner combines these items with its own partner-level items in determining its own GILTI inclusion under Section 951A and Section 250 deduction.

(3) The tested foreign income taxes of the CFC also flow through the partnership to the partner. The partner calculates its own inclusion percentage, taking into account items from the partnership as well as its own partner-level items. The partner then determines its FTCs under Section 960(d) and its Section 78 gross-up. The Section 904 limits are determined at the partner level.

2. Discussion

The statute and legislative history are not conclusive on which approach should be adopted. In contrast to new Section 163(j), there is no statutory provision stating that either Section 951A or Section 250 should be determined at the partnership level. As a literal matter, Section 951A requires the U.S. shareholder of the CFC to include GILTI in income. If the partnership is a U.S. shareholder, this seems to require the GILTI inclusion to be at the partnership level.

By contrast, Section 250(a)(1) allows a deduction "to a domestic corporation" for a percentage of the amount included in its gross income under Section 951A. Similarly, Section 250(a)(2) limits the GILTI/FDII combined deduction to "the taxable income of the domestic corporation" determined without regard to this section. These provisions seem to require the Section 250 deduction to be at the level of the corporate partner of a partnership. Confusing matters further, the legislative history implies in two places that Section 250 applies at the partnership level.[171]

[170] Section 960(d) allows an FTC to a domestic corporation with a Section 951A inclusion, and does not require that the corporation be a U.S. shareholder.

[171] Conference Report at 623 n. 1517, describing the Senate Bill ("The Committee intends that the deduction allowed by new Code section 250 be treated as exempting the deducted income from tax. Thus, for example, the deduction for global intangible low-taxed income could give rise to an increase in a domestic corporate partner's basis in a domestic partnership under section 705(a)(1)(B)."); and at 626 n. 1525, describing the Final Bill ("Due to the reduction in the effective U.S. tax rate resulting from the

We believe that there are a number of advantages of the Partner Level Approach. First, it taxes a U.S. shareholder on its share of the net CFC tested income minus NDTIR determined by reference to all the CFCs in which it has an interest, regardless of whether the interest is held directly or through a partnership. In particular, this approach allows tested income from all CFCs in which the U.S. shareholder has an interest to be offset by tested loss, NDTIR and FTCs from other CFCs in which it has an interest. We believe this is the proper result.

Second, by contrast, the Partnership Level Approach would encourage tax planning to achieve very different tax results with very little change in economic position. This issue is the same as that for consolidated groups if members are not aggregated, where aggregation can then be achieved electively by restructuring. The Partnership Level Approach is comparable to nonaggregation in the consolidated return context, and the Partner Level Approach is comparable to aggregation in that context.

As discussed in Part IV.B.4(a) in the context of a consolidated group, sometimes aggregation of CFCs helps the taxpayer and sometimes it hurts the taxpayer. For example, the Partnership Level Approach would be adverse to a partner with a GILTI inclusion from a partnership with no ability to offset the inclusion with tested loss or NDTIR from CFCs held directly or through other partnerships. Likewise, a U.S. shareholder could have a GILTI inclusion from CFCs held directly with no offset for such items allocated from one or more partnerships.

In other cases, the Partnership Level Approach is more favorable for taxpayers than the Partner Level Approach. For example, a U.S. shareholder might hold a CFC with high-taxed income through a partnership, and directly hold a low-taxed CFC that generates NDTIR. Assuming the Partnership Level Approach results in a separate inclusion percentage to the corporate partner for Section 951A items from the partnership (*see* discussion below), that approach will prevent the NDTIR from reducing the inclusion percentage for the FTC on the high-taxed income from the partnership. *See* Example 9(b) for the consolidated return analog to this example.

The Partnership Level Approach in effect makes aggregation elective, except possibly for FTCs, since a U.S. shareholder with multiple CFCs could transfer some of them to (say) a 99% owned partnership and achieve very different results. Likewise, it would often be advantageous for a partnership to transfer its interest in one or more CFCs to its partners. There is no logical reason that the GILTI results should differ in these situations.

Third, the Partnership Level Approach can give rise to very counter-intuitive results. Suppose a U.S. partner directly holds 10% of the equity in a CFC and indirectly holds the same or a different class of equity in the same CFC through a U.S. partnership that is a U.S. shareholder. The partner could then have both GILTI inclusions and tested

deduction for FDII and GILTI, the conferees expect the Secretary to provide, as appropriate, regulations or other guidance similar to that under amended section 965 with respect to the determination of basis adjustments under section 705(a)(1) and the determination of gain or loss under section 986(c).")

income from the same CFC, with the latter but not the former being offset by tested losses and NDTIR of other CFCs owned by the partner. This is a very peculiar result.

Fourth, the Partnership Level Approach could not apply to a foreign partnership, since it cannot be a "U.S. shareholder" of a CFC. As a result, the Partnership Level Approach results in large differences in tax treatment of tested income depending upon whether the shareholder partnership is a U.S. or foreign partnership. While this is already true to some extent today, there is no good policy reason to increase these differences even further.

Fifth, the Partnership Level Approach is necessarily a hybrid of the two approaches, because under Section 960(d), the calculation of the inclusion percentage must be made at the level of the corporate partner. This in effect requires the entire FTC calculation to be made at the level of the corporate partner.

In fact, Section 960(d)(2) is unclear as to whether any corporation can only have a single inclusion percentage or can have multiple inclusion percentages. Under the former interpretation, all partnership level items must be aggregated with all nonpartnership items of the corporation to determine a single inclusion percentage. Under the latter interpretation, a corporate partner has a separate inclusion percentage for its share of a Section 951A inclusion passed through from any particular partnership, and another inclusion percentage for any nonpartnership Section 951A inclusion. Under either interpretation, however, the Partnership Level Approach has the disadvantage of being a rather complex hybrid approach.

Finally, the Partner Level Approach is supported by analogy to other situations where regulations apply that approach. The so-called "Brown Group" regulations look through partnerships for various purposes in applying Subpart F.[172] Under the portfolio interest rules,[173] the status of being a 10% shareholder of the issuer (and thus ineligible for the portfolio interest exception to withholding tax) applies at the partner level, rather than the partnership level, when the partnership holds debt of the issuer.[174]

On the other hand, the Partnership Level Approach is consistent with Section 3.05(b) of Notice 2018-26. This section states that if a partnership is a U.S. shareholder of a deferred foreign income corporation, the Section 965 calculations are made at the partnership level. U.S. partners are required to report their share of the partnership's inclusion amount, regardless of whether they themselves are U.S. shareholders.

However, applying Section 965 at the partnership level does not involve inter-relationships with partner level items comparable to the issues in applying GILTI at the partnership level. Moreover, Section 965 is a one-time provision. As a result, we do not

[172] T.D. 9008, July 22, 2002.

[173] Sections 871(h), 881(c).

[174] Treas. Reg. § 1.871-14(g)(3)(i).

believe the rules under that section should control the rules that will apply permanently under GILTI.

A benefit of the Partnership Level Approach is that, in contrast to the Partner Level Approach, it does *not* provide a U.S. shareholder in a CFC with a greater Section 163(j) limitation if the U.S. shareholder holds a CFC inside rather than outside a partnership. There is no policy justification for this distinction that arises under the Partner Level Approach. Moreover, the increased Section 163(j) limitation that arises under the Partner Level Approach is inconsistent with applying the Section 250 deduction before the Section 163(j) limitation. *See* Part IV.D.3.

To illustrate, assume that outside a partnership, the Section 250 deduction applies before the Section 163(j) limitation. The same result would arise under the Partnership Level Approach, since all calculations under both GILTI and Section 163(j) are made at the partnership level. Yet under the Partner Level Approach, Section 163(j) is still required by statute to be applied first at the partnership level, and then Section 951A and Section 250 are applied at the partner level. This allows a larger Section 163(j) limitation because the partnership taxable income is computed without taking into account the Section 250 deduction.

> <u>Example 18(a): Partner directly holds CFC and has Section 163(j) limitation.</u> Assume a corporation is engaged in business and directly owns a CFC, the CFC gives rise to $100 of Section 951A inclusion, and the corporation has $50 of interest expense and $50 of net profit (aside from the inclusion) before taking account of this interest expense. The corporation has a Section 250(a)(1) deduction of $50, leaving it with taxable income of $100 before interest expense. Under Section 163(j), the interest deduction is limited to $30, so net taxable income is $70. Section 250(a)(2) does not apply because taxable income before the Section 250(a)(1) deduction is $120.
>
> <u>Example 18(b): The business, the CFC and Section 163(j) interest are at partnership level</u>. Same facts as Example 18(a), except the business, the CFC and the debt are held through a partnership.

In Example 18(b), under the Partnership Level Approach, the partnership has $100 of Section 951A inclusion and $50 of Section 250 deduction, leaving taxable income before interest expense of $100 and a Section 163(j) limit on interest of $30. The partnership passes through $70 of taxable income to the partner, the same result as in Example 18(a).

In Example 18(b), under the Partner Level Approach, the partnership has $100 of tested income, no Section 250 deduction, and $50 of business income. The Section 163(j) limit must be applied at the partnership level and is $45. The partnership passes through $100 of tested income, $50 of business income and a $45 interest deduction to the partner. The partner has a Section 951A inclusion of $100, a Section 250 deduction of $50, and an interest deduction of $45, and business income of $50. Taxable income is $55, as compared to $70 in the other cases.

In summary, under the Partner Level Approach, Section 163(j) applied at the partnership level before Section 250 applied at the partner level. The result is that the interest allowed was 30% of $150, rather than 30% of $100, for a reduction in taxable income of $15. If this ordering rule is not allowed outside a partnership, there is no policy reason for it to be allowed merely because the CFC and debt are held by a partnership engaged in a trade or business.

3. Conclusions

We believe that regulations or legislation should adopt the Partner Level Approach. In general, this involves applying aggregate rather than entity principles to partnerships for GILTI purposes. Aggregate principles generally reach results that are more economically correct than if a partnership is treated as an entity. Here, in particular, the results make sense by avoiding arbitrary effects of the entity approach, and by preventing taxpayers from selectively grouping and ungrouping CFCs under partnerships to maximize tax benefits.

The results under Section 163(j) do not make sense under this approach, but we are reluctant to change our recommended approach to solve this narrow issue. Rather, we believe it is important to adopt, along with the Partner Level Approach, one of the approaches to Section 163(j) described below to avoid the undue benefit from applying Section 163(j) at the partnership level and Section 250 at the partner level.[175]

One way to reach a sensible result under Section 163(j) under the Partner Level Approach would be a rule that solely for purposes of applying that section at the partnership level, a notional Section 250 deduction must be applied before Section 163(j), based on the hypothetical Section 951A inclusion and resulting Section 250 deduction that the partnership would have if it was a corporation. This would limit the ability of taxpayers to

[175] In the Report on Section 163(j), we accepted as a policy matter the fact that if a partnership receives dividends, the DRD applies at the level of a corporate partner, yet the Section 163(j) deduction is calculated at the partnership level without regard to the deduction. We stated this result was a “direct consequence” of the decision by Congress to apply Section 163(j) at the partnership level.

There, the mismatch between DRD and Section 163(j) was clearly mandated by the statute. Here, although only corporations obtain the benefit of the Section 250 deduction, the statute does not state whether the Section 250 deduction should be at the partner or partnership level. In fact, as noted in the text, the Conference Report implies that the Section 250 deduction will be taken at the partnership level, and we can speculate that the reason was to avoid an undue benefit under Section 163(j) that would arise if the Section 250 deduction were at the partner level. We believe that in the GILTI context, the proposal in the text best carries out the intent of Congress.

increase the Section 163(j) limit merely by putting the CFC and the debt into a partnership rather than holding the CFC and being liable for the debt directly.

If Treasury does not believe it has the authority to adopt these positions in regulations, it should request a statutory amendment. We note, however, that there is no provision in the statute mandating the Section 951A inclusion or the Section 250 deduction be at the partnership level. While the Conference Report assumes the deduction is taken at the partnership level, it does not say so directly, and the notional deduction under Section 250 at the partnership level that we propose could be viewed as a partial implementation of that legislative history.

This approach appears to us to be a reasonable way to accommodate the policies of GILTI and Section 163(j). We also note that Section 7 of Notice 2018-28 requires certain aspects of the partnership-level calculation under Section 163(j) to be taken into account by the partner in doing its own Section 163(j) calculation, to avoid a double benefit from partnership interest income. That result does not go as far as our proposal for a notional Section 250 deduction at the partnership level. However, it indicates a view that elements of a particular calculation may be relevant at both the partner and partnership levels in order to avoid unjustified results.

Another way to reach a sensible result for Section 163(j) and Section 250 under the Partner Level Approach would start with a rule that the Section 951A inclusion and the Section 250 deduction are taken entirely at the partner level. Then, a rule would be adopted that if a partnership is a shareholder owning 10% or more of the stock of a corporation, that stock would automatically be considered as held for investment rather than as a business asset, and no interest expense of the partnership on debt allocable to that stock would be considered business interest expense under Section 163(j). As a result, if the partnership was a U.S. shareholder of a CFC, any inclusion by the partnership of tested income from the CFC would be investment income, and any interest expense of the partnership allocable to stock of the CFC would not be business interest expense. As a result, Section 163(j) would apply at the partnership level without regard to either such item.

Tested income and interest expense would then presumably pass through to a corporate partner as business income and business interest expense, respectively, and would be subject to Section 163(j) at the partner level. As a result, both Section 250 and Section 163(j) would apply at the partner level, with the same result as if the partner held the CFC stock directly.[176]

This approach requires treating all 10% shareholdings by partnerships as investment assets under Section 163(j). This would be difficult to justify as a factual matter in many circumstances. As a result, a *per se* rule would be necessary to achieve the desired

[176] *See* the Report on Section 163(j), at 41-42, for a discussion of the consequences under Section 163(j) when a partnership holds investment assets. This approach would also reach a similar result under the Partnership Level Approach. In that case, the Section 250 deduction would be taken at the partnership level and pass through to the partner, and Section 163(j) would also apply at the partner level because the interest expense would not be business interest expense at the partnership level.

coordination with Section 250 in all cases. Lack of a *per se* rule would also allow considerable electivity by taxpayers who could combine or disaggregate partnership business activity and ownership of subsidiaries. In addition, there is no logical reason for the *per se* rule to apply only to 10% holdings in CFCs as opposed to holdings in any domestic or foreign corporation. Consequently, this proposal would have significance in the domestic context well beyond GILTI, and would require further consideration that is beyond the scope of this Report.

4. Related Issues

If (contrary to our proposal) the Partnership Level Approach is adopted, regulations should clarify how it is applied in certain ownership situations described below. In that connection, note that under Sections 958(b) and 318(a)(3)(A), in testing whether a U.S. partnership is a U.S. shareholder of a CFC, and in testing for CFC status, a partnership is deemed to own the stock in a foreign corporation owned by the partners in the partnership. We believe regulations should confirm the following:

(1) If a U.S. partnership owns directly (or indirectly under Section 958(a)) 10% of a CFC, then the partnership is a U.S. shareholder and its GILTI calculation should be based on such ownership in the CFC.

(2) Suppose a U.S. partnership owns directly (or indirectly under Section 958(a)) less than 10% of a CFC, but owns 10% after taking into account constructive ownership of CFC stock owned by its partners under Section 958(b). The partnership is a U.S. shareholder, but its inclusion under Section 951A is limited to its *pro rata* share of the tested income of the CFC based on its direct and Section 958(a) indirect ownership.

(3) Suppose a partnership owns 100% of a CFC, and it has two 50% U.S. partners. The partnership and each partner are U.S. shareholders of the CFC. However, as in (2), the income inclusion is at the partnership level, so the calculations should still be made at the partnership level rather than the partner level.

(4) In all of these cases, the Section 250 deduction would be available even to a corporate partner that was not itself a U.S. shareholder of the CFC. Section 250 is triggered by a Section 951A inclusion by a domestic corporation, regardless of the status of the corporation as a U.S. shareholder.

Regulations should also state whether, under the Partnership Level Approach, the Section 250(a)(2) limit is determined at the partnership level or the partner level. If it is determined at the partnership level, the partnership might obtain a Section 250 deduction and pass it through to a partner that did not itself have sufficient taxable income to be entitled to the deduction directly. In this situation, regulations should also state whether Section 172(d)(9) would apply to limit the partner from using the passed-through Section 250 deduction in calculating its own NOL carryover.

Moreover, as discussed above, under the Partnership Level Approach, regulations should clarify whether under Section 960(d), a domestic corporation with Section 951A inclusions from more than one partnership, or from one or more partnerships and from any directly held CFCs, will have a single or multiple inclusion percentages. Also, even if a corporation has only a single Section 951A inclusion from a single partnership, regulations should also clarify how the inclusion percentage is determined under the Partnership Level Approach. The Section 951A inclusion at the partnership level is based on items that go into the calculation of the inclusion percentage (*e.g.*, NDTIR, interest expense, tested income and tested losses of each CFC). Regulations should clarify whether there is a "look-through" of some or all of these items directly to the corporate partner, or whether there is a netting of any of these items (*e.g.*, tested income and tested loss) at the partnership level before the net amount is passed through to the corporate partner.

In addition, regulations should confirm certain additional aspects of the relationship between the Section 250 deduction and the Section 163(j) limit. Under our proposal for both the Partnership Level Approach and the Partner Level Approach, the Section 250 deduction would be calculated either actually or notionally at the partnership level before the Section 163(j) deduction is determined at the partnership level. However, individuals and non-U.S. corporations are not eligible for the Section 250 deduction. As a result, presumably only the usable portion of the Section 250 deduction should be taken into account in calculating the Section 163(j) limit. To illustrate, if all the partners are individuals, it would not make sense for the Section 163(j) limit to assume a 50% deduction to all partners, when none in fact are entitled to the deduction.

The partnership should therefore obtain an "extra" Section 163(j) deduction on account of its individual partners who are not entitled to a Section 250 deduction. Presumably such extra deduction would be required to be allocated to the individual partners. This would reduce the partnership's carryforward of Section 163(j) deductions.

Regulations should clarify that the partnership must limit the extra allocation of interest deduction to a partner to the interest deductions that are allowable to the partnership under Section 163(j) only because the partner's share of partnership income is not reduced by the Section 250 deduction at the partnership level with respect to that partner. The extra allocation should reduce the portion of the carryover that is allocated to the partner. Absent such a rule, a partnership could allocate a disproportionate amount of its total interest deductions to partners that could not use a Section 250 deduction, and there would not be substantial economic effect to such an allocation. Such a special allocation also seems inconsistent with the statutory requirement that the Section 163(j) limit be determined at the partnership level.

Logically, the same approach of an increased Section 163(j) allocation should apply for a corporate partner that could not use its entire Section 250 deduction because of the taxable income limit in Section 250(a)(2). However, partners of a partnership might not be willing to inform the partnership about whether their Section 250 deduction would be so limited. As to partners such as direct non-U.S. partners who would not obtain a Section 250 deduction, presumably the Section 163(j) deduction would be determined without regard to an actual or notional Section 250 deduction at the partnership level, although it would be necessary to look through a partner that is a partnership to determine the nature of the ultimate partners.

Finally, Part IV.D.7 discusses certain issues concerning tax basis in a partnership interest.

G. Other Issues

1. Section 962 Election

If an individual U.S. shareholder directly holds stock in a CFC, the individual has an income inclusion under Section 951A without a deduction under Section 250. As a result, the maximum tax rate on the GILTI inclusion is 37%. No foreign tax credit is allowed, although foreign taxes reduce tested income and therefore the GILTI inclusion. In the past, the shareholder was not taxed on current earnings except for Subpart F income, and if the CFC was in a treaty country, a dividend was QDI taxed at the rate of 20% (disregarding Medicare tax).[177] As a result, the Act imposes a significant tax increase on a U.S. shareholder in this situation.

Section 962 is designed to allow an individual U.S. shareholder of a CFC to elect to be placed in approximately the same position for Subpart F inclusions as if the CFC stock was held through a domestic corporation. Moreover, Section 951A(f)(1)(A) states that for purposes of Section 962, the Section 951A inclusion is to be included in income in the same manner as a Section 951(a) inclusion under Subpart F. Therefore, Congress clearly contemplated that an individual could obtain relief from the GILTI consequences above by making the Section 962 election.

Section 962(a) imposes tax on the electing individual shareholder at the corporate rate on the "amounts which are included in his gross income under section 951(a)" if the shareholder were a corporation. The gross income inclusion for GILTI is the Section 951A inclusion (including the Section 78 gross-up if an FTC is being claimed) without regard to the Section 250 deduction. Moreover, the regulations make clear that the corporate tax is imposed on Subpart F income without the allowance of any deductions.[178]

The no-deduction rule makes sense for purposes of Subpart F, since the tax is being imposed as if the CFC was held by a hypothetical domestic corporation having no assets other than CFC stock. However, this rationale does not apply to the Section 250 deduction, and it seems doubtful that Congress intended to require that Section 962 apply without the deduction. The deduction is intended to create a reduced effective tax rate, rather than operate as a typical deduction that involves an outlay of funds.[179] The fact that Congress chose to achieve a reduced tax rate on foreign earnings by means of a gross income

[177] Section 1(h)(11).

[178] Treas. Reg. § 1.962-1(b)(1)(i).

[179] *See, e.g.*, Conference Report at 623 n. 1517 ("The Committee intends that the deduction allowed by new Code section 250 be treated as exempting the deducted income from tax.").

inclusion and a deduction, rather than a reduced tax rate, should have no effect on the policy of Section 962 of treating the shareholder as owning the CFC stock through a corporation.

To be sure, the language of Section 951A(f)(1)(A) does not itself seem broad enough to authorize the Section 250 deduction. In addition, Section 5 of Notice 2018-26 allows a shareholder making a Section 962 election to obtain the Section 965(c) deduction at the shareholder level. However, the Notice is expressly limited to Section 965 and relies in part on the fact that individuals are themselves eligible for the Section 965 deduction for dividends received directly.

Nevertheless, we believe that Treasury should issue regulations confirming that the Section 250 deduction is available for a Section 962 election. If Treasury does not believe it has the authority to do so, we recommend an amendment to the statute.

Next, when the CFC distributes PTI to the U.S. shareholder, the distribution is included in the shareholder's income under Section 962(d). Treasury should clarify whether the income is QDI. Allowing treatment as QDI is necessary to achieve the purpose of Section 962 of treating an individual shareholder of a CFC approximately the same as if the CFC stock had been held by a domestic corporation owned by the U.S. shareholder. Under this construct, the CFC's distribution of PTI to the U.S. shareholder is treated as a distribution by the CFC of PTI to the domestic corporation, followed by a dividend from the domestic corporation to the U.S. shareholder.[180] We note that resolution of this issue has broader implications than GILTI.

Finally, the statute and regulation[181] state that only an individual U.S. shareholder (*i.e.*, with 10% ownership in the CFC) can make the election. Section 5 of Notice 2018-26 states that for purposes of Section 951, only an individual that is a U.S. shareholder of a CFC, whether by virtue of directly held stock, stock held through a partnership, or both, can make the Section 962 election. In such case, the election applies both to directly owned stock in the CFC as well as the individual's share of partnership income earned through the CFC. If a U.S. partnership is a U.S. shareholder of a CFC but an individual partner is not, the individual cannot make the election. These rules automatically apply to Section 951A by cross-reference.

We believe these positions are reasonable. We note that an individual partner in a foreign partnership clearly looks through the foreign partnership under the usual rules, in determining whether the individual is a U.S. shareholder of the CFC eligible for the election.[182]

[180] Treas. Reg. § 1.962-3(b)(4) achieves similar parity by treating a redemption of stock by the CFC as eligible for capital gain treatment to the U.S. shareholder, rather than being considered a partial taxable distribution of earnings and profits.

[181] Treas. Reg. § 1.962-2(a).

[182] *See* Treas. Reg. § 1.962-2(b)(1), requiring the reporting of any intermediate partnership through which the individual holds the interest in the CFC.

2. Fiscal Transition Year 2017-2018

If a CFC has a fiscal year, income earned in the 2017-2018 fiscal year is exempt from GILTI.[183] This gives rise to opportunities for avoiding Section 951A inclusions in subsequent taxable years. For example, a CFC might sell an appreciated asset to an affiliate during this period, in which case the affiliate can take depreciation or amortization deductions in future periods to reduce its tested income in those years. If the asset is a depreciable tangible asset, this transaction may also increase the overall QBAI in the system, which will increase future NDTIR. If the affiliate has a calendar year tax year, it can also take a current deduction from tested income for interest expense, royalties, etc. paid during this period to a fiscal year affiliate.

The statute[184] contemplates a broad delegation of authority to Treasury to adopt anti-abuse rules for transactions intended to increase QBAI, including during the transition period. The legislative history[185] contemplates a much broader delegation of authority to disregard all noneconomic transactions intended to minimize tax under the GILTI rules, not only during the transition period. We have been asked by government representatives to consider the possible scope of regulations to exercise this authority.

Suppose a transaction during the transition period between affiliates gives rise to exempt income in the current year, and a deduction from tested income in the current year or a future year (*e.g.*, through use of tax basis created in the transition year). Possible tests for disallowance of the deduction from tested income are the following, from the most permissive to the most restrictive:

(1) No disallowance.

(2) Presumptive allowance overcome by government showing of a bad purpose.

(3) Presumptive disallowance overcome with a showing of a good business purpose.

(4) Disallowance if "the principal purpose" of the transaction was to obtain exempt income and a deduction from tested income.

(5) Disallowance if "a principal purpose" of the transaction was to obtain exempt income and a deduction from tested income.

(6) Automatic disallowance.

[183] Section 951A applies to taxable years of a foreign corporation beginning after December 31, 2017.

[184] Section 951A(d)(4).

[185] Conference Report at 645.

Any of these standards could be enforced in the case of an asset sale by mandating a carryover basis for calculating tested income. Moreover, similar standards might apply to acceleration of income into the transition period, such as prepayments from customers or sale/leasebacks of property with third parties, or to deferral of deductions until after the transition period.

We note that in the context of transactions that reduce Section 965 tax liability, Section 3.04(a) of Notice 2018-26 adopts alternative (5) as a general matter, with several of the other alternatives applying in the case of various specified categories of transactions. In addition, Section 3.04(b) of the Notice disregards any change in method of accounting on or after November 2, 2017 for purposes of Section 965, regardless of the purpose of the change. It is not clear whether Treasury will adopt similar anti-abuse rules for GILTI, although we note that the statutory basis for anti-abuse rules under Section 951A is narrower than the broad grant of authority for anti-abuse rules under Section 965(o).

If Treasury does not believe that the statute and the Conference Report give it the authority to issue regulations of the type described in the Conference Report and that it believes are necessary to eliminate abuses during or after the transition period, it should request an amendment to the statute to conform its authority to that described in the Conference Report.

3. Effect of Section 958(b)(4) Repeal

The Act repealed Section 958(b)(4), which prohibited the "downward attribution" rules from treating stock that is owned by a non-U.S. person as being owned by a U.S. person.[186] While the repeal is unconditional, a colloquy (the "**colloquy**") on the Senate floor states that the repeal was not intended to apply to a U.S. shareholder of a CFC if the CFC qualifies as such only because of downward attribution to a U.S. person that is not related to the U.S. shareholder.[187] It further states that Treasury Regulations should interpret the provision accordingly.[188] The Senate Finance Committee's explanation of the corresponding provision in the Senate Bill is to the same effect,[189] and there is no indication that Congress intended repeal to have broader consequences.

[186] Act § 14213.

[187] 163 Cong. Rec. No. 207 (Dec. 19, 2017) at p. S8110 (colloquy between Senator Hatch, Chairman of the Senate Finance Committee and Senator Perdue).

[188] *Id.*

[189] "This provision is not intended to cause a foreign corporation to be treated as a controlled foreign corporation with respect to a U.S. shareholder as a result of attribution of ownership under section 318(a)(3) to a U.S. person that is not a related person (within the meaning of section 954(d)(3)) to such U.S. shareholder as a result of the repeal of section 958(b)(4)." Committee Print, *Reconciliation Recommendations Pursuant to H. Con. Res. 71*, S. Prt. 115–20, (December 2017), p. 378, as reprinted on the website of the Senate Budget Committee, available at *https://www.budget.senate.gov/taxreform*.

The unconditional repeal of Section 958(b)(4) could create Section 951A inclusions in the following situations. According to the colloquy, such inclusions were not intended to be created by such repeal.

- A U.S. corporation or partnership (D1) owns 10% of the stock of foreign corporation (F1), and the other 90% of F1 is owned by an unrelated foreign corporation with no U.S. shareholders but with a U.S. subsidiary (D2). Then, D2 constructively owns 90% of F1, F1 would be a CFC, and D1 would have a Section 951A (and Subpart F) inclusion from F1. If D1 was a partnership, its partners would have a Section 951A inclusion and its individual partners would not have a Section 250 deduction.

- D1 owns 10% of F1, and F1 owns 100% of both a domestic subsidiary D2 and a foreign subsidiary F2. Then, D2 constructively owns 100% of F2, F2 is a CFC, and D1 has a Section 951A inclusion from F2.

We do not believe that these results should arise. There is no logic to a U.S. person being treated as a U.S. shareholder of a CFC merely because an unrelated foreign shareholder of the purported CFC happens to have a U.S. subsidiary with no direct ownership interest in the CFC.

We therefore believe that the consequences of the repeal of Section 958(b)(4) should be limited to conform to the apparent Congressional intent as expressed in the colloquy, either by regulations or an amendment to the statute. Section 3.01 of Notice 2018-26 gives very limited relief from the repeal of Section 958(b)(4) in applying the constructive ownership rules to partnerships for purposes of Section 965. This may indicate that Treasury does not believe it has the authority to further limit the consequences of repeal, in which case we recommend requesting an amendment to the statute.

Of course, limiting the consequences of the repeal would have significance well beyond GILTI. Thus, any regulations or statutory amendment should take into account the intended results not just for GILTI, but also for other Code sections that were affected by the repeal.

In addition, even as to GILTI, the colloquy does not deal with the case where the tax treatment of a U.S. shareholder depends upon the status of a corporation as a CFC (or not) before or after the U.S. shareholder became a U.S. shareholder. Return to two cases discussed in Part IV.D.2.

- Similar to footnote 117: A foreign corporation (F) has a foreign subsidiary (F1) and a U.S. subsidiary (US1). U.S. corporation (P) buys the stock of F1 from F in the middle of the year. Then, US1 constructively owned all of F1 for the period before the sale, so F1 is a CFC for the entire year. P apparently has a Section 951A or Subpart F inclusion for the entire year rather than only for the post-sale portion of the year.

- Same as Example 14(c): A U.S. shareholder (US1) of a CFC sells stock in the

CFC to a non-U.S. person F, but F has a U.S. subsidiary (FSub) so the CFC remains a CFC for the entire year. As a result, there is no Section 951A inclusion or Subpart F income reported for the year of the sale.

In the first case, the overinclusion in income to P does not arise because F1 was a CFC *as to P* during the first part of the year, but rather because it was a CFC at all in the first part of the year (when P was not a shareholder). Likewise, in the second case, the underinclusion arises because the CFC remained a CFC during the second half of the year, at a time when US1 was not a shareholder. As a result, additional changes beyond the colloquy would be necessary if the intent was to change the result in these situations.

4. Overlap Between Section 250(a)(2) and Section 172(d)(9)

Section 172(d)(9) states that the Section 250 deduction is not allowed in calculating a net operating loss. Regulations should clarify the situations where this provision becomes relevant in light of Section 250(a)(2), which limits the combined GILTI/FDII deduction to a percentage of taxable income determined without regard to Section 250. On its face, Section 172(d)(9) could never become applicable, since limiting the Section 250 deduction to a percentage of taxable income (otherwise determined) would by itself prevent the Section 250 deduction from creating or increasing a net operating loss that would be limited under Section 172(d)(9). Moreover, Section 250(a)(2) must apply before Section 172(d)(9), since the former affects deductions allowed in the current year and the latter only affects carryovers to future years.

However, in Part IV.D.4, we discuss the possibility that the Section 250(a)(2) carve-back does not limit the Section 250(a)(1) deduction for the Section 78 gross-up amount, in which case the Section 250(a)(1) deduction might create a taxable loss for the year. Moreover, in Part IV.F.4, we propose a possible occasion for Section 172(d)(9) to apply in the partnership context. It is not clear whether the drafters had either of these situation in mind, so it would be helpful for regulations to clarify cases in which Section 172(d)(9) would be applicable.

5. Medicare Tax (Section 1411)

Regulations should clarify whether GILTI inclusions are investment income under Section 1411.

6. REIT Income

Regulations should clarify the extent to which GILTI inclusions are qualified income for REIT purposes.[190] There is clear statutory authority for such regulations.[191] The current Treasury/IRS Priority Guidance Plan already includes a project to determine

[190] Section 856(c).

[191] Section 856(c)(5)(J).

whether Subpart F income is qualifying income under Section 856(c),[192] and this project should logically be extended to GILTI inclusions. Some PLRs have applied look-through treatment for passive income of a CFC that is Subpart F income.[193]

7. RIC Income

Section 951A(f)(1)(A) treats GILTI inclusions as Subpart F income for purposes of Section 851(b). Section 851(b) (flush language) states that Subpart F inclusions are not treated as qualifying dividends unless there is an actual distribution that corresponds to the inclusion. Proposed regulations state that Subpart F inclusions do not qualify as other income derived with respect to the business of investing in stock.[194] In a prior Report, we stated our disagreement with this aspect of the proposed regulations.[195] Regulations should clarify the rules for a RIC that has a GILTI inclusion.

8. UBTI

We believe that GILTI inclusions are not unrelated business taxable income to tax-exempt U.S. shareholders under the terms of Section 512. Nevertheless, we believe that published guidance to confirm this would be helpful because of the importance of the issue to tax-exempts and the lack of published guidance in analogous areas such as Subpart F. The Tax Section is preparing a broader Report on tax-exempt issues that will address this issue in greater detail.

H. Proposed Aggregation of CFCs held by a U.S. Shareholder

This section proposes legislation to treat all Related CFCs of a particular U.S. shareholder as a single corporation for purposes of the GILTI calculations. We believe that the existing rules that treat each CFC separately are unjustified as a policy matter, are very unfair to taxpayers, and invite restructurings solely for tax purposes. We acknowledge that the existing rules are clear and are supported by the legislative history of the Act. Nevertheless, we urge the Congress to reconsider these provisions and for Treasury to support such reconsideration.

Under Sections 951A and 250, if a single U.S. corporation is a U.S. shareholder in more than one Related CFC, several uneconomic results arise from the separate treatment of each CFC.

[192] Department of the Treasury, 2017-2018 Priority Guidance Plan, as updated February 7, 2018.

[193] *See, e.g.*, PLRs 201605005 (addressing REIT qualification), 201430017 (addressing UBTI for a tax-exempt organization), and 201043041 (addressing UBTI for a charitable remainder unitrust).

[194] REG-123600-16, Sept. 28, 2016.

[195] NYSBA Tax Section Report Number 1359, *Report on Proposed Regulations under Section 851 Dealing with Imputations from CFCs and PFICs,* Nov. 29, 2016.

First, QBAI can create NDTIR only to the extent the underlying property is "tangible properly used in the production of tested income".[196] A CFC with a tested loss does not literally have tested income, and so QBAI of any CFC with a tested loss can never create NDTIR. This QBAI is "wasted" and never provides any tax benefit to a U.S. shareholder.

The mere possibility of wasted QBAI could have a significant effect on supply chain planning. For example, a business model might contemplate manufacturing in one CFC and sales by another CFC. All the QBAI is in the first CFC. If there is a risk that the first CFC will have a tested loss, this model becomes uneconomic and the taxpayer is forced to combine both CFCs, either in actuality or through check the box. It is doubtful that Congress intended this to be a result of the GILTI rules.

The statute might be read broadly to say that QBAI qualifies if it produces income that *would be* tested income if the corporation in question had positive tested income. However, the legislative history is clear that this is not the intended interpretation of the statute.[197]

Second, foreign taxes are taken into account to the extent they are "properly attributable" to tested income.[198] The legislative history is clear that this prevents the U.S. shareholder from receiving an FTC for taxes paid by a CFC with a tested loss.[199] As a result, even if a CFC has income that is treated as income for both U.S. and foreign tax purposes, and is subject to foreign tax, an offsetting loss in the CFC that produces an overall tested loss in the CFC precludes an FTC.

This result may be particularly unfair to taxpayers when a CFC has an overall tested loss, but a branch or a disregarded subsidiary has, on a stand-alone basis, tested income and pays foreign taxes. The branch income reduces the shareholder's tested loss from the CFC, which may increase the shareholder's net CFC tested income and Section 951A inclusion. The foreign taxes paid by the branch are a real cost of the increase in tested income, but no FTCs are available.

As noted above, the legislative history makes clear that the lack of FTCs for a CFC with no tested income was intended by Congress. Therefore, we do not suggest that Treasury should change this result by regulation. However, we urge Congress to reconsider

[196] Section 951A(d)(2)(A).

[197] Conference Report at 642 n. 1536 ("Specified tangible property does not include property used in the production of tested loss, so that a CFC that has a tested loss in a taxable year does not have QBAI for the taxable year".).

[198] Section 960(d)(3).

[199] Conference Report at 643 n. 1538 ("Tested foreign income taxes do not include any foreign income tax paid or accrued by a CFC that is properly attributable to the CFC's tested loss (if any)").

these rules since they give very arbitrary results and invite restructurings solely to minimize tax liability.

Moreover, these rules give extremely arbitrary results that can be very unfair to taxpayers. Consider a U.S. shareholder that holds two CFCs, CFC1 and CFC2. If CFC1 has tested income for a year and CFC2 has a tested loss, the tested loss will reduce the net CFC tested income of the U.S. shareholder. However, the U.S. shareholder will obtain no benefit from any FTCs or notional QBAI return of CFC2. This is true whether CFC2's tested loss is $1 or $1 billion.

On the other hand, if CFC2 has $1 of tested income, all of its FTCs and QBAI return would be taken into account by the U.S. shareholder. It is difficult to understand why there should be such a vastly different outcome depending on whether CFC2 has income or loss under U.S. tax principles – a distinction that could turn on less than $1.

These rules also cause very formalistic results. Turn back to Example 15(a), where CFC1 has two divisions, division 1 generates tested income, division 2 generates tested loss, there is overall net positive tested income, and division 2 bears a foreign tax. We conclude that there should not be a tracing of FTC to particular dollars of tested income, so the FTC should be allowed for division 2 even though it generates a tested loss on a stand-alone basis. Moreover, we reach the same conclusion in Example 15(b), where division 2 is transferred to a disregarded subsidiary.

Assume now that CFC1 transfers division 2 to a subsidiary entity, CFC2, that is a corporation for U.S. tax purposes. Now, CFC2 has a tested loss and bears a foreign tax. However, since it is a separate corporation, the U.S. shareholder does not receive any FTC for that foreign tax.

There is no logical reason for this distinction. Moreover, the same distinction arises if division 2 has QBAI return rather than FTC. As in Examples 15(a) and 15(b), it is clear that if a particular CFC has any tested income, the QBAI return of that CFC is not limited to the return on particular assets that generate positive tested income. Rather, the deduction for NDTIR under Section 951A(b)(1)(B) aggregates all QBAI returns of all CFCs with positive tested income, without any tracing of QBAI return of a CFC to particular tested income of the same CFC.

Similarly, suppose CFC1 has a tested loss, interest expense, and notional QBAI return, and CFC2 has tested income and QBAI return. The notional QBAI return of CFC1 is disregarded, yet it is unclear whether the interest expense of CFC1 reduces the NDTIR generated by CFC2's QBAI (*see* discussion in Part IV.D.6). If this interest expense did reduce the NDTIR, all the notional QBAI return of CFC1, and the QBAI return of CFC2 up to CFC1's interest expense, would both be "wasted". This result would make no sense at all.

Finally, suppose CFC1 has $100 of tested income and pays foreign taxes, and CFC2 has a tested loss. If CFC2's tested loss is less than $100, the U.S. shareholder will have net CFC tested income, but the inclusion percentage for the FTC will be reduced on account of the tested loss. If instead CFC2 was a branch of CFC1, the net CFC tested income would be the same, but the inclusion percentage would be 100% (assume no NDTIR), so there would be no cutback on the FTC. On the other hand, if the CFC2 tested loss was $100 or more, the U.S. shareholder would be worse off if CFC2 was a branch of CFC1 than a separate CFC, because as a branch, the disadvantages of a CFC without tested income would then encompass CFC1 as well as CFC2.

These results are arbitrary and counter-intuitive, and encourage restructuring of business organizations purely for tax reasons. In particular, Related CFCs of a U.S. shareholder will be separated or combined (including by using "check-the-box" elections) to distribute tested income among CFCs in a manner so as to minimize the likelihood that CFCs with meaningful QBAI and/or FTCs will have tested losses. It might also become desirable to artificially accelerate income at year end in particular CFCs to prevent the existence of a tax loss for the year. Taxpayers will also attempt to rely on the administrative relief to make retroactive check the box elections, if events do not turn out as expected.

The need for such tax planning would be reduced or eliminated if all Related CFCs of a particular U.S. shareholder were treated as a single corporation for purposes of the GILTI calculations. The rule would apply regardless of whether the CFCs were each directly held by the shareholder or if they were in chains of ownership. Then, the tested income or tested loss of a particular CFC would not matter, and FTCs and QBAI return of all CFCs would be available as long as there was overall tested income. This result would not be unduly favorable to taxpayers, since it can be created by self-help today if the U.S. shareholder puts all its CFCs under a single CFC holding company and checks the box on all the subsidiary CFCs. In fact, mandatory aggregation can be viewed as anti-taxpayer, because the well-advised taxpayer today has the choice of aggregation or nonaggregation by simple tax planning, and nonaggregation is often more favorable.

Such aggregation is clearly at odds with Congressional intent in drafting Section 951A. However, it is not clear that Congress realized the anomalous results created by nonaggregation and how self-help could achieve results similar to aggregation.

If this proposal was enacted, and regulations were adopted to treat all members of a consolidated group as a single corporation for purposes of Section 951A,[200] the result would be the aggregation of all Related CFCs of all members of a consolidated group. We believe this would greatly simplify the GILTI rules, be much fairer to taxpayers, and avoid the need for uneconomic tax planning by taxpayers.

We are not suggesting, however, that all Related CFCs owned by a single U.S. shareholder (or members of a single consolidated group) should be treated as a single corporation for all purposes, so that all transactions between them should be disregarded in calculating tested income. This would, for example, eliminate tested income when one CFC sells an asset to another CFC at a gain. While elements of such a rule apply under

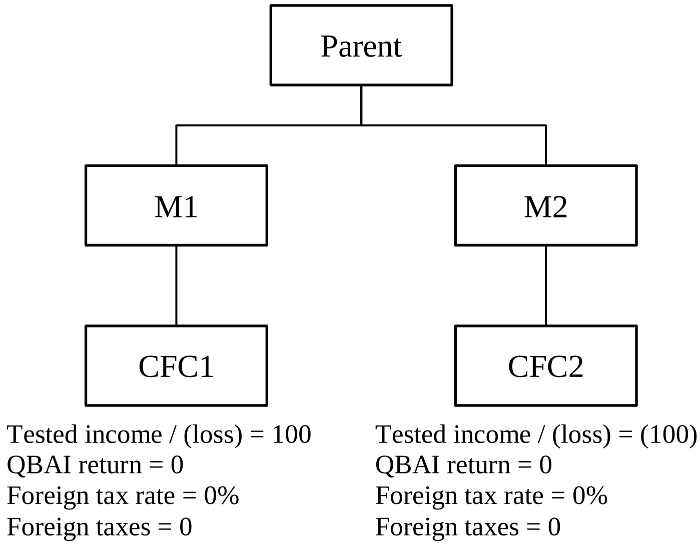
[200] *See* Part IV.B.4.

Subpart F for transactions between CFCs, such a rule would require considerably more analysis.

APPENDIX 1

The charts and calculations on the following pages illustrate certain of the examples in the Report.

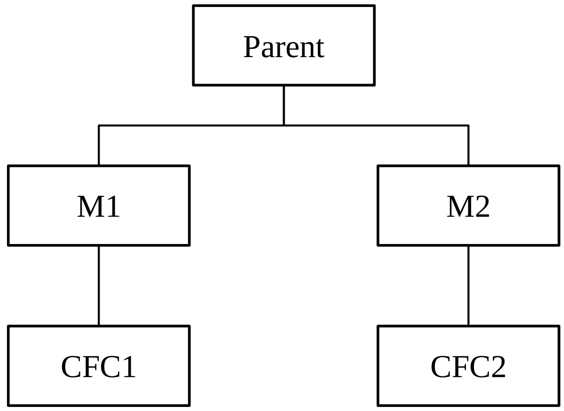
Example 6(a)



	Nonaggregation		**Aggregation**
	M1	**M2**	**M**
Net CFC tested income	100	0	0
NDTIR	0	0	0
Section 951A inclusion	100	0	0
Aggregate of Related CFCs' tested income	100	0	100
Inclusion percentage (Section 951A incl. / Agg. Rel. CFCs' tested income)	100%	0%	0%
Foreign tax paid by Related CFCs with tested income	0	0	0
FTCs (80% * Inclusion percentage * Foreign tax)	0	0	0
Section 78 amount (Inclusion percentage * Foreign tax)	0	0	0
GILTI inclusion (Section 951A inclusion + Section 78 amount)	100	0	0
US tax before FTCs (GILTI inclusion * 50%[201] * 21%)	10.50	0	0
Incremental US tax, taking into account FTCs (US tax before FTCs - FTCs)	10.50	0	0
Aggregate tax (Foreign tax + Incremental US tax)	10.50	0	0
Aggregate tax for consolidated group	**10.50**		**0**

[201] Assumes full Section 250 deduction for GILTI is available.

Example 6(b)[202]



Tested income / (loss) = 100
QBAI return = 100
Foreign tax rate = 0%
Foreign taxes = 0

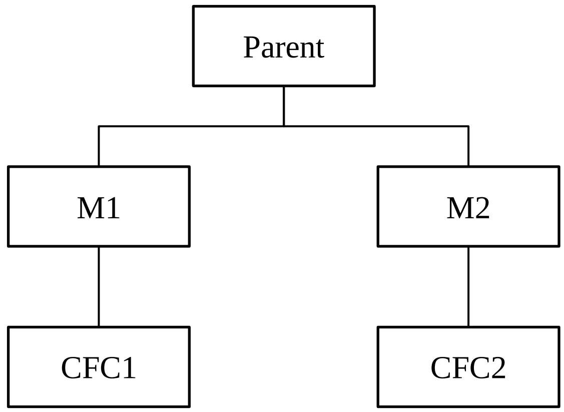
Tested income / (loss) = (50)
Interest expense = (100)
QBAI return = 0
Foreign tax rate = 0%
Foreign taxes = 0

	Nonaggregation		**Aggregation**
	M1	**M2**	**M**
Net CFC tested income	100	0	50
NDTIR	100	0	0
Section 951A inclusion	0	0	50
Aggregate of Related CFCs' tested income	100	0	100
Inclusion percentage (Section 951A incl. / Agg. Rel. CFCs' tested income)	0%	0%	50%
Foreign tax paid by Related CFCs with tested income	0	0	0
FTCs (80% * Inclusion percentage * Foreign tax)	0	0	0
Section 78 amount (Inclusion percentage * Foreign tax)	0	0	0
GILTI inclusion (Section 951A inclusion + Section 78 amount)	0	0	50
US tax before FTCs (GILTI inclusion * 50%[203] * 21%)	0	0	5.25
Incremental US tax, taking into account FTCs (US tax before FTCs - FTCs)	0	0	5.25
Aggregate tax (Foreign tax + Incremental US tax)	0	0	5.25
Aggregate tax for consolidated group	**0**		**5.25**

[202] This example assumes that interest expense in a Related CFC with tested losses reduces the U.S. shareholder's NDTIR from other CFCs with QBAI return. See discussion in Part IV.D.6.

[203] Assumes full Section 250 deduction for GILTI is available.

Example 7



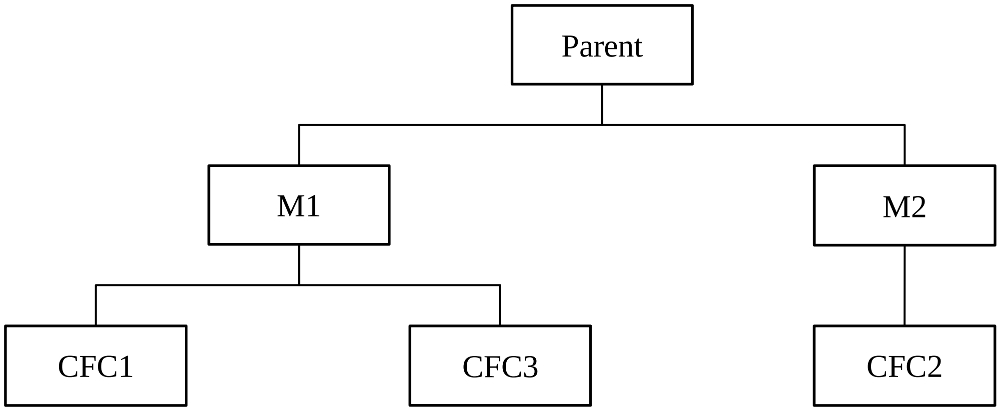
Tested income / (loss) = 100
QBAI return = 0
Foreign tax rate = 0%
Foreign taxes = 0

Tested income / (loss) = 10
QBAI return = 100
Foreign tax rate = 0%
Foreign taxes = 0

	Nonaggregation		**Aggregation**
	M1	**M2**	**M**
Net CFC tested income	100	10	110
NDTIR	0	100	100
Section 951A inclusion	100	0	10
Aggregate of Related CFCs’ tested income	100	10	110
Inclusion percentage (Section 951A incl. / Agg. Rel. CFCs' tested income)	100%	0%	9%
Foreign tax paid by Related CFCs with tested income	0	0	0
FTCs (80% * Inclusion percentage * Foreign tax)	0	0	0
Section 78 amount (Inclusion percentage * Foreign tax)	0	0	0
GILTI inclusion (Section 951A inclusion + Section 78 amount)	100	0	10
US tax before FTCs (GILTI inclusion * 50%[204] * 21%)	10.50	0	1.05
Incremental US tax, taking into account FTCs (US tax before FTCs - FTCs)	10.50	0	1.05
Aggregate tax (Foreign tax + Incremental US tax)	10.50	0	1.05
Aggregate tax for consolidated group	**10.50**		**1.05**

[204] Assumes full Section 250 deduction for GILTI is available.

Example 8(b)

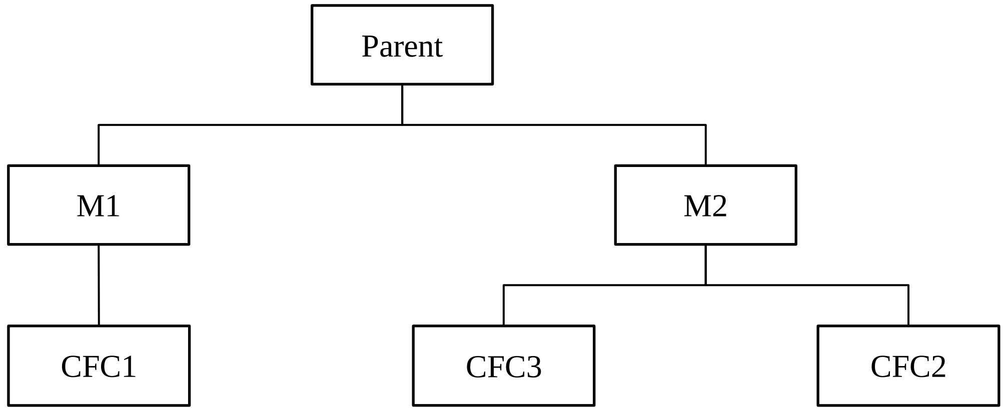


CFC1	CFC3	CFC2
Tested income / (loss) = 100	Tested income / (loss) = (100)	Tested income / (loss) = 100
QBAI return = 0	QBAI return = 0	QBAI return = 0
Foreign tax rate = 13.125%	Foreign tax rate = 0%	Foreign tax rate = 0%
Foreign taxes = 15.11	Foreign taxes = 0	Foreign taxes = 0

	Nonaggregation		**Aggregation**
	M1	**M2**	**M**
Net CFC tested income	0	100	100
NDTIR	0	0	0
Section 951A inclusion	0	100	100
Aggregate of Related CFCs’ tested income	100	100	200
Inclusion percentage (Section 951A incl. / Agg. Rel. CFCs' tested income)	0%	100%	50%
Foreign tax paid by Related CFCs with tested income	15.11	0	15.11
FTCs (80% * Inclusion percentage * Foreign tax)	0	0	6.04
Section 78 amount (Inclusion percentage * Foreign tax)	0	0	7.55
GILTI inclusion (Section 951A inclusion + Section 78 amount)	0	100	107.55
US tax before FTCs (GILTI inclusion * 50%[205] * 21%)	0	10.50	11.29
Incremental US tax, taking into account FTCs (US tax before FTCs - FTCs)	0	10.50	5.25
Aggregate tax (Foreign tax + Incremental US tax)	15.11	10.50	20.36
Aggregate tax for consolidated group	**25.61**		**20.36**

[205] Assumes full Section 250 deduction for GILTI is available.

Example 8(c)



Tested income / (loss) = 100
QBAI return = 0
Foreign tax rate = 13.125%
Foreign taxes = 15.11

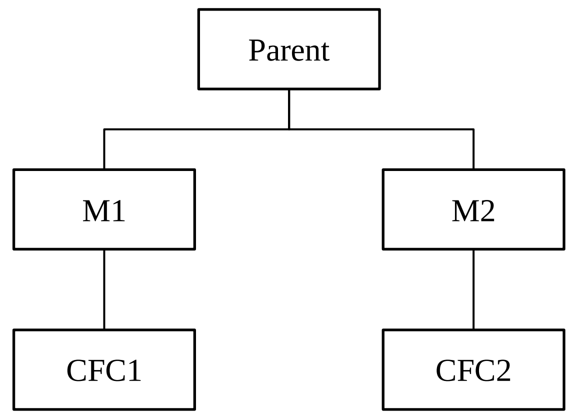
Tested income / (loss) = (100)
QBAI return = 0
Foreign tax rate = 0%
Foreign taxes = 0

Tested income / (loss) = 100
QBAI return = 0
Foreign tax rate = 0%
Foreign taxes = 0

	Nonaggregation		**Aggregation**
	M1	**M2**	**M**
Net CFC tested income	100	0	100
NDTIR	0	0	0
Section 951A inclusion	100	0	100
Aggregate of Related CFCs’ tested income	100	100	200
Inclusion percentage (Section 951A incl. / Agg. Rel. CFCs' tested income)	100%	0%	50%
Foreign tax paid by Related CFCs with tested income	15.11	0	15.11
FTCs (80% * Inclusion percentage * Foreign tax)	12.09	0	6.04
Section 78 amount (Inclusion percentage * Foreign tax)	15.11	0	7.55
GILTI inclusion (Section 951A inclusion + Section 78 amount)	115.11	0	107.55
US tax before FTCs (GILTI inclusion * 50%[206] * 21%)	12.09	0	11.29
Incremental US tax, taking into account FTCs (US tax before FTCs - FTCs)	0	0	5.25
Aggregate tax (Foreign tax + Incremental US tax)	15.11	0	20.36
Aggregate tax for consolidated group	**15.11**		**20.36**

[206] Assumes full Section 250 deduction for GILTI is available.

Example 9(b)



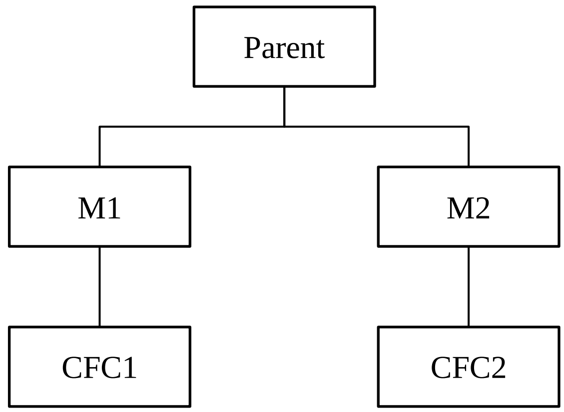
Tested income / (loss) = 100
QBAI return = 0
Foreign tax rate = 13.125%
Foreign taxes = 15.11

Tested income / (loss) = 100
QBAI return = 100
Foreign tax rate = 0%
Foreign taxes = 0

	Nonaggregation		**Aggregation**
	M1	**M2**	**M**
Net CFC tested income	100	100	200
NDTIR	0	100	100
Section 951A inclusion	100	0	100
Aggregate of Related CFCs' tested income	100	100	200
Inclusion percentage (Section 951A incl. / Agg. Rel. CFCs' tested income)	100%	0%	50%
Foreign tax paid by Related CFCs with tested income	15.11	0	15.11
FTCs (80% * Inclusion percentage * Foreign tax)	12.09	0	6.04
Section 78 amount (Inclusion percentage * Foreign tax)	15.11	0	7.55
GILTI inclusion (Section 951A inclusion + Section 78 amount)	115.11	0	107.55
US tax before FTCs (GILTI inclusion * 50%[207] * 21%)	12.09	0	11.29
Incremental US tax, taking into account FTCs (US tax before FTCs - FTCs)	0	0	5.25
Aggregate tax (Foreign tax + Incremental US tax)	15.11	0	20.36
Aggregate tax for consolidated group	**15.11**		**20.36**

[207] Assumes full Section 250 deduction for GILTI is available.

Example 9(c)



Tested income / (loss) = 100
QBAI return = 0
Foreign tax rate = 0%
Foreign taxes = 0

Tested income / (loss) = 100
QBAI return = 100
Foreign tax rate = 13.125%
Foreign taxes = 15.11

	Nonaggregation		**Aggregation**
	M1	**M2**	**M**
Net CFC tested income	100	100	200
NDTIR	0	100	100
Section 951A inclusion	100	0	100
Aggregate of Related CFCs' tested income	100	100	200
Inclusion percentage (Section 951A incl. / Agg. Rel. CFCs' tested income)	100%	0%	50%
Foreign tax paid by Related CFCs with tested income	0	15.11	15.11
FTCs (80% * Inclusion percentage * Foreign tax)	0	0	6.04
Section 78 amount (Inclusion percentage * Foreign tax)	0	0	7.55
GILTI inclusion (Section 951A inclusion + Section 78 amount)	100	0	107.55
US tax before FTCs (GILTI inclusion * 50%[208] * 21%)	10.50	0	11.29
Incremental US tax, taking into account FTCs (US tax before FTCs - FTCs)	10.50	0	5.25
Aggregate tax (Foreign tax + Incremental US tax)	10.50	15.11	20.36
Aggregate tax for consolidated group	**25.61**		**20.36**

208 Assumes full Section 250 deduction for GILTI is available.

Example 16(a)

	Taxable income	U.S. source basket	GILTI basket	Foreign source general basket		
				Exempt CFC income	**Direct income**	**Basket total**
Business income	700	700	0	0	0	0
Expenses	(700)	(500)	(100)	(100)	0	(100)
GILTI gross	600	0	600	0	0	0
GILTI deduction	(300)	0	(300)	0	0	0
Total	**300**	**200**	**200**	**(100)**	**0**	**(100)**

Calculate GILTI fraction without taking into account Section 904(b)(4), and by re-allocating $100 loss from foreign source general basket to GILTI basket

$$\text{GILTI fraction} = \frac{\text{GILTI basket income} - \text{Foreign source general basket loss}}{\text{Worldwide income}}$$

$$\text{GILTI fraction} = \frac{100}{300} = 0.33$$

Apply Section 904(b)(4) to disregard $100 of expenses allocable to exempt CFC income

	Taxable income	U.S. source basket	GILTI basket	Foreign source general basket		
				Exempt CFC income	**Direct income**	**Basket total**
Business income	700	700	0	0	0	0
Expenses	(600)	(500)	(100)	0	0	0
GILTI gross	600	0	600	0	0	0
GILTI deduction	(300)	0	(300)	0	0	0
Total	**400**	**200**	**200**	**0**	**0**	**0**

$$\text{GILTI fraction} = \frac{\text{GILTI basket income}}{\text{Worldwide income}}$$

$$\text{GILTI fraction} = \frac{200}{400} = 0.50$$

Example 16(b)

	Taxable income	U.S. source basket	GILTI basket	Foreign source general basket		
				Exempt CFC income	Direct income	Basket total
Business income	150	100	0	0	50	50
Expenses	(150)	(40)	(60)	(40)	(10)	(50)
GILTI gross	600	0	600	0	0	0
GILTI deduction	(300)	0	(300)	0	0	0
Total	**300**	**60**	**240**	**(40)**	**40**	**0**

Calculate GILTI and foreign source general basket fractions without taking into account Section 904(b)(4)

$$\text{GILTI fraction} = \frac{\text{GILTI basket income}}{\text{Worldwide income}} = \frac{240}{300} = 0.80$$

$$\text{Foreign general basket fraction} = \frac{\text{Foreign general basket income}}{\text{Worldwide income}} = \frac{0}{300} = 0$$

Apply Section 904(b)(4) to disregard $40 of expenses allocable to exempt CFC income

	Taxable income	U.S. source basket	GILTI basket	Foreign source general basket		
				Exempt CFC income	Direct income	Basket total
Business income	150	100	0	0	50	50
Expenses	(110)	(40)	(60)	0	(10)	(10)
GILTI gross	600	0	600	0	0	0
GILTI deduction	(300)	0	(300)	0	0	0
Total	**340**	**60**	**240**	**0**	**40**	**40**

$$\text{GILTI fraction} = \frac{\text{GILTI basket income}}{\text{Worldwide income}} = \frac{240}{340} = 0.71$$

$$\text{Foreign general basket fraction} = \frac{\text{Foreign general basket income}}{\text{Worldwide income}} = \frac{40}{340} = 0.12$$

I

(Legislative acts)

DIRECTIVES

COUNCIL DIRECTIVE (EU) 2016/1164

of 12 July 2016

laying down rules against tax avoidance practices that directly affect the functioning of the internal market

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty on the Functioning of the European Union, and in particular Article 115 thereof,

Having regard to the proposal from the European Commission,

After transmission of the draft legislative act to the national parliaments,

Having regard to the opinion of the European Parliament [1],

Having regard to the opinion of the European Economic and Social Committee [2],

Acting in accordance with a special legislative procedure,

Whereas:

(1) The current political priorities in international taxation highlight the need for ensuring that tax is paid where profits and value are generated. It is thus imperative to restore trust in the fairness of tax systems and allow governments to effectively exercise their tax sovereignty. These new political objectives have been translated into concrete action recommendations in the context of the initiative against base erosion and profit shifting (BEPS) by the Organisation for Economic Cooperation and Development (OECD). The European Council has welcomed this work in its conclusions of 13-14 March 2013 and 19-20 December 2013. In response to the need for fairer taxation, the Commission, in its communication of 17 June 2015 sets out an action plan for fair and efficient corporate taxation in the European Union.

(2) The final reports on the 15 OECD Action Items against BEPS were released to the public on 5 October 2015. This output was welcomed by the Council in its conclusions of 8 December 2015. The Council conclusions stressed the need to find common, yet flexible, solutions at the EU level consistent with OECD BEPS conclusions. In addition, the conclusions supported an effective and swift coordinated implementation of the anti-BEPS measures at the EU level and considered that EU directives should be, where appropriate, the preferred vehicle for implementing OECD BEPS conclusions at the EU level. It is essential for the good functioning of the internal

[1] Not yet published in the Official Journal.
[2] Not yet published in the Official Journal.

market that, as a minimum, Member States implement their commitments under BEPS and more broadly, take action to discourage tax avoidance practices and ensure fair and effective taxation in the Union in a sufficiently coherent and coordinated fashion. In a market of highly integrated economies, there is a need for common strategic approaches and coordinated action, to improve the functioning of the internal market and maximise the positive effects of the initiative against BEPS. Furthermore, only a common framework could prevent a fragmentation of the market and put an end to currently existing mismatches and market distortions. Finally, national implementing measures which follow a common line across the Union would provide taxpayers with legal certainty in that those measures would be compatible with Union law.

(3) It is necessary to lay down rules in order to strengthen the average level of protection against aggressive tax planning in the internal market. As these rules would have to fit in 28 separate corporate tax systems, they should be limited to general provisions and leave the implementation to Member States as they are better placed to shape the specific elements of those rules in a way that fits best their corporate tax systems. This objective could be achieved by creating a minimum level of protection for national corporate tax systems against tax avoidance practices across the Union. It is therefore necessary to coordinate the responses of Member States in implementing the outputs of the 15 OECD Action Items against BEPS with the aim to improve the effectiveness of the internal market as a whole in tackling tax avoidance practices. It is therefore necessary to set a common minimum level of protection for the internal market in specific fields.

(4) It is necessary to establish rules applicable to all taxpayers that are subject to corporate tax in a Member State. Considering that it would result in the need to cover a broader range of national taxes, it is not desirable to extend the scope of this Directive to types of entities which are not subject to corporate tax in a Member State; that is, in particular, transparent entities. Those rules should also apply to permanent establishments of those corporate taxpayers which may be situated in other Member State(s). Corporate taxpayers may be resident for tax purposes in a Member State or be established under the laws of a Member State. Permanent establishments of entities resident for tax purposes in a third country should also be covered by those rules if they are situated in one or more Member State.

(5) It is necessary to lay down rules against the erosion of tax bases in the internal market and the shifting of profits out of the internal market. Rules in the following areas are necessary in order to contribute to achieving that objective: limitations to the deductibility of interest, exit taxation, a general anti-abuse rule, controlled foreign company rules and rules to tackle hybrid mismatches. Where the application of those rules gives rise to double taxation, taxpayers should receive relief through a deduction for the tax paid in another Member State or third country, as the case may be. Thus, the rules should not only aim to counter tax avoidance practices but also avoid creating other obstacles to the market, such as double taxation.

(6) In an effort to reduce their global tax liability, groups of companies have increasingly engaged in BEPS, through excessive interest payments. The interest limitation rule is necessary to discourage such practices by limiting the deductibility of taxpayers' exceeding borrowing costs. It is therefore necessary to fix a ratio for deductibility which refers to a taxpayer's taxable earnings before interest, tax, depreciation and amortisation (EBITDA). Member States could decrease this ratio or place time limits or restrict the amount of unrelieved borrowing costs that can be carried forward or back to ensure a higher level of protection. Given that the aim is to lay down minimum standards, it could be possible for Member States to adopt an alternative measure referring to a taxpayer's earnings before interest and tax (EBIT) and fixed in a way that it is equivalent to the EBITDA-based ratio. Member States could in addition to the interest limitation rule provided by this Directive also use targeted rules against intra-group debt financing, in particular thin capitalisation rules. Tax exempt revenues should not be set off against deductible borrowing costs. This is because only taxable income should be taken into account in determining how much interest may be deducted.

(7) Where the taxpayer is part of a group which files statutory consolidated accounts, the indebtedness of the overall group at worldwide level may be considered for the purpose of granting taxpayers entitlement to deduct higher amounts of exceeding borrowing costs. It may also be appropriate to lay down rules for an equity escape provision, where the interest limitation rule does not apply if the company can demonstrate that its equity over total assets ratio is broadly equal to or higher than the equivalent group ratio. The interest limitation rule should apply in relation to a taxpayer's exceeding borrowing costs without distinction of whether the costs originate in

debt taken out nationally, cross-border within the Union or with a third country, or whether they originate from third parties, associated enterprises or intra-group. Where a group includes more than one entity in a Member State, the Member State may consider the overall position of all group entities in the same State, including a separate entity taxation system to allow the transfer of profits or interest capacity between entities within a group, when applying rules that limit the deductibility of interest.

(8) To reduce the administrative and compliance burden of the rules without significantly diminishing their tax effect, it may be appropriate to provide for a safe harbour rule so that net interest is always deductible up to a fixed amount, when this leads to a higher deduction than the EBITDA-based ratio. Member States could reduce the fixed monetary threshold in order to ensure a higher level of protection of their domestic tax base. Since BEPS in principle takes place through excessive interest payments among entities which are associated enterprises, it is appropriate and necessary to allow the possible exclusion of standalone entities from the scope of the interest limitation rule given the limited risks of tax avoidance. In order to facilitate the transition to the new interest limitation rule, Member States could provide for a grandfathering clause that would cover existing loans to the extent that their terms are not subsequently modified, i.e. in case of a subsequent modification, the grandfathering would not apply to any increase in the amount or duration of the loan but would be limited to the original terms of the loan. Without prejudice to State aid rules, Member States could also exclude exceeding borrowing costs incurred on loans used to fund long-term public infrastructure projects considering that such financing arrangements present little or no BEPS risks. In this context, Member States should properly demonstrate that financing arrangements for public infrastructure projects present special features which justify such treatment vis-à-vis other financing arrangements subject to the restrictive rule.

(9) Although it is generally accepted that financial undertakings, i.e. financial institutions and insurance undertakings, should also be subject to limitations to the deductibility of interest, it is equally acknowledged that these two sectors present special features which call for a more customised approach. As the discussions in this field are not yet sufficiently conclusive in the international and Union context, it is not yet possible to provide specific rules in the financial and insurance sectors and Member States should therefore be able to exclude them from the scope of interest limitation rules.

(10) Exit taxes have the function of ensuring that where a taxpayer moves assets or its tax residence out of the tax jurisdiction of a State, that State taxes the economic value of any capital gain created in its territory even though that gain has not yet been realised at the time of the exit. It is therefore necessary to specify cases in which taxpayers are subject to exit tax rules and taxed on unrealised capital gains which have been built in their transferred assets. It is also helpful to clarify that transfers of assets, including cash, between a parent company and its subsidiaries fall outside the scope of the envisaged rule on exit taxation. In order to compute the amounts, it is critical to fix a market value for the transferred assets at the time of exit of the assets based on the arm's length principle. In order to ensure the compatibility of the rule with the use of the credit method, it is desirable to allow Member States to refer to the moment when the right to tax the transferred assets is lost. The right to tax should be defined at national level. It is also necessary to allow the receiving State to dispute the value of the transferred assets established by the exit State when it does not reflect such a market value. Member States could resort to this effect to existing dispute resolution mechanisms. Within the Union, it is necessary to address the application of exit taxation and illustrate the conditions for being compliant with Union law. In those situations, taxpayers should have the right to either immediately pay the amount of exit tax assessed or defer payment of the amount of tax by paying it in instalments over a certain number of years, possibly together with interest and a guarantee.

Member States could request, for this purpose, the taxpayers concerned to include the necessary information in a declaration. Exit tax should not be charged when the transfer of assets is of a temporary nature and the assets are set to revert to the Member State of the transferor, where the transfer takes place in order to meet prudential capital requirements or for the purpose of liquidity management or when it comes to securities' financing transactions or assets posted as collateral.

(11) General anti-abuse rules (GAARs) feature in tax systems to tackle abusive tax practices that have not yet been dealt with through specifically targeted provisions. GAARs have therefore a function aimed to fill in gaps, which

should not affect the applicability of specific anti-abuse rules. Within the Union, GAARs should be applied to arrangements that are not genuine; otherwise, the taxpayer should have the right to choose the most tax efficient structure for its commercial affairs. It is furthermore important to ensure that the GAARs apply in domestic situations, within the Union and vis-à-vis third countries in a uniform manner, so that their scope and results of application in domestic and cross-border situations do not differ. Member States should not be prevented from applying penalties where the GAAR is applicable. When evaluating whether an arrangement should be regarded as non-genuine, it could be possible for Member States to consider all valid economic reasons, including financial activities.

(12) Controlled foreign company (CFC) rules have the effect of re-attributing the income of a low-taxed controlled subsidiary to its parent company. Then, the parent company becomes taxable on this attributed income in the State where it is resident for tax purposes. Depending on the policy priorities of that State, CFC rules may target an entire low-taxed subsidiary, specific categories of income or be limited to income which has artificially been diverted to the subsidiary. In particular, in order to ensure that CFC rules are a proportionate response to BEPS concerns, it is critical that Member States that limit their CFC rules to income which has been artificially diverted to the subsidiary precisely target situations where most of the decision-making functions which generated diverted income at the level of the controlled subsidiary are carried out in the Member State of the taxpayer. With a view to limiting the administrative burden and compliance costs, it should also be acceptable that those Member States exempt certain entities with low profits or a low profit margin that give rise to lower risks of tax avoidance. Accordingly, it is necessary that the CFC rules extend to the profits of permanent establishments where those profits are not subject to tax or are tax exempt in the Member State of the taxpayer. However, there is no need to tax, under the CFC rules, the profits of permanent establishments which are denied the tax exemption under national rules because these permanent establishments are treated as though they were controlled foreign companies. In order to ensure a higher level of protection, Member States could reduce the control threshold, or employ a higher threshold in comparing the actual corporate tax paid with the corporate tax that would have been charged in the Member State of the taxpayer. Member States could, in transposing CFC rules into their national law, use a sufficiently high tax rate fractional threshold.

It is desirable to address situations both in third countries and within the Union. To comply with the fundamental freedoms, the income categories should be combined with a substance carve-out aimed to limit, within the Union, the impact of the rules to cases where the CFC does not carry on a substantive economic activity. It is important that tax administrations and taxpayers cooperate to gather the relevant facts and circumstances to determine whether the carve-out rule is to apply. It should be acceptable that, in transposing CFC rules into their national law, Member States use white, grey or black lists of third countries, which are compiled on the basis of certain criteria set out in this Directive and may include the corporate tax rate level, or use white lists of Member States compiled on that basis.

(13) Hybrid mismatches are the consequence of differences in the legal characterisation of payments (financial instruments) or entities and those differences surface in the interaction between the legal systems of two jurisdictions. The effect of such mismatches is often a double deduction (i.e. deduction in both states) or a deduction of the income in one state without inclusion in the tax base of the other. To neutralise the effects of hybrid mismatch arrangements, it is necessary to lay down rules whereby one of the two jurisdictions in a mismatch should deny the deduction of a payment leading to such an outcome. In this context, it is useful to clarify that measures aimed to tackle hybrid mismatches in this Directive are aimed to tackle mismatch situations attributable to differences in the legal characterisation of a financial instrument or entity and are not intended to affect the general features of the tax system of a Member State. Although Member States have agreed guidance, in the framework of the Group of the Code of Conduct on Business Taxation, on the tax treatment of hybrid entities and hybrid permanent establishments within the Union as well as on the tax treatment of hybrid entities in relations with third countries, it is still necessary to enact binding rules. It is critical that further work is undertaken on hybrid mismatches between Member States and third countries, as well as on other hybrid mismatches such as those involving permanent establishments.

(14) It is necessary to clarify that the implementation of the rules against tax avoidance provided in this Directive should not affect the taxpayers' obligation to comply with the arm's length principle or the Member State's right to adjust a tax liability upwards in accordance with the arm's length principle, where applicable.

(15) The European Data Protection Supervisor was consulted in accordance with Article 28(2) of Regulation (EC) No 45/2001 of the European Parliament and of the Council [1]. The right to protection of personal data according to Article 8 of the Charter of Fundamental Rights of the European Union as well as Directive 95/46/EC of the European Parliament and of the Council [2] applies to the processing of personal data carried out within the framework of this Directive.

(16) Considering that a key objective of this Directive is to improve the resilience of the internal market as a whole against cross-border tax avoidance practices, this cannot be sufficiently achieved by the Member States acting individually. National corporate tax systems are disparate and independent action by Member States would only replicate the existing fragmentation of the internal market in direct taxation. It would thus allow inefficiencies and distortions to persist in the interaction of distinct national measures. The result would be lack of coordination. Rather, by reason of the fact that much inefficiency in the internal market primarily gives rise to problems of a cross-border nature, remedial measures should be adopted at Union level. It is therefore critical to adopt solutions that function for the internal market as a whole and this can be better achieved at Union level. Thus, the Union may adopt measures, in accordance with the principle of subsidiarity as set out in Article 5 of the Treaty on European Union. In accordance with the principle of proportionality, as set out in that Article, this Directive does not go beyond what is necessary in order to achieve that objective. By setting a minimum level of protection for the internal market, this Directive only aims to achieve the essential minimum degree of coordination within the Union for the purpose of materialising its objectives.

(17) The Commission should evaluate the implementation of this Directive four years after its entry into force and report to the Council thereon. Member States should communicate to the Commission all information necessary for this evaluation.

HAS ADOPTED THIS DIRECTIVE:

CHAPTER I

GENERAL PROVISIONS

Article 1

Scope

This Directive applies to all taxpayers that are subject to corporate tax in one or more Member States, including permanent establishments in one or more Member States of entities resident for tax purposes in a third country.

Article 2

Definitions

For the purposes of this Directive, the following definitions apply:

(1) 'borrowing costs' means interest expenses on all forms of debt, other costs economically equivalent to interest and expenses incurred in connection with the raising of finance as defined in national law, including, without being limited to, payments under profit participating loans, imputed interest on instruments such as convertible bonds and zero coupon bonds, amounts under alternative financing arrangements, such as Islamic finance, the finance cost element of finance lease payments, capitalised interest included in the balance sheet value of a related asset, or the amortisation of capitalised interest, amounts measured by reference to a funding return under transfer pricing rules where applicable, notional interest amounts under derivative instruments or hedging arrangements related to an

[1] Regulation (EC) No 45/2001 of the European Parliament and of the Council of 18 December 2000 on the protection of individuals with regard to the processing of personal data by the Community institutions and bodies and on the free movement of such data (OJ L 8, 12.1.2001, p. 1).

[2] Directive 95/46/EC of the European Parliament and the Council of 24 October 1995 on the protection of individuals with regard to the processing of personal data and on the free movement of such data (OJ L 281, 23.11.1995, p. 31).

entity's borrowings, certain foreign exchange gains and losses on borrowings and instruments connected with the raising of finance, guarantee fees for financing arrangements, arrangement fees and similar costs related to the borrowing of funds;

(2) 'exceeding borrowing costs' means the amount by which the deductible borrowing costs of a taxpayer exceed taxable interest revenues and other economically equivalent taxable revenues that the taxpayer receives according to national law;

(3) 'tax period' means a tax year, calendar year or any other appropriate period for tax purposes;

(4) 'associated enterprise' means:

(a) an entity in which the taxpayer holds directly or indirectly a participation in terms of voting rights or capital ownership of 25 percent or more or is entitled to receive 25 percent or more of the profits of that entity;

(b) an individual or entity which holds directly or indirectly a participation in terms of voting rights or capital ownership in a taxpayer of 25 percent or more or is entitled to receive 25 percent or more of the profits of the taxpayer;

If an individual or entity holds directly or indirectly a participation of 25 percent or more in a taxpayer and one or more entities, all the entities concerned, including the taxpayer, shall also be regarded as associated enterprises.

For the purposes of Article 9 and where the mismatch involves a hybrid entity, this definition is modified so that the 25 percent requirement is replaced by a 50 percent requirement.

(5) 'financial undertaking' means any of the following entities:

(a) a credit institution or an investment firm as defined in point (1) of Article 4(1) of Directive 2004/39/EC of the European Parliament and of the Council [1] or an alternative investment fund manager (AIFM) as defined in point (b) of Article 4(1) of Directive 2011/61/EU of the European Parliament and of the Council [2] or an undertaking for collective investment in transferable securities (UCITS) management company as defined in point (b) of Article 2(1) of Directive 2009/65/EC of the European Parliament and of the Council [3];

(b) an insurance undertaking as defined in point (1) of Article 13 of Directive 2009/138/EC of the European Parliament and of the Council [4];

(c) a reinsurance undertaking as defined in point (4) of Article 13 of Directive 2009/138/EC;

(d) an institution for occupational retirement provision falling within the scope of Directive 2003/41/EC of the European Parliament and of the Council [5], unless a Member State has chosen not to apply that Directive in whole or in part to that institution in accordance with Article 5 of that Directive or the delegate of an institution for occupational retirement provision as referred to in Article 19(1) of that Directive;

(e) pension institutions operating pension schemes which are considered to be social security schemes covered by Regulation (EC) No 883/2004 of the European Parliament and of the Council [6] and Regulation (EC) No 987/2009 of the European Parliament and of the Council [7] as well as any legal entity set up for the purpose of investment of such schemes;

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(1) Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC (OJ L 145, 30.4.2004, p. 1).

(2) Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010 (OJ L 174, 1.7.2011, p. 1).

(3) Directive 2009/65/EC of the European Parliament and of the Council of 13 July 2009 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) (OJ L 302, 17.11.2009, p. 32).

(4) Directive 2009/138/EC of the European Parliament and of the Council of 25 November 2009 on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II) (OJ L 335, 17.12.2009, p. 1).

(5) Directive 2003/41/EC of the European Parliament and of the Council of 3 June 2003 on the activities and supervision of institutions for occupational retirement provision (OJ L 235, 23.9.2003, p. 10).

(6) Regulation (EC) No 883/2004 of the European Parliament and of the Council of 29 April 2004 on the coordination of social security systems (OJ L 166, 30.4.2004, p. 1).

(7) Regulation (EC) No 987/2009 of the European Parliament and of the Council of 16 September 2009 laying down the procedure for implementing Regulation (EC) No 883/2004 on the coordination of social security systems (OJ L 284, 30.10.2009, p. 1).

(f) an alternative investment fund (AIF) managed by an AIFM as defined in point (b) of Article 4(1) of Directive 2011/61/EU or an AIF supervised under the applicable national law;

(g) UCITS in the meaning of Article 1(2) of Directive 2009/65/EC;

(h) a central counterparty as defined in point (1) of Article 2 of Regulation (EU) No 648/2012 of the European Parliament and of the Council ([1]);

(i) a central securities depository as defined in point (1) of Article 2(1) of Regulation (EU) No 909/2014 of the European Parliament and of the Council ([2]).

(6) 'transfer of assets' means an operation whereby a Member State loses the right to tax the transferred assets, whilst the assets remain under the legal or economic ownership of the same taxpayer;

(7) 'transfer of tax residence' means an operation whereby a taxpayer ceases to be resident for tax purposes in a Member State, whilst acquiring tax residence in another Member State or third country;

(8) 'transfer of a business carried on by a permanent establishment' means an operation whereby a taxpayer ceases to have taxable presence in a Member State whilst acquiring such presence in another Member State or third country without becoming resident for tax purposes in that Member State or third country;

(9) 'hybrid mismatch' means a situation between a taxpayer in one Member State and an associated enterprise in another Member State or a structured arrangement between parties in Member States where the following outcome is attributable to differences in the legal characterisation of a financial instrument or entity:

(a) a deduction of the same payment, expenses or losses occurs both in the Member State in which the payment has its source, the expenses are incurred or the losses are suffered and in another Member State ('double deduction'); or

(b) there is a deduction of a payment in the Member State in which the payment has its source without a corresponding inclusion for tax purposes of the same payment in the other Member State ('deduction without inclusion').

Article 3

Minimum level of protection

This Directive shall not preclude the application of domestic or agreement-based provisions aimed at safeguarding a higher level of protection for domestic corporate tax bases.

CHAPTER II

MEASURES AGAINST TAX AVOIDANCE

Article 4

Interest limitation rule

1. Exceeding borrowing costs shall be deductible in the tax period in which they are incurred only up to 30 percent of the taxpayer's earnings before interest, tax, depreciation and amortisation (EBITDA).

([1]) Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories (OJ L 201, 27.7.2012, p. 1).

([2]) Regulation (EU) No 909/2014 of the European Parliament and of the Council of 23 July 2014 on improving securities settlement in the European Union and on central securities depositories and amending Directives 98/26/EC and 2014/65/EU and Regulation (EU) No 236/2012 (OJ L 257, 28.8.2014, p. 1).

For the purpose of this Article, Member States may also treat as a taxpayer:

(a) an entity which is permitted or required to apply the rules on behalf of a group, as defined according to national tax law;

(b) an entity in a group, as defined according to national tax law, which does not consolidate the results of its members for tax purposes.

In such circumstances, exceeding borrowing costs and the EBITDA may be calculated at the level of the group and comprise the results of all its members.

2. The EBITDA shall be calculated by adding back to the income subject to corporate tax in the Member State of the taxpayer the tax-adjusted amounts for exceeding borrowing costs as well as the tax-adjusted amounts for depreciation and amortisation. Tax exempt income shall be excluded from the EBITDA of a taxpayer.

3. By derogation from paragraph 1, the taxpayer may be given the right:

(a) to deduct exceeding borrowing costs up to EUR 3 000 000;

(b) to fully deduct exceeding borrowing costs if the taxpayer is a standalone entity.

For the purposes of the second subparagraph of paragraph 1, the amount of EUR 3 000 000 shall be considered for the entire group.

For the purposes of point (b) of the first subparagraph, a standalone entity means a taxpayer that is not part of a consolidated group for financial accounting purposes and has no associated enterprise or permanent establishment.

4. Member States may exclude from the scope of paragraph 1 exceeding borrowing costs incurred on:

(a) loans which were concluded before 17 June 2016, but the exclusion shall not extend to any subsequent modification of such loans;

(b) loans used to fund a long-term public infrastructure project where the project operator, borrowing costs, assets and income are all in the Union.

For the purposes of point (b) of the first subparagraph, a long-term public infrastructure project means a project to provide, upgrade, operate and/or maintain a large-scale asset that is considered in the general public interest by a Member State.

Where point (b) of the first subparagraph applies, any income arising from a long-term public infrastructure project shall be excluded from the EBITDA of the taxpayer, and any excluded exceeding borrowing cost shall not be included in the exceeding borrowing costs of the group vis-à-vis third parties referred to in point (b) of paragraph 5.

5. Where the taxpayer is a member of a consolidated group for financial accounting purposes, the taxpayer may be given the right to either:

(a) fully deduct its exceeding borrowing costs if it can demonstrate that the ratio of its equity over its total assets is equal to or higher than the equivalent ratio of the group and subject to the following conditions:

   (i) the ratio of the taxpayer's equity over its total assets is considered to be equal to the equivalent ratio of the group if the ratio of the taxpayer's equity over its total assets is lower by up to two percentage points; and

   (ii) all assets and liabilities are valued using the same method as in the consolidated financial statements referred to in paragraph 8;

   or

(b) deduct exceeding borrowing costs at an amount in excess of what it would be entitled to deduct under paragraph 1. This higher limit to the deductibility of exceeding borrowing costs shall refer to the consolidated group for financial accounting purposes in which the taxpayer is a member and be calculated in two steps:

(i) first, the group ratio is determined by dividing the exceeding borrowing costs of the group vis-à-vis third-parties over the EBITDA of the group; and

(ii) second, the group ratio is multiplied by the EBITDA of the taxpayer calculated pursuant to paragraph 2.

6. The Member State of the taxpayer may provide for rules either:

(a) to carry forward, without time limitation, exceeding borrowing costs which cannot be deducted in the current tax period under paragraphs 1 to 5;

(b) to carry forward, without time limitation, and back, for a maximum of three years, exceeding borrowing costs which cannot be deducted in the current tax period under paragraphs 1 to 5; or

(c) to carry forward, without time limitation, exceeding borrowing costs and, for a maximum of five years, unused interest capacity, which cannot be deducted in the current tax period under paragraphs 1 to 5.

7. Member States may exclude financial undertakings from the scope of paragraphs 1 to 6, including where such financial undertakings are part of a consolidated group for financial accounting purposes.

8. For the purpose of this Article, the consolidated group for financial accounting purposes consists of all entities which are fully included in consolidated financial statements drawn up in accordance with the International Financial Reporting Standards or the national financial reporting system of a Member State. The taxpayer may be given the right to use consolidated financial statements prepared under other accounting standards.

Article 5

Exit taxation

1. A taxpayer shall be subject to tax at an amount equal to the market value of the transferred assets, at the time of exit of the assets, less their value for tax purposes, in any of the following circumstances:

(a) a taxpayer transfers assets from its head office to its permanent establishment in another Member State or in a third country in so far as the Member State of the head office no longer has the right to tax the transferred assets due to the transfer;

(b) a taxpayer transfers assets from its permanent establishment in a Member State to its head office or another permanent establishment in another Member State or in a third country in so far as the Member State of the permanent establishment no longer has the right to tax the transferred assets due to the transfer;

(c) a taxpayer transfers its tax residence to another Member State or to a third country, except for those assets which remain effectively connected with a permanent establishment in the first Member State;

(d) a taxpayer transfers the business carried on by its permanent establishment from a Member State to another Member State or to a third country in so far as the Member State of the permanent establishment no longer has the right to tax the transferred assets due to the transfer.

2. A taxpayer shall be given the right to defer the payment of an exit tax referred to in paragraph 1, by paying it in instalments over five years, in any of the following circumstances:

(a) a taxpayer transfers assets from its head office to its permanent establishment in another Member State or in a third country that is party to the Agreement on the European Economic Area (EEA Agreement);

(b) a taxpayer transfers assets from its permanent establishment in a Member State to its head office or another permanent establishment in another Member State or a third country that is party to the EEA Agreement;

(c) a taxpayer transfers its tax residence to another Member State or to a third country that is party to the EEA Agreement;

(d) a taxpayer transfers the business carried on by its permanent establishment to another Member State or a third country that is party to the EEA Agreement.

This paragraph shall apply to third countries that are party to the EEA Agreement if they have concluded an agreement with the Member State of the taxpayer or with the Union on the mutual assistance for the recovery of tax claims, equivalent to the mutual assistance provided for in Council Directive 2010/24/EU [1].

3. If a taxpayer defers the payment in accordance with paragraph 2, interest may be charged in accordance with the legislation of the Member State of the taxpayer or of the permanent establishment, as the case may be.

If there is a demonstrable and actual risk of non-recovery, taxpayers may also be required to provide a guarantee as a condition for deferring the payment in accordance with paragraph 2.

The second subparagraph shall not apply where the legislation in the Member State of the taxpayer or of the permanent establishment provides for the possibility of recovery of the tax debt through another taxpayer which is member of the same group and is resident for tax purposes in that Member State.

4. Where paragraph 2 applies, the deferral of payment shall be immediately discontinued and the tax debt becomes recoverable in the following cases:

(a) the transferred assets or the business carried on by the permanent establishment of the taxpayer are sold or otherwise disposed of;

(b) the transferred assets are subsequently transferred to a third country;

(c) the taxpayer's tax residence or the business carried on by its permanent establishment is subsequently transferred to a third country;

(d) the taxpayer goes bankrupt or is wound up;

(e) the taxpayer fails to honour its obligations in relation to the instalments and does not correct its situation over a reasonable period of time, which shall not exceed 12 months.

Points (b) and (c) shall not apply to third countries that are party to the EEA Agreement if they have concluded an agreement with the Member State of the taxpayer or with the Union on the mutual assistance for the recovery of tax claims, equivalent to the mutual assistance provided for in Directive 2010/24/EU.

5. Where the transfer of assets, tax residence or the business carried on by a permanent establishment is to another Member State, that Member State shall accept the value established by the Member State of the taxpayer or of the permanent establishment as the starting value of the assets for tax purposes, unless this does not reflect the market value.

6. For the purposes of paragraphs 1 to 5, 'market value' is the amount for which an asset can be exchanged or mutual obligations can be settled between willing unrelated buyers and sellers in a direct transaction.

7. Provided that the assets are set to revert to the Member State of the transferor within a period of 12 months, this Article shall not apply to asset transfers related to the financing of securities, assets posted as collateral or where the asset transfer takes place in order to meet prudential capital requirements or for the purpose of liquidity management.

[1] Council Directive 2010/24/EU of 16 March 2010 concerning mutual assistance for the recovery of claims relating to taxes, duties and other measures (OJ L 84, 31.3.2010, p. 1).

Article 6

General anti-abuse rule

1. For the purposes of calculating the corporate tax liability, a Member State shall ignore an arrangement or a series of arrangements which, having been put into place for the main purpose or one of the main purposes of obtaining a tax advantage that defeats the object or purpose of the applicable tax law, are not genuine having regard to all relevant facts and circumstances. An arrangement may comprise more than one step or part.

2. For the purposes of paragraph 1, an arrangement or a series thereof shall be regarded as non-genuine to the extent that they are not put into place for valid commercial reasons which reflect economic reality.

3. Where arrangements or a series thereof are ignored in accordance with paragraph 1, the tax liability shall be calculated in accordance with national law.

Article 7

Controlled foreign company rule

1. The Member State of a taxpayer shall treat an entity, or a permanent establishment of which the profits are not subject to tax or are exempt from tax in that Member State, as a controlled foreign company where the following conditions are met:

(a) in the case of an entity, the taxpayer by itself, or together with its associated enterprises holds a direct or indirect participation of more than 50 percent of the voting rights, or owns directly or indirectly more than 50 percent of capital or is entitled to receive more than 50 percent of the profits of that entity; and

(b) the actual corporate tax paid on its profits by the entity or permanent establishment is lower than the difference between the corporate tax that would have been charged on the entity or permanent establishment under the applicable corporate tax system in the Member State of the taxpayer and the actual corporate tax paid on its profits by the entity or permanent establishment.

For the purposes of point (b) of the first subparagraph, the permanent establishment of a controlled foreign company that is not subject to tax or is exempt from tax in the jurisdiction of the controlled foreign company shall not be taken into account. Furthermore the corporate tax that would have been charged in the Member State of the taxpayer means as computed according to the rules of the Member State of the taxpayer.

2. Where an entity or permanent establishment is treated as a controlled foreign company under paragraph 1, the Member State of the taxpayer shall include in the tax base:

(a) the non-distributed income of the entity or the income of the permanent establishment which is derived from the following categories:

(i) interest or any other income generated by financial assets;

(ii) royalties or any other income generated from intellectual property;

(iii) dividends and income from the disposal of shares;

(iv) income from financial leasing;

(v) income from insurance, banking and other financial activities;

(vi) income from invoicing companies that earn sales and services income from goods and services purchased from and sold to associated enterprises, and add no or little economic value;

This point shall not apply where the controlled foreign company carries on a substantive economic activity supported by staff, equipment, assets and premises, as evidenced by relevant facts and circumstances.

Where the controlled foreign company is resident or situated in a third country that is not party to the EEA Agreement, Member States may decide to refrain from applying the preceding subparagraph.

or

(b) the non-distributed income of the entity or permanent establishment arising from non-genuine arrangements which have been put in place for the essential purpose of obtaining a tax advantage.

For the purposes of this point, an arrangement or a series thereof shall be regarded as non-genuine to the extent that the entity or permanent establishment would not own the assets or would not have undertaken the risks which generate all, or part of, its income if it were not controlled by a company where the significant people functions, which are relevant to those assets and risks, are carried out and are instrumental in generating the controlled company's income.

3. Where, under the rules of a Member State, the tax base of a taxpayer is calculated according to point (a) of paragraph 2, the Member State may opt not to treat an entity or permanent establishment as a controlled foreign company under paragraph 1 if one third or less of the income accruing to the entity or permanent establishment falls within the categories under point (a) of paragraph 2.

Where, under the rules of a Member State, the tax base of a taxpayer is calculated according to point (a) of paragraph 2, the Member State may opt not to treat financial undertakings as controlled foreign companies if one third or less of the entity's income from the categories under point (a) of paragraph 2 comes from transactions with the taxpayer or its associated enterprises.

4. Member States may exclude from the scope of point (b) of paragraph 2 an entity or permanent establishment:

(a) with accounting profits of no more than EUR 750 000, and non-trading income of no more than EUR 75 000; or

(b) of which the accounting profits amount to no more than 10 percent of its operating costs for the tax period.

For the purpose of point (b) of the first subparagraph, the operating costs may not include the cost of goods sold outside the country where the entity is resident, or the permanent establishment is situated, for tax purposes and payments to associated enterprises.

Article 8

Computation of controlled foreign company income

1. Where point (a) of Article 7(2) applies, the income to be included in the tax base of the taxpayer shall be calculated in accordance with the rules of the corporate tax law of the Member State where the taxpayer is resident for tax purposes or situated. Losses of the entity or permanent establishment shall not be included in the tax base but may be carried forward, according to national law, and taken into account in subsequent tax periods.

2. Where point (b) of Article 7(2) applies, the income to be included in the tax base of the taxpayer shall be limited to amounts generated through assets and risks which are linked to significant people functions carried out by the controlling company. The attribution of controlled foreign company income shall be calculated in accordance with the arm's length principle.

3. The income to be included in the tax base shall be calculated in proportion to the taxpayer's participation in the entity as defined in point (a) of Article 7(1).

4. The income shall be included in the tax period of the taxpayer in which the tax year of the entity ends.

5. Where the entity distributes profits to the taxpayer, and those distributed profits are included in the taxable income of the taxpayer, the amounts of income previously included in the tax base pursuant to Article 7 shall be deducted from the tax base when calculating the amount of tax due on the distributed profits, in order to ensure there is no double taxation.

6. Where the taxpayer disposes of its participation in the entity or of the business carried out by the permanent establishment, and any part of the proceeds from the disposal previously has been included in the tax base pursuant to Article 7, that amount shall be deducted from the tax base when calculating the amount of tax due on those proceeds, in order to ensure there is no double taxation.

7. The Member State of the taxpayer shall allow a deduction of the tax paid by the entity or permanent establishment from the tax liability of the taxpayer in its state of tax residence or location. The deduction shall be calculated in accordance with national law.

Article 9

Hybrid mismatches

1. To the extent that a hybrid mismatch results in a double deduction, the deduction shall be given only in the Member State where such payment has its source.

2. To the extent that a hybrid mismatch results in a deduction without inclusion, the Member State of the payer shall deny the deduction of such payment.

CHAPTER III

FINAL PROVISIONS

Article 10

Review

1. The Commission shall evaluate the implementation of this Directive, in particular the impact of Article 4, by 9 August 2020 and report to the Council thereon. The report by the Commission shall, if appropriate, be accompanied by a legislative proposal.

2. Member States shall communicate to the Commission all information necessary for evaluating the implementation of this Directive.

3. Member States referred to in Article 11(6) shall communicate to the Commission before 1 July 2017 all information necessary for evaluating the effectiveness of the national targeted rules for preventing base erosion and profit shifting risks (BEPS).

Article 11

Transposition

1. Member States shall, by 31 December 2018, adopt and publish the laws, regulations and administrative provisions necessary to comply with this Directive. They shall communicate to the Commission the text of those provisions without delay.

They shall apply those provisions from 1 January 2019.

When Member States adopt those provisions, they shall contain a reference to this Directive or be accompanied by such a reference on the occasion of their official publication. Member States shall determine how such reference is to be made.

2. Member States shall communicate to the Commission the text of the main provisions of national law which they adopt in the field covered by this Directive.

3. Where this Directive mentions a monetary amount in euros (EUR), Member States whose currency is not the euro may opt to calculate the corresponding value in the national currency on 12 July 2016.

4. By way of derogation from Article 5(2), Estonia may, for as long as it does not tax undistributed profits, consider a transfer of assets in monetary or non-monetary form, including cash, from a permanent establishment situated in Estonia to a head office or another permanent establishment in another Member State or in a third country that is a party to the EEA Agreement as profit distribution and charge income tax, without giving taxpayers the right to defer the payment of such tax.

5. By way of derogation from paragraph 1, Member States shall, by 31 December 2019, adopt and publish, the laws, regulations and administrative provisions necessary to comply with Article 5. They shall communicate to the Commission the text of those provisions without delay.

They shall apply those provisions from 1 January 2020.

When Member States adopt those provisions, they shall contain a reference to this Directive or be accompanied by such a reference on the occasion of their official publication. Member States shall determine how such reference is to be made.

6. By way of derogation from Article 4, Member States which have national targeted rules for preventing BEPS risks at 8 August 2016, which are equally effective to the interest limitation rule set out in this Directive, may apply these targeted rules until the end of the first full fiscal year following the date of publication of the agreement between the OECD members on the official website on a minimum standard with regard to BEPS Action 4, but at the latest until 1 January 2024.

Article 12

Entry into force

This Directive shall enter into force on the twentieth day following that of its publication in the *Official Journal of the European Union*.

Article 13

Addressees

This Directive is addressed to the Member States.

Done at Brussels, 12 July 2016.

For the Council

The President

P. KAŽIMÍR

I

(Legislative acts)

DIRECTIVES

COUNCIL DIRECTIVE (EU) 2017/952

of 29 May 2017

amending Directive (EU) 2016/1164 as regards hybrid mismatches with third countries

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty on the Functioning of the European Union, and in particular Article 115 thereof,

Having regard to the proposal from the European Commission,

After transmission of the draft legislative act to the national parliaments,

Having regard to the opinion of the European Parliament ([1]),

Having regard to the opinion of the European Economic and Social Committee ([2]),

Acting in accordance with a special legislative procedure,

Whereas:

(1) It is imperative to restore trust in the fairness of tax systems and allow governments to effectively exercise their tax sovereignty. Therefore, the Organisation for Economic Cooperation and Development (OECD) has issued concrete action recommendations in the context of the initiative against Base Erosion and Profit Shifting (BEPS).

(2) The final reports on the 15 OECD Action Items against BEPS were released to the public on 5 October 2015. This output was welcomed by the Council in its conclusions of 8 December 2015. The Council conclusions stressed the need to find common, yet flexible, solutions at Union level consistent with OECD BEPS conclusions.

(3) In response to the need for fairer taxation and, in particular, to follow up on the OECD BEPS conclusions, the Commission presented its Anti-Tax Avoidance Package on 28 January 2016. Council Directive (EU) 2016/1164 ([3]), concerning rules against tax avoidance, was adopted in the framework of that package.

(4) Directive (EU) 2016/1164 provides for a framework to tackle hybrid mismatches.

(5) It is necessary to establish rules that neutralise hybrid mismatches in as comprehensive a manner as possible. Considering that Directive (EU) 2016/1164 only covers hybrid mismatches that arise in the interaction between

([1]) Opinion of 27 April 2017 (not yet published in the Official Journal).
([2]) Opinion of 14 December 2016 (not yet published in the Official Journal).
([3]) Council Directive (EU) 2016/1164 of 12 July 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market (OJ L 193, 19.7.2016, p. 1).

the corporate tax systems of Member States, the ECOFIN Council issued a statement on 12 July 2016 requesting the Commission to put forward by October 2016 a proposal on hybrid mismatches involving third countries in order to provide for rules consistent with and no less effective than the rules recommended by the OECD report on Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2 — 2015 Final Report ('OECD BEPS report on Action 2'), with a view to reaching an agreement by the end of 2016.

(6) Directive (EU) 2016/1164 recognises, inter alia, that it is critical for further work to be undertaken on other hybrid mismatches such as those involving permanent establishments. In view of that, it is essential that hybrid permanent establishment mismatches be addressed in that Directive as well.

(7) In order to provide for a framework that is consistent with and no less effective than the OECD BEPS report on Action 2, it is essential that Directive (EU) 2016/1164 also include rules on hybrid transfers, imported mismatches and address the full range of double deduction outcomes, in order to prevent taxpayers from exploiting remaining loopholes.

(8) Directive (EU) 2016/1164 includes rules on hybrid mismatches between Member States and should thus also include rules on hybrid mismatches with third countries where at least one of the parties involved is a corporate taxpayer or, in the case of reverse hybrids, an entity in a Member State, as well as rules on imported mismatches. Consequently, the rules on hybrid mismatches and tax residency mismatches should apply to all taxpayers that are subject to corporate tax in a Member State including to permanent establishments, or to arrangements treated as permanent establishments, of entities resident in third countries. Rules on reverse hybrid mismatches should apply to all entities that are treated as transparent for tax purposes by a Member State.

(9) Rules on hybrid mismatches should address mismatch situations which result from double deductions, from conflict in the characterisation of financial instruments, payments and entities, or from the allocation of payments. Since hybrid mismatches could lead to a double deduction or to a deduction without inclusion, it is necessary to lay down rules whereby the Member State concerned either denies the deduction of a payment, expenses or losses or requires the taxpayer to include the payment in its taxable income, as appropriate. However, those rules apply only to deductible payments and should not affect the general features of a tax system, whether it is a classical or an imputation system.

(10) Hybrid permanent establishment mismatches occur where differences between the rules in the jurisdictions of permanent establishment and of residence for allocating income and expenditure between different parts of the same entity give rise to a mismatch in tax outcomes and include those cases where a mismatch outcome arises due to the fact that a permanent establishment is disregarded under the laws of the branch jurisdiction. Those mismatch outcomes may lead to a double deduction or a deduction without inclusion, and should therefore be eliminated. In the case of disregarded permanent establishments, the Member State in which the taxpayer is a resident should include the income that would otherwise be attributed to the permanent establishment.

(11) Any adjustments that are required to be made under this Directive should in principle not affect the allocation of taxing rights between jurisdictions laid down under a double taxation treaty.

(12) In order to ensure proportionality, it is necessary to address only the cases where there is a substantial risk of avoiding taxation through the use of hybrid mismatches. It is therefore appropriate to cover hybrid mismatches that arise between the head office and permanent establishment or between two or more permanent establishments of the same entity, hybrid mismatches that arise between the taxpayer and its associated enterprises or between associated enterprises, and those resulting from a structured arrangement involving a taxpayer.

(13) Mismatches that, in particular, result from the hybrid nature of entities should be addressed only where one of the associated enterprises has, at a minimum, effective control over the other associated enterprises. Consequently, in those cases, it should be required that an associated enterprise be held by, or hold, the taxpayer or another associated enterprise through a participation in terms of voting rights, capital ownership or entitlement to received profits of 50 per cent or more. The ownership, or rights of persons who are acting together, should be aggregated for the purposes of applying this requirement.

(14) In order to provide for a sufficiently comprehensive definition of 'associated enterprise' for the purposes of the rules on hybrid mismatches, that definition should also comprise an entity that is part of the same consolidated group for accounting purposes, an enterprise in which the taxpayer has a significant influence in the management and, conversely, an enterprise that has a significant influence in the management of the taxpayer.

(15) It is necessary to address four categories of hybrid mismatches: first, hybrid mismatches that result from payments under a financial instrument; second, hybrid mismatches that are the consequence of differences in the allocation of payments made to a hybrid entity or permanent establishment, including as a result of payments to a disregarded permanent establishment; third, hybrid mismatches that result from payments made by a hybrid entity to its owner, or deemed payments between the head office and permanent establishment or between two or more permanent establishments; lastly, double deduction outcomes resulting from payments made by a hybrid entity or permanent establishment.

(16) In respect of payments under a financial instrument, a hybrid mismatch could arise where the deduction without inclusion outcome is attributable to the differences in the characterisation of the instrument or the payments made under it. If the character of the payment qualifies it for double tax relief under the laws of the payee jurisdiction, such as an exemption from tax, a reduction in the rate of tax or any credit or refund of tax, the payment should be treated as giving rise to a hybrid mismatch to the extent of the resulting undertaxed amount. A payment under a financial instrument should not, however, be treated as giving rise to a hybrid mismatch where the tax relief granted in the payee jurisdiction is solely due to the tax status of the payee or the fact that the instrument is held subject to the terms of a special regime.

(17) In order to avoid unintended outcomes in the interaction between the hybrid financial instrument rule and the loss-absorbing capacity requirements imposed on banks, and without prejudice to State aid rules, Member States should be able to exclude from the scope of this Directive intra-group instruments that have been issued with the sole purpose of meeting the issuer's loss-absorbing capacity requirements and not for the purposes of avoiding tax.

(18) In respect of payments made to a hybrid entity or permanent establishment, a hybrid mismatch could arise where the deduction without inclusion outcome results from differences in the rules governing the allocation of that payment between the hybrid entity and its owner in the case of a payment that is made to a hybrid entity, between the head office and permanent establishment, or between two or more permanent establishments in the case of a deemed payment to a permanent establishment. The definition of hybrid mismatch should only apply where the mismatch outcome is a result of differences in the rules governing the allocation of payments under the laws of the two jurisdictions and a payment should not give rise to a hybrid mismatch that would have arisen in any event due to the tax exempt status of the payee under the laws of any payee jurisdiction.

(19) The definition of hybrid mismatch should also capture deduction without inclusion outcomes that are the result of payments made to a disregarded permanent establishment. A disregarded permanent establishment is any arrangement that is treated as giving rise to a permanent establishment under the laws of the head office jurisdiction but which is not treated as a permanent establishment under the laws of the other jurisdiction. The hybrid mismatch rule should not apply, however, where the mismatch would have arisen in any event due to the tax exempt status of the payee under the laws of any payee jurisdiction.

(20) In respect of payments made by a hybrid entity to its owner, or deemed payments made between the head office and permanent establishment or between two or more permanent establishments, a hybrid mismatch could arise where the deduction without inclusion outcome results from the payment or deemed payment not being recognised in the payee jurisdiction. In that case, where the mismatch outcome is a consequence of the non-allocation of the payment or deemed payment, the payee jurisdiction is the jurisdiction where the payment or deemed payment is treated as being received under the laws of the payer jurisdiction. As with other hybrid entities and branch mismatches that give rise to deduction without inclusion outcomes, no hybrid mismatch should arise where the payee is exempt from tax under the laws of the payee jurisdiction. In respect of this

category of hybrid mismatches, however, a mismatch outcome would only arise to the extent that the payer jurisdiction allows the deduction in respect of the payment or deemed payment to be set off against an amount that is not dual-inclusion income. If the payer jurisdiction allows the deduction to be carried forward to a subsequent tax period, then the requirement to make any adjustment under this Directive could be deferred until such time as the deduction is actually set off against non-dual-inclusion income in the payer jurisdiction.

(21) The hybrid mismatch definition should also capture double deduction outcomes regardless of whether they arise as a result of payments, expenses that are not treated as payments under domestic law or as a result of amortisation or depreciation losses. As with deemed payments and payments made by a hybrid entity that are disregarded by the payee, a hybrid mismatch should only arise, however, to the extent that the payer jurisdiction allows the deduction to be set off against an amount that is not dual-inclusion income. This means that if the payer jurisdiction allows the deduction to be carried forward to a subsequent tax period, the requirement to make an adjustment under this Directive could be deferred until such time as the deduction is actually set off against non-dual-inclusion income in the payer jurisdiction.

(22) Differences in tax outcomes that are solely attributable to differences in the value ascribed to a payment, including through the application of transfer pricing, should not fall within the scope of a hybrid mismatch. Furthermore, as jurisdictions use different tax periods and have different rules for recognising when items of income or expenditure have been derived or incurred, those timing differences should not generally be treated as giving rise to mismatches in tax outcomes. However, a deductible payment under a financial instrument that cannot reasonably be expected to be included in income within a reasonable period of time should be treated as giving rise to a hybrid mismatch if that deduction without inclusion outcome is attributable to differences in the characterisation of the financial instrument or payments made under it. It should be understood that a mismatch outcome could arise if a payment made under a financial instrument is not included in income within a reasonable period of time. Such a payment should be treated as included in income within a reasonable period of time, if included by the payee within 12 months of the end of the payer's tax period or as determined under the arm's length principle. Member States could require that a payment be included within a fixed period of time in order to avoid giving rise to a mismatch outcome and secure tax control.

(23) Hybrid transfers could give rise to a difference in tax treatment if, as a result of an arrangement to transfer a financial instrument, the underlying return on that instrument was treated as derived by more than one of the parties to the arrangement. In those cases, the payment under the hybrid transfer could give rise to a deduction for the payer while being treated as a return on the underlying instrument by the payee. This difference in tax treatment could lead to a deduction without inclusion outcome or to the generation of a surplus tax credit for the tax withheld at source on the underlying instrument. Such mismatches should therefore be eliminated. In the case of a deduction without inclusion, the same rules should apply as for neutralising mismatches from payments under a hybrid financial instrument. In the case of hybrid transfers that have been structured to produce surplus tax credits, the Member State concerned should prevent the payer from using the surplus credit to obtain a tax advantage including through the application of a general anti-abuse rule consistent with Article 6 of Directive (EU) 2016/1164.

(24) It is necessary to provide for a rule that allows Member States to tackle discrepancies in the transposition and implementation of this Directive resulting in a hybrid mismatch despite the fact that Member States act in compliance with this Directive. Where such a situation arises and the primary rule provided for in this Directive does not apply, a secondary rule should apply. Nevertheless, the application of both the primary and secondary rules only apply to hybrid mismatches as defined by this Directive and should not affect the general features of the tax system of a Member State.

(25) Imported mismatches shift the effect of a hybrid mismatch between parties in third countries into the jurisdiction of a Member State through the use of a non-hybrid instrument thereby undermining the effectiveness of the rules that neutralise hybrid mismatches. A deductible payment in a Member State can be used to fund expenditure involving a hybrid mismatch. To counter such imported mismatches, it is necessary to include rules that disallow the deduction of a payment if the corresponding income from that payment is set off, directly or indirectly, against a deduction that arises under a hybrid mismatch giving rise to a double deduction or a deduction without inclusion between third countries.

(26) A dual resident mismatch could lead to a double deduction if a payment made by a dual resident taxpayer is deducted under the laws of both jurisdictions where the taxpayer is resident. As dual resident mismatches could give rise to double deduction outcomes, they should fall within the scope of this Directive. A Member State should deny the duplicate deduction arising in respect of a dual resident company to the extent that this payment is set off against an amount that is not treated as income under the laws of the other jurisdiction.

(27) The objective of this Directive is to improve the resilience of the internal market as a whole against hybrid mismatches. This cannot be sufficiently achieved by the Member States acting individually, given that national corporate tax systems are disparate and that independent action by Member States would only replicate the existing fragmentation of the internal market in direct taxation. It would thus allow inefficiencies and distortions to persist in the interaction of distinct national measures. This would result in a lack of coordination. That objective can rather, due to the cross-border nature of hybrid mismatches and the need to adopt solutions that function for the internal market as a whole, be better achieved at Union level. The Union may adopt measures, in accordance with the principle of subsidiarity as set out in Article 5 of the Treaty on European Union. In accordance with the principle of proportionality, as set out in that Article, this Directive does not go beyond what is necessary in order to achieve that objective. By setting the required level of protection for the internal market, this Directive only aims to achieve the essential degree of coordination within the Union that is necessary to achieve its objective.

(28) In implementing this Directive, Member States should use the applicable explanations and examples in the OECD BEPS report on Action 2 as a source of illustration or interpretation to the extent that they are consistent with the provisions of this Directive and with Union law.

(29) The hybrid mismatch rules in Article 9(1) and (2) only apply to the extent that the situation involving a taxpayer gives rise to a mismatch outcome. No mismatch outcome should arise when an arrangement is subject to adjustment under Article 9(5) or 9a and, accordingly, arrangements that are subject to adjustment under those parts of this Directive should not be subject to any further adjustment under the hybrid mismatch rules.

(30) Where the provisions of another directive, such as those in Council Directive 2011/96/EU ([1]), lead to the neutralisation of the mismatch in tax outcomes, there should be no scope for the application of the hybrid mismatch rules provided for in this Directive.

(31) The Commission should evaluate the implementation of this Directive 5 years after its entry into force and report to the Council thereon. Member States should communicate to the Commission all information necessary for this evaluation.

(32) Directive (EU) 2016/1164 should therefore be amended accordingly,

HAS ADOPTED THIS DIRECTIVE:

Article 1

Directive (EU) 2016/1164 is amended as follows:

(1) Article 1 is replaced by the following:

'*Article 1*

Scope

1. This Directive applies to all taxpayers that are subject to corporate tax in one or more Member States, including permanent establishments in one or more Member States of entities resident for tax purposes in a third country.

2. Article 9a also applies to all entities that are treated as transparent for tax purposes by a Member State.';

([1]) Council Directive 2011/96/EU of 30 November 2011 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States (OJ L 345, 29.12.2011, p. 8).

(2) Article 2 is amended as follows:

(a) in point (4), the last subparagraph is replaced by the following:

'For the purposes of Articles 9 and 9a:

(a) Where the mismatch outcome arises under points (b), (c), (d), (e) or (g) of the first subparagraph of point (9) of this Article or where an adjustment is required under Article 9(3) or Article 9a, the definition of associated enterprise is modified so that the 25 per cent requirement is replaced by a 50 per cent requirement;

(b) a person who acts together with another person in respect of the voting rights or capital ownership of an entity shall be treated as holding a participation in all of the voting rights or capital ownership of that entity that are held by the other person;

(c) an associated enterprise also means an entity that is part of the same consolidated group for financial accounting purposes as the taxpayer, an enterprise in which the taxpayer has a significant influence in the management or an enterprise that has a significant influence in the management of the taxpayer.';

(b) point (9) is replaced by the following:

'(9) "hybrid mismatch" means a situation involving a taxpayer or, with respect to Article 9(3), an entity where:

(a) a payment under a financial instrument gives rise to a deduction without inclusion outcome and:

(i) such payment is not included within a reasonable period of time; and

(ii) the mismatch outcome is attributable to differences in the characterisation of the instrument or the payment made under it.

For the purposes of the first subparagraph, a payment under a financial instrument shall be treated as included in income within a reasonable period of time where:

(i) the payment is included by the jurisdiction of the payee in a tax period that commences within 12 months of the end of the payer's tax period; or

(ii) it is reasonable to expect that the payment will be included by the jurisdiction of the payee in a future tax period and the terms of payment are those that would be expected to be agreed between independent enterprises;

(b) a payment to a hybrid entity gives rise to a deduction without inclusion and that mismatch outcome is the result of differences in the allocation of payments made to the hybrid entity under the laws of the jurisdiction where the hybrid entity is established or registered and the jurisdiction of any person with a participation in that hybrid entity;

(c) a payment to an entity with one or more permanent establishments gives rise to a deduction without inclusion and that mismatch outcome is the result of differences in the allocation of payments between the head office and permanent establishment or between two or more permanent establishments of the same entity under the laws of the jurisdictions where the entity operates;

(d) a payment gives rise to a deduction without inclusion as a result of a payment to a disregarded permanent establishment;

(e) a payment by a hybrid entity gives rise to a deduction without inclusion and that mismatch is the result of the fact that the payment is disregarded under the laws of the payee jurisdiction;

(f) a deemed payment between the head office and permanent establishment or between two or more permanent establishments gives rise to a deduction without inclusion and that mismatch is the result of the fact that the payment is disregarded under the laws of the payee jurisdiction; or

(g) a double deduction outcome occurs.

For the purposes of this point (9):

(a) a payment representing the underlying return on a transferred financial instrument shall not give rise to a hybrid mismatch under point (a) of the first subparagraph where the payment is made by a financial trader under an on-market hybrid transfer provided the payer jurisdiction requires the financial trader to include as income all amounts received in relation to the transferred financial instrument;

(b) a hybrid mismatch shall only arise under points (e), (f) or (g) of the first subparagraph to the extent that the payer jurisdiction allows the deduction to be set off against an amount that is not dual-inclusion income;

(c) a mismatch outcome shall not be treated as a hybrid mismatch unless it arises between associated enterprises, between a taxpayer and an associated enterprise, between the head office and permanent establishment, between two or more permanent establishments of the same entity or under a structured arrangement.

For the purposes of this point (9) and Articles 9, 9a and 9b:

(a) "mismatch outcome" means a double deduction or a deduction without inclusion;

(b) "double deduction" means a deduction of the same payment, expenses or losses in the jurisdiction in which the payment has its source, the expenses are incurred or the losses are suffered (payer jurisdiction) and in another jurisdiction (investor jurisdiction). In the case of a payment by a hybrid entity or permanent establishment the payer jurisdiction is the jurisdiction where the hybrid entity or permanent establishment is established or situated;

(c) "deduction without inclusion" means the deduction of a payment or deemed payment between the head office and permanent establishment or between two or more permanent establishments in any jurisdiction in which that payment or deemed payment is treated as made (payer jurisdiction) without a corresponding inclusion for tax purposes of that payment or deemed payment in the payee jurisdiction. The payee jurisdiction is any jurisdiction where that payment or deemed payment is received, or is treated as being received under the laws of any other jurisdiction;

(d) "deduction" means the amount that is treated as deductible from the taxable income under the laws of the payer or investor jurisdiction. The term "deductible" shall be construed accordingly;

(e) "inclusion" means the amount that is taken into account in the taxable income under the laws of the payee jurisdiction. A payment under a financial instrument shall not be treated as included to the extent that the payment qualifies for any tax relief solely due to the way that payment is characterised under the laws of the payee jurisdiction. The term "included" shall be construed accordingly;

(f) "tax relief" means a tax exemption, reduction in the tax rate or any tax credit or refund (other than a credit for taxes withheld at source);

(g) "dual inclusion income" means any item of income that is included under the laws of both jurisdictions where the mismatch outcome has arisen;

(h) "person" means an individual or entity;

(i) "hybrid entity" means any entity or arrangement that is regarded as a taxable entity under the laws of one jurisdiction and whose income or expenditure is treated as income or expenditure of one or more other persons under the laws of another jurisdiction;

(j) "financial instrument" means any instrument to the extent that it gives rise to a financing or equity return that is taxed under the rules for taxing debt, equity or derivatives under the laws of either the payee or payer jurisdictions and includes a hybrid transfer;

(k) "financial trader" is a person or entity engaged in the business of regularly buying and selling financial instruments on its own account for the purposes of making a profit;

(l) “hybrid transfer” means any arrangement to transfer a financial instrument where the underlying return on the transferred financial instrument is treated for tax purposes as derived simultaneously by more than one of the parties to that arrangement;

(m) “on-market hybrid transfer” means any hybrid transfer that is entered into by a financial trader in the ordinary course of business, and not as part of a structured arrangement;

(n) “disregarded permanent establishment” means any arrangement that is treated as giving rise to a permanent establishment under the laws of the head office jurisdiction and is not treated as giving rise to a permanent establishment under the laws of the other jurisdiction.’;

(c) the following points are added:

‘(10) “consolidated group for financial accounting purposes” means a group consisting of all entities which are fully included in consolidated financial statements drawn up in accordance with the International Financial Reporting Standards or the national financial reporting system of a Member State;

(11) “structured arrangement” means an arrangement involving a hybrid mismatch where the mismatch outcome is priced into the terms of the arrangement or an arrangement that has been designed to produce a hybrid mismatch outcome, unless the taxpayer or an associated enterprise could not reasonably have been expected to be aware of the hybrid mismatch and did not share in the value of the tax benefit resulting from the hybrid mismatch.’;

(3) Article 4 is amended as follows:

(a) in point (a) of paragraph 5, point (ii) is replaced by the following:

‘(ii) all assets and liabilities are valued using the same method as in the consolidated financial statements drawn up in accordance with the International Financial Reporting Standards or the national financial reporting system of a Member State;’;

(b) paragraph 8 is replaced by the following:

‘8. For the purposes of paragraphs 1 to 7, the taxpayer may be given the right to use consolidated financial statements prepared under accounting standards other than the International Financial Reporting Standards or the national financial reporting system of a Member State.’;

(4) Article 9 is replaced by the following:

‘*Article 9*

Hybrid mismatches

1. To the extent that a hybrid mismatch results in a double deduction:

(a) the deduction shall be denied in the Member State that is the investor jurisdiction; and

(b) where the deduction is not denied in the investor jurisdiction, the deduction shall be denied in the Member State that is the payer jurisdiction.

Nevertheless, any such deduction shall be eligible to be set off against dual inclusion income whether arising in a current or subsequent tax period.

2. To the extent that a hybrid mismatch results in a deduction without inclusion:

(a) the deduction shall be denied in the Member State that is the payer jurisdiction; and

(b) where the deduction is not denied in the payer jurisdiction, the amount of the payment that would otherwise give rise to a mismatch outcome shall be included in income in the Member State that is the payee jurisdiction.

3. A Member State shall deny a deduction for any payment by a taxpayer to the extent that such payment directly or indirectly funds deductible expenditure giving rise to a hybrid mismatch through a transaction or series of transactions between associated enterprises or entered into as part of a structured arrangement except to the extent that one of the jurisdictions involved in the transaction or series of transactions has made an equivalent adjustment in respect of such hybrid mismatch.

4. A Member State may exclude from the scope of:

(a) point (b) of paragraph 2 of this Article hybrid mismatches as defined in points (b), (c), (d) or (f) of the first subparagraph of Article 2(9);

(b) points (a) and (b) of paragraph 2 of this Article hybrid mismatches resulting from a payment of interest under a financial instrument to an associated enterprise where:

(i) the financial instrument has conversion, bail-in or write down features;

(ii) the financial instrument has been issued with the sole purpose of satisfying loss absorbing capacity requirements applicable to the banking sector and the financial instrument is recognised as such in the taxpayer's loss absorbing capacity requirements;

(iii) the financial instrument has been issued

— in connection with financial instruments with conversion, bail-in or write down features at the level of a parent undertaking,

— at a level necessary to satisfy applicable loss absorbing capacity requirements,

— not as part of a structured arrangement; and

(iv) the overall net deduction for the consolidated group under the arrangement does not exceed the amount that it would have been had the taxpayer issued such financial instrument directly to the market.

Point (b) shall apply until 31 December 2022.

5. To the extent that a hybrid mismatch involves disregarded permanent establishment income which is not subject to tax in the Member State in which the taxpayer is resident for tax purposes, that Member State shall require the taxpayer to include the income that would otherwise be attributed to the disregarded permanent establishment. This applies unless the Member State is required to exempt the income under a double taxation treaty entered into by the Member State with a third country.

6. To the extent that a hybrid transfer is designed to produce a relief for tax withheld at source on a payment derived from a transferred financial instrument to more than one of the parties involved, the Member State of the taxpayer shall limit the benefit of such relief in proportion to the net taxable income regarding such payment.';

(5) the following Articles are inserted:

'*Article 9a*

Reverse hybrid mismatches

1. Where one or more associated non-resident entities holding in aggregate a direct or indirect interest in 50 per cent or more of the voting rights, capital interests or rights to a share of profit in a hybrid entity that is incorporated or established in a Member State are located in a jurisdiction or jurisdictions that regard the hybrid entity as a taxable person, the hybrid entity shall be regarded as a resident of that Member State and taxed on its income to the extent that that income is not otherwise taxed under the laws of the Member State or any other jurisdiction.

2. Paragraph 1 shall not apply to a collective investment vehicle. For the purposes of this Article, "collective investment vehicle" means an investment fund or vehicle that is widely held, holds a diversified portfolio of securities and is subject to investor-protection regulation in the country in which it is established.

Article 9b

Tax residency mismatches

To the extent that a deduction for payment, expenses or losses of a taxpayer who is resident for tax purposes in two or more jurisdictions is deductible from the tax base in both jurisdictions, the Member State of the taxpayer shall deny the deduction to the extent that the other jurisdiction allows the duplicate deduction to be set off against income that is not dual-inclusion income. If both jurisdictions are Member States, the Member State where the taxpayer is not deemed to be a resident according to the double taxation treaty between the two Member States concerned shall deny the deduction.';

(6) in Article 10(1), the following subparagraph is added:

'By derogation from the first subparagraph, the Commission shall evaluate the implementation of Articles 9 and 9b, and in particular the consequences of the exemption set in point (b) of Article 9(4), by 1 January 2022 and report to the Council thereon.';

(7) in Article 11, the following paragraph is inserted:

'5a. By way of derogation from paragraph 1, Member States shall, by 31 December 2019, adopt and publish the laws, regulations and administrative provisions necessary to comply with Article 9. They shall communicate to the Commission the text of those provisions without delay.

They shall apply those provisions from 1 January 2020.

When Member States adopt those provisions, they shall contain a reference to this Directive or be accompanied by such a reference on the occasion of their official publication. Member States shall determine how such reference is to be made.'.

Article 2

1. Member States shall adopt and publish, by 31 December 2019, the laws, regulations and administrative provisions necessary to comply with this Directive. They shall forthwith communicate to the Commission the text of those provisions.

They shall apply those provisions from 1 January 2020.

When Member States adopt those provisions, they shall contain a reference to this Directive or be accompanied by such a reference on the occasion of their official publication. Member States shall determine how such reference is to be made.

2. Member States shall communicate to the Commission the text of the main provisions of national law which they adopt in the field covered by this Directive.

3. By way of derogation from paragraph 1, Member States shall, by 31 December 2021, adopt and publish the laws, regulations and administrative provisions necessary to comply with Article 9a of Directive (EU) 2016/1164. They shall communicate to the Commission the text of those provisions without delay.

They shall apply those provisions from 1 January 2022.

When Member States adopt those provisions, they shall contain a reference to this Directive or be accompanied by such a reference on the occasion of their official publication. Member States shall determine how such reference is to be made.

Article 3

This Directive shall enter into force on the twentieth day following that of its publication in the *Official Journal of the European Union*.

Article 4

This Directive is addressed to the Member States.

Done at Brussels, 29 May 2017.

For the Council

The President

C. CARDONA

OECD/G20 Base Erosion and Profit Shifting Project

Neutralising the Effects of Branch Mismatch Arrangements

ACTION 2: INCLUSIVE FRAMEWORK ON BEPS

OECD

OECD/G20 Base Erosion and Profit Shifting Project

Neutralising the Effects of Branch Mismatch Arrangements, Action 2

INCLUSIVE FRAMEWORK ON BEPS

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Please cite this publication as:
OECD (2017), *Neutralising the Effects of Branch Mismatch Arrangements, Action 2: Inclusive Framework on BEPS*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris.
http://dx.doi.org/10.1787/9789264278790-en

ISBN 978-92-64-27795-3 (print)
ISBN 978-92-64-27879-0 (PDF)

Series: OECD/G20 Base Erosion and Profit Shifting Project
ISSN 2313-2604 (print)
ISSN 2313-2612 (online)

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Foreword

The integration of national economies and markets has increased substantially in recent years, putting a strain on the international tax rules, which were designed more than a century ago. Weaknesses in the current rules create opportunities for base erosion and profit shifting (BEPS), requiring bold moves by policy makers to restore confidence in the system and ensure that profits are taxed where economic activities take place and value is created.

Following the release of the report *Addressing Base Erosion and Profit Shifting* in February 2013, OECD and G20 countries adopted a 15-point Action Plan to address BEPS in September 2013. The Action Plan identified 15 actions along three key pillars: introducing coherence in the domestic rules that affect cross-border activities, reinforcing substance requirements in the existing international standards, and improving transparency as well as certainty.

After two years of work, measures in response to the 15 actions were delivered to G20 Leaders in Antalya in November 2015. All the different outputs, including those delivered in an interim form in 2014, were consolidated into a comprehensive package. The BEPS package of measures represents the first substantial renovation of the international tax rules in almost a century. Once the new measures become applicable, it is expected that profits will be reported where the economic activities that generate them are carried out and where value is created. BEPS planning strategies that rely on outdated rules or on poorly co-ordinated domestic measures will be rendered ineffective.

Implementation is now the focus of this work. The BEPS package is designed to be implemented via changes in domestic law and practices, and via treaty provisions. With the negotiation for a multilateral instrument (MLI) having been finalised in 2016 to facilitate the implementation of the treaty related measures, 67 countries signed the MLI on 7 June 2017, paving the way for swift implementation of the treaty related measures. OECD and G20 countries also agreed to continue to work together to ensure a consistent and co-ordinated implementation of the BEPS recommendations and to make the project more inclusive. Globalisation requires that global solutions and a global dialogue be established which go beyond OECD and G20 countries.

As a result, the OECD established an Inclusive Framework on BEPS, bringing all interested and committed countries and jurisdictions on an equal footing in the Committee on Fiscal Affairs and all its subsidiary bodies. The Inclusive Framework, which already has 100 members, will monitor and peer review the implementation of the minimum standards as well as complete the work on standard setting to address BEPS issues. In addition to BEPS Members, other international organisations and regional tax bodies are involved in the work of the Inclusive Framework, which also consults business and the civil society on its different work streams.

A better understanding of how the BEPS recommendations are implemented in practice could reduce misunderstandings and disputes between governments. Greater focus on implementation and tax administration should therefore be mutually beneficial to governments and business. Proposed improvements to data and analysis will help support ongoing evaluation of the quantitative impact of BEPS, as well as evaluating the impact of the countermeasures developed under the BEPS Project.

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Abbreviations and acronyms

ATAD	Anti-Tax Avoidance Directive
BEPS	Base Erosion and Profit Shifting
CFA	Committee on Fiscal Affairs
CFC	Controlled Foreign Company
DD	Double deduction
D/NI	Deduction/no inclusion
IP	Intellectual Property
OECD	Organisation for Economic Co-operation and Development
PE	Permanent Establishment
R&D	Research and Development
SPV	Special Purpose lending Vehicle
WP11	Working Party No.11 on Aggressive Tax Planning

Executive summary

The Report on *Neutralising the Effects of Hybrid Mismatch Arrangements* (Action 2 Report, OECD 2015) sets out recommendations for domestic rules designed to neutralise mismatches in tax outcomes that arise in respect of payments under a hybrid mismatch arrangement. The recommendations in Chapters 3 to 8 of that report set out rules targeting payments made by or to a hybrid entity that give rise to one of three types of mismatches:

a. deduction/no inclusion (D/NI) outcomes, where the payment is deductible under the rules of the payer jurisdiction but not included in the ordinary income of the payee

b. double deduction (DD) outcomes, where the payment triggers two deductions in respect of the same payment

c. indirect deduction/no inclusion (indirect D/NI) outcomes, where the income from a deductible payment is set off by the payee against a deduction under a hybrid mismatch arrangement.

The Action 2 Report (OECD 2015) includes specific recommendations for improvements to domestic law intended to reduce the frequency of such mismatches as well as targeted hybrid mismatch rules which adjust the tax consequences in either the payer or payee jurisdiction in order to neutralise the hybrid mismatch without disturbing any of the other tax, commercial or regulatory outcomes.

The Action 2 Report considers mismatches that are the result of differences in the tax treatment or characterisation of an instrument or entity. The report does not directly consider similar issues that can arise through the use of branch structures. These branch mismatches occur where the residence jurisdiction (i.e. the jurisdiction in which the head office is established) and a branch jurisdiction (i.e. the jurisdiction in which the branch is located) take a different view as to the allocation of income and expenditure between the branch and head office and include situations where the branch jurisdiction does not treat the taxpayer as having a taxable presence in that jurisdiction.

Branch mismatches are a product of inconsistencies in the domestic rules for determining the amount of income and expenditure subject to tax in each jurisdiction where the taxpayer operates. Branch mismatches exploit both differences in the domestic rules for determining whether an enterprise is subject to tax in a particular jurisdiction and the amount of income and expenditure to be taken into account in calculating that tax liability. For example, the residence jurisdiction may include all of the taxpayer's income on a worldwide basis (including all the income of foreign branches) while providing the taxpayer with a tax credit or exemption to eliminate double taxation on foreign income, while the branch jurisdiction treats the branch operation as a separate enterprise and taxes only the net income properly attributable to the branch. Although both these approaches to calculating the net income of the taxpayer in each jurisdiction may be intended to ensure that the taxpayer's entire net income is subject to tax in at least one jurisdiction (while avoiding economic double taxation of the same income), the different approaches to calculating that income may allow the taxpayer to leave an item of income out of the charge to taxation or allow the same item of expenditure to be deducted twice from the net income in two jurisdictions. Alternatively, the effect of an adjustment in one jurisdiction may be ignored in the other, thereby reducing the aggregate amount of income that the taxpayer is required to bring into charge to taxation.

Branch mismatch arrangements can be used to produce the same types of mismatches that are targeted by the recommendations in the Action 2 Report (OECD, 2015). For example:

a. A deductible payment made to a branch may not be brought into income in either the branch or residence jurisdiction (a D/NI outcome analogous to that described in Chapters 4 and 5 of the Action 2 Report (OECD, 2015)).

b. A branch may make (or be treated as making) a deductible payment to the head office that is not taken into account in calculating the net income of the head office under the laws of the residence jurisdiction (a D/NI outcome analogous to that described in Chapter 3 of the Action 2 Report (OECD, 2015)).

c. The same item of expenditure may be treated as deductible under the laws of both the residence and the branch jurisdictions (a DD outcome analogous to that described in Chapters 6 and 7 of the Action 2 Report (OECD, 2015)).

d. The income from a payment may be offset against a deduction under a branch mismatch arrangement (an indirect D/NI outcome analogous to that described in Chapter 8 of the Action 2 Report (OECD, 2015)).

Branch mismatch arrangements offer multinationals opportunities to reduce their overall tax burden by exploiting differences in the rules governing the allocation of payments between two jurisdictions, thereby raising the same issues as hybrid mismatches in terms of competition, transparency, efficiency and fairness. While a taxpayer's decision to operate through a branch will generally be driven by commercial or regulatory (rather than tax) factors, the mismatch that arises under the branch structure is the result of a taxpayer exploiting inconsistent positions adopted by the residence and branch jurisdiction on the allocation of income and expenditure between the branch and head office. For example, in the case of diverted branch payments, the mismatch arises due to the fact that the payee does not take a payment into account in either the residence or the branch jurisdiction. In the case of double deduction structures, the taxpayer deducts the same expense in different jurisdictions and sets that deduction off against income that is not subject to tax in the other jurisdiction while, in the case of a deemed branch payment, the payer is generally compensating the payee for an asset, function or risk that the payee does not treat itself as holding, performing or bearing for tax purposes.

Mismatches will not arise where all jurisdictions adhere to a common standard in the rules for determining a taxable presence and in the allocation of income or expenditure to different parts of the same enterprise and those standards are applied consistently by the taxpayer in both jurisdictions. Such international standards are the primary solution for addressing such mismatches. A number of the BEPS Action Items set out modifications to international tax standards that may reduce the BEPS opportunities associated with these types of mismatches. For example:

a. The Action 7 Report on *Preventing the Artificial Avoidance of Permanent Establishment Status* (OECD, 2015) includes recommendations for changes to the permanent establishment definition to address techniques used to inappropriately avoid creating a taxable presence in the branch jurisdiction.

b. The Report on Actions 8-10 (*Aligning Transfer Pricing outcomes with Value Creation* (OECD 2015)) sets out changes to the transfer pricing guidelines designed to ensure that the transfer pricing of multinational enterprises better aligns the taxation of profits with economic activity.

In practice, however, differences between the rules (or in the application of the rules) for calculating the net income of a branch or head office will continue to exist in those cases where both jurisdictions have not aligned their rules and practice in accordance with a common standard. While, the most comprehensive and effective way of addressing differences in the allocation of profit between the branch and head office would be for all jurisdictions to adhere to a single standard in attributing and calculating branch income, in the absence of this type of harmonisation, a country cannot protect its tax base from the risks posed by branch mismatches simply by adhering to such an agreed standard. The recommendations set out in this report call for one-off adjustments in order to neutralise tax planning opportunities that can arise in those cases where taxpayers exploit differences in the methodology for calculating the net income of the branch and head office.

Given the similarity between hybrid and branch mismatches, both in terms of structure and outcomes, countries that have adopted hybrid mismatch rules have, at the same time, generally chosen to adopt an equivalent and parallel set of rules targeting branch mismatches.[1] These branch mismatch rules apply the same analysis and solutions set out in the Action 2 Report (OECD, 2015) to neutralise mismatches that arise in the branch context. The adoption of branch and hybrid mismatch rules as a single package supports the integrity of the common approach set out in Action 2 by aligning the treatment of both types of mismatches and thereby preventing taxpayers shifting from hybrid mismatch to branch mismatch arrangements in order to secure the same tax advantages.

On 22 August 2016, the Committee on Fiscal Affairs (CFA) issued a discussion document on branch mismatch arrangements[2] inviting interested parties to comment on recommendations for branch mismatch rules that would bring the treatment of these structures into line with the treatment of hybrid mismatch arrangements as set out in the Action 2 Report (OECD, 2015). The recommendations in this report have been prepared in light of the comments received on that discussion document and the legal changes that countries have made since the release of the Action 2 Report (OECD, 2015).

The introduction to this report describes the various categories of branch mismatch arrangement covered by this report and the recommendations for specific changes to domestic law and branch mismatch rules that would bring the tax treatment of these arrangements into line with the common approach set out in the Action 2 Report (OECD, 2015), are set out in Chapters 1-5.

Annex A of this report summarises the recommendations and Annex B sets out a number of examples illustrating the intended operation of the recommended rules.

Notes

1. See the new Part 6A TIOPA 2010 (Taxation International and other Provisions) Act 2010, which came into effect on 1 January 2017 (the "UK Hybrids Rules") and the Council Directive amending Directive (EU) 2016/1164 as regards hybrid mismatches with third countries dated 12 May 2017 ("ATAD 2"), http://dsms.consilium.europa.eu/952/Actions/Newsletter.aspx?messageid=13108&customerid=37917&password=enc_643345636135526A32344361_enc (accessed on 13 June 2017).

2. See *The OECD releases a discussion draft on branch mismatch structures under Action 2 of the BEPS Action Plan* (22 August 2016): www.oecd.org/tax/aggressive/oecd-releases-discussion-draft-on-branch-mismatch-structures-under-action-2-of-the-beps-action-plan.htm (accessed on 31 May 2017).

Introduction

1. Branch mismatches arise where the ordinary rules for allocating income and expenditure between the branch and head office result in a portion of the net income of the taxpayer escaping the charge to taxation in both the branch and residence jurisdiction. Unlike hybrid mismatches, which result from conflicts in the legal treatment of entities or instruments, branch mismatches are the result of differences in the way the branch and head office account for a payment made by or to the branch. Because branch mismatches turn on differences in tax accounting rather than legal characterisation, the same basic legal structure may call for the application of different branch mismatch rules, depending on the accounting treatment adopted by the branch and head office.

2. This report identifies five basic types of branch mismatch arrangements:

a. disregarded branch structures where the branch does not give rise to a permanent establishment (PE) or other taxable presence in the branch jurisdiction

b. diverted branch payments where the branch jurisdiction recognises the existence of the branch but the payment made to the branch is treated by the branch jurisdiction as attributable to the head office, while the residence jurisdiction exempts the payment from taxation on the grounds that the payment was made to the branch

c. deemed branch payments where the branch is treated as making a notional payment which results in a mismatch in tax outcomes under the laws of the residence and branch jurisdictions

d. DD branch payments where the same item of expenditure gives rise to a deduction under the laws of both the residence and branch jurisdictions

e. imported branch mismatches where the payee offsets the income from a deductible payment against a deduction arising under a branch mismatch arrangement.

Branch mismatches rules can arise directly as well as indirectly through a taxpayer's investment through a transparent structure such as a partnership.

Branch payee structures that give rise to D/NI outcomes

3. The first two categories of mismatches considered in this report are D/NI outcomes that arise where the residence jurisdiction treats a deductible payment as received through a foreign branch (and therefore excludes or exempts the payment from ordinary income) while the branch jurisdiction does not tax the payee because:

a. in the case of a disregarded branch structure, the payee has an insufficient presence in the branch jurisdiction to be taxable on such payment

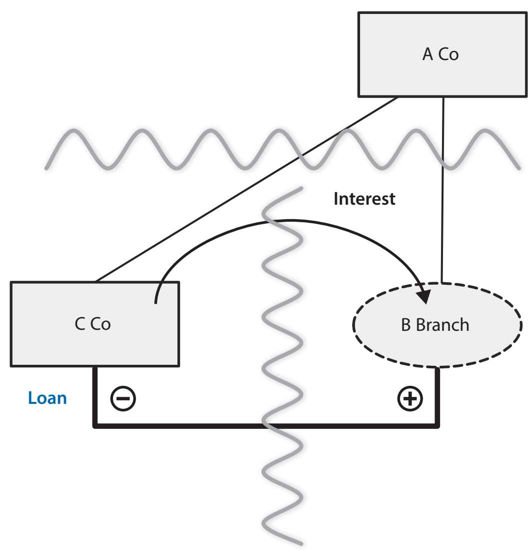
b. in the case of a diverted branch payment the branch jurisdiction exempts or excludes the payment from taxation on the grounds that the payment is treated as made to the head office.

Both these structures are discussed in further detail below.

Disregarded branch structure

4. In a disregarded branch structure the mismatch arises due to the fact that a deductible payment received by a taxpayer is treated, under the laws of the residence jurisdiction, as being made to a foreign branch (and therefore eligible for an exemption from income), while the branch jurisdiction does not recognise the existence of the branch and therefore does not subject the payment to tax. An example of a disregarded branch structure is illustrated in Figure 1.

Figure 1. **Disregarded branch structure**



5. In this case A Co lends money to C Co (a related company) through a branch located in Country B. Country C permits C Co to claim a deduction for the interest payment. Country A exempts or excludes the interest payment from taxation on the grounds that it is attributable to a foreign branch. The interest income is not, however, taxed in Country B because A Co does not have a sufficient presence in Country B to be subject to tax in that jurisdiction. The payment of interest therefore gives rise to an intra-group mismatch (a D/NI outcome).

6. The D/NI mismatch that results from a disregarded branch structure can arise in a number of ways and could be a product of the domestic rules operating in each jurisdiction or due to a conflict between domestic law and treaty requirements. For example:

a. The interest payment could be treated as income of a foreign branch (and therefore tax exempt) under Country A domestic law but may not be included in income under Country B domestic law because the branch does not give rise to taxable presence in Country B for domestic law purposes.

b. The branch could be treated as constituting a permanent establishment (PE) under the Country A-B tax treaty so that Country A is required to exempt the interest payment from tax under a provision equivalent to Article 23A of the OECD Model Tax Convention on Income and Capital: Condensed Version 2014[1] (Model Tax Convention, OECD 2014) (even though the branch does not give rise to a taxable presence under Country B's domestic law).

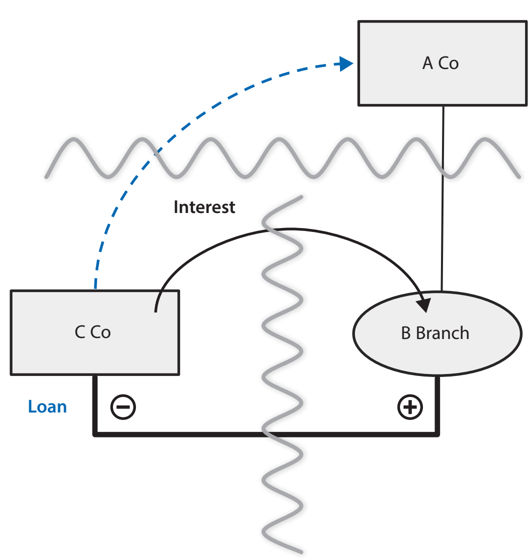
c. The branch may not meet the legal definition of a PE under the Country A-B tax treaty so that the payment of interest received by the branch is excluded from taxation by Country B because a provision equivalent to Article 7 of the Model Tax Convention (OECD, 2014) does not allow Country B to tax residents of Country A in the absence of a PE as defined under that treaty. This may be the outcome provided for under the treaty even though Country A's domestic law allows A Co to treat the payment as exempt from tax in Country A as income of a foreign branch.

7. The mechanics and the resulting tax outcomes from the use of a disregarded branch structure are similar to those of a reverse hybrid (discussed in Chapters 4 and 5 of the Action 2 Report (OECD, 2015)) in that both the residence and the branch jurisdiction exempt or exclude the payment from income on the grounds that the payment should be treated as received (and therefore properly subject to tax) in the other jurisdiction.

Diverted branch payment

8. A diverted branch payment has the same structure and outcomes as a payment to a disregarded branch except that the mismatch arises, not because of a conflict in the characterisation of the branch, but rather due to a difference between the laws of the residence and branch jurisdiction as to the attribution of payments to the branch. An example of a diverted branch payment is illustrated in Figure 2. This example is the same as that described in Figure 1, except that both the residence and branch jurisdiction recognise the existence of the branch. The mismatch arises from the fact that the branch treats the deductible interest payment as if it was paid directly to the head office in Country A, while the head office continues to treat the payment as made to the branch. As a consequence, the payment is not subject to tax in either jurisdiction (a D/NI outcome).

Figure 2. **Diverted branch payment**



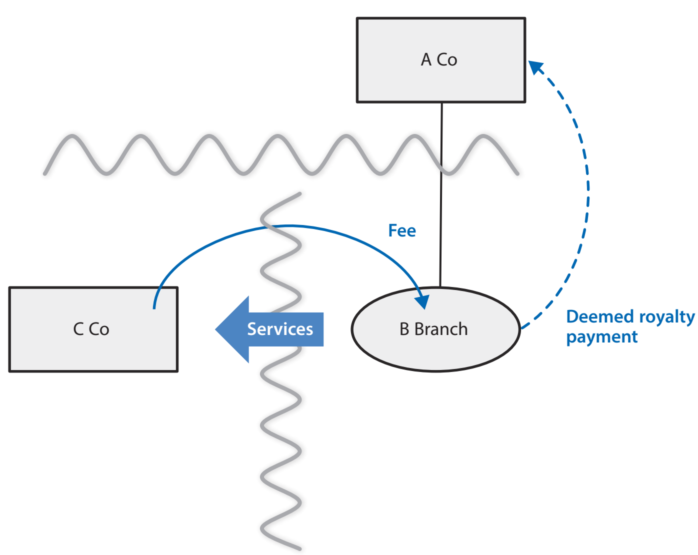
9. This mismatch in tax treatment could be due to a difference in the rules used by Country A and B for allocating income to the branch (or a difference in the interpretation or application of those rules) or due to specific rules in Country B that exclude or exempt this type of income from taxation at the branch level due to the fact that the payment is treated as made to a non-resident. As with the disregarded branch structures, the mechanism by which the mismatch in tax outcome arises is similar to that of a reverse hybrid in that both the residence and the branch jurisdiction exempt or exclude the payment from taxation on the basis that it should properly be regarded as received in the other jurisdiction.

Deemed branch payments

10. In the case of diverted or disregarded branch payments the mismatch arises in respect of a deductible payment that is not included in income in either the branch or residence jurisdiction. It is also possible, however, to generate internal mismatches between the branch and residence jurisdictions where the rules in those jurisdictions for allocating net income between the branch and head office permit the taxpayer to recognise a deemed payment between two parts of the same taxpayer and there is no corresponding adjustment to the net income in the payee jurisdiction that takes into account the effect of this payment.

11. A structure illustrating a deemed branch payment is set out in Figure 3. In this example A Co supplies services to an unrelated company (C Co) through a branch located in Country B. The services supplied by the branch exploit underlying intangibles owned by A Co. Country B attributes the ownership of those intangibles to the head office and treats the branch as making a corresponding arm's length payment to compensate A Co for the use of those intangibles. This deemed payment is deductible under Country B law but is not recognised under Country A law (because Country A attributes the ownership of the intangibles to the branch). Meanwhile, the services income received by the branch is exempt from taxation under Country A law due to an exemption or exclusion for branch income in Country A.

Figure 3. **Deemed branch payment**



12. The deemed payment will give rise to an intra-group mismatch (a D/NI outcome) to the extent the deduction is set off against branch income which is exempt from tax in Country A (non-dual inclusion income). Deemed branch payments can only arise in those cases where the rules for allocating net income to the branch or head office allow for the recognition of notional payments between various parts of the same taxpayer. While the structure illustrated above involves a deemed royalty payment, the application of tax or accounting principles as well as income allocation principles in the branch jurisdiction can also give rise to other deemed payments (such as interest) with similar tax consequences.

13. The mismatches that arise in respect of deemed branch payments are similar to those that arise in respect of disregarded hybrid payments described in Chapter 3 of the Action 2 Report (OECD, 2015). In that case a hybrid payer (a person that is treated as a separate entity under the laws of the payer jurisdiction but as transparent or disregarded by the payee) makes a deductible payment that is disregarded under the laws of the payee jurisdiction due to the transparent tax treatment of the payer. The deduction resulting from that payment is then set off against income that is not subject to tax in the payee jurisdiction (i.e. against non-dual inclusion income).

14. The mechanics of, and outcomes resulting from, deemed branch and disregarded hybrid payments are substantially the same. The branch is entitled to a deduction for an item that is treated as expenditure under the laws of the payer/branch jurisdiction but that is disregarded in the payee/residence jurisdiction because the payee does not treat the payer as a separate enterprise for tax purposes. The deduction that is attributable to the mismatch is then set off against non-dual inclusion income, giving rise to a mismatch in tax outcomes.

DD branch payments

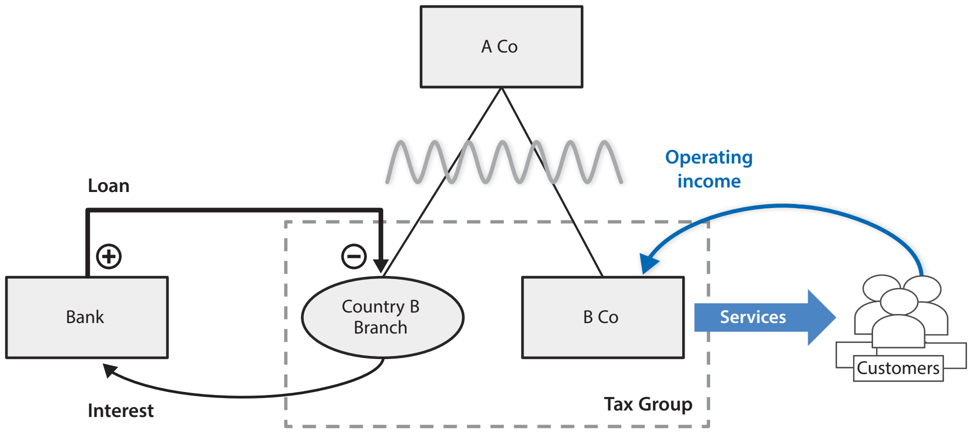
15. DD outcomes arise where the same item of expenditure is treated as deductible under the laws of more than one jurisdiction. These type of mismatches give rise to tax policy concerns where the laws of both jurisdictions permit the deduction to be offset against income that is not taxable under the laws of the other jurisdiction (i.e. against non-dual inclusion income).

16. DD branch payments can arise where the residence jurisdiction provides the head office an exemption for branch income while permitting it to deduct the expenditures attributable to the branch. Mismatches can arise where the rules for allocating income and expenditure in the branch jurisdiction also allow the taxpayer to claim a deduction for the same expenditure under the laws of the branch jurisdiction. In these cases the general exemption for branch profits provided by the residence jurisdiction means that the deduction in the branch will be set off against income that is not subject to tax in the residence jurisdiction (i.e. against non-dual inclusion income).

17. DD branch payments can also arise in the context of taxable branches (i.e. where the residence jurisdiction brings all the income and expenditure of the branch into account for tax purposes). Taxable branches can be used to generate DD branch outcomes where the branch is permitted to join a tax group or there is some other mechanism in place in the branch jurisdiction that allows expenditure or loss to be set off against income derived by another person that is not taxable under the laws of the residence jurisdiction.

18. In the example illustrated in Figure 4, A Co has established both a branch operation and a subsidiary in Country B. Country B law permits the subsidiary (B Co) and the Country B Branch to form a group for tax purposes, which allows the expenditure incurred by the Country B Branch to be offset against the income of the subsidiary.

Figure 4. **DD branch payment**



19. If Country B Branch is treated as taxable under the laws of Country A, then the interest expense incurred by the branch will give rise to separate deductions under the laws of Country A and Country B. Because Country B Branch and B Co are members of the same tax group this interest expenditure can also be offset, under Country B law, against the operating income derived by the subsidiary (i.e. against non-dual inclusion income). This structure therefore permits the same interest expense to be set off simultaneously against different items of income in the residence and branch jurisdiction.

20. The issues raised by these structures are discussed in Chapter 6 of the Action 2 Report (OECD, 2015) which sets out general hybrid mismatch rules neutralising the effect of DD outcomes. While the recommendations set out in Chapter 6 are drafted broadly enough to cover DD outcomes arising in respect of branch structures, the Action 2 Report (OECD, 2015) does not specifically consider the application of the deductible hybrid payments rule to DD branch payments such as those identified above.

Imported branch mismatches

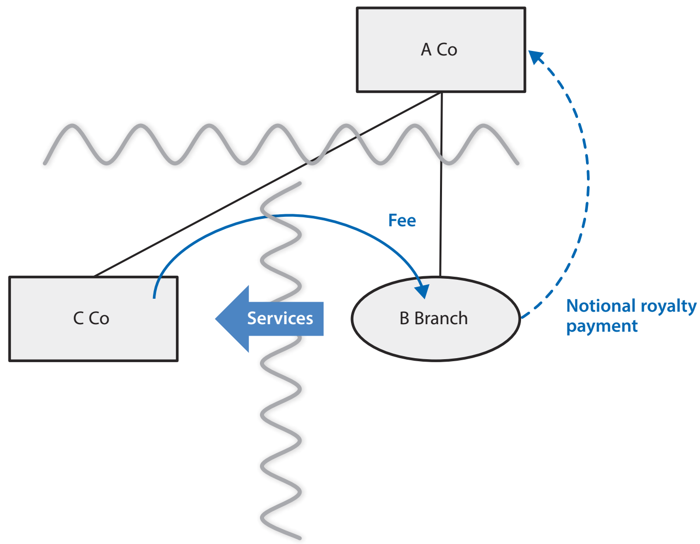
21. An imported branch mismatch can arise where a person with a deduction under a branch mismatch arrangement offsets that deduction against a taxable payment received from a third party. An example of an imported branch mismatch is illustrated in Figure 5. This example is similar to that illustrated in Figure 3 except that A Co and C Co are part of the same group and it is assumed that there is no rule in either Country A or B addressing the mismatch in tax outcomes arising from a deemed royalty payment. As a consequence, a deduction under a branch mismatch arrangement is set off against the (deductible) service fee paid by C Co resulting in an indirect D/NI outcome.

22. The structure is similar to the imported mismatch structures described in Recommendation 8 of the Action 2 Report (OECD, 2015) in that it relies on the taxpayer engineering a mismatch (in this case a branch mismatch) under the laws of two jurisdictions and importing the effect of that mismatch into a third jurisdiction through a plain-vanilla instrument with an otherwise orthodox tax treatment.

23. Imported branch mismatch structures raise similar tax policy issues to those identified in the Action 2 Report (OECD, 2015) in that the most appropriate and effective way to neutralise the mismatch is for either or both Country A and B to implement branch

mismatch rules neutralising the mismatch. However, in order to maintain the integrity of the other recommendations (in the event Country A or B do not have branch mismatch rules), an imported mismatch rule is needed to deny the deduction for any payment that is directly or indirectly set off against any type of branch mismatch payment.

Figure 5. **Imported branch mismatches**



Summary of Recommendations

24. This report is divided into five chapters that set out specific recommendations for improvements to domestic law designed to reduce the frequency of branch mismatches as well as targeted branch mismatch rules, which neutralise the mismatch in tax outcomes without disturbing any of the other tax, commercial or regulatory outcomes. The recommendations set out in each chapter are summarised briefly below:

a. Chapter 1 contains specific recommendations regarding the scope and operation of the branch exemption intended to achieve a closer alignment between that exemption and the policy of exempting the income of a foreign branch as a method of relieving income from double taxation (**Recommendation 1**).

b. Chapter 2 sets out the operation of the branch payee mismatch rule which denies the payer a deduction for a diverted or disregarded branch payment made to a related person or under a structured arrangement to the extent the payment is not included in income by the payee (a rule that is equivalent to the reverse hybrid rule set out in Chapter 4 of the Action 2 Report (OECD, 2015)) (**Recommendation 2**).

c. Chapter 3 describes the deemed branch payment rule which denies a deduction for a deemed payment between the branch and the head office (or between two branches of the same person) to the extent that payment gives rise to a D/NI outcome and the resulting deduction is set off against non-dual inclusion income (a rule that is equivalent to the disregarded hybrid payment rule set out in Chapter 3 of the Action 2 Report (OECD, 2015)) (**Recommendation 3**).

d. Chapter 4 clarifies the scope of the double deduction rule set out in Chapter 6 of the Action 2 Report (OECD, 2015) in respect of DD outcomes arising from payments made by a branch (**Recommendation 4**).

e. Chapter 5 provides for an imported mismatch rule consistent with Recommendation 8 in the Action 2 Report (OECD, 2015) that would deny a deduction for a payment made within the same control group or under a structured arrangement to the extent the income from such payment is set off against expenditure giving rise to a branch mismatch (**Recommendation 5**).

25. The recommendations in this report follow the same structure of those set out in the Action 2 Report (OECD, 2015) and, accordingly, any technical terms that are not defined in this report have the same meaning as the terms used in Action 2 Report (OECD, 2015).

Recommendation 1 not a branch mismatch rule

26. The recommendations described in Chapter 1 are not branch mismatch rules. Rather they are specific recommendations for changes to the scope of the branch exemption that are designed to bring the scope and operation of that exemption into line with the intended policy of avoiding double taxation of branch income. While narrowing the scope of the branch exemption will have the effect of reducing the frequency of branch mismatches (and therefore the need to apply any of the recommended branch mismatch rules set out in Chapters 2 to 5 of the report), the recommendations in Chapter 1 do not specifically target branch mismatches and apply to a wider range of payments than those targeted by the branch mismatch rules. The recommendations in Chapter 1 should not, however, be interpreted as requiring countries to make any change to deliberate policy decisions they have made, including in respect of the territorial scope of their tax regime, and do not purport to affect a country's obligations under a tax treaty.

Recommendations in Chapters 2 to 5 only require adjustments in respect of branch mismatches

27. The branch mismatch rules described in Chapters 2 to 5 are intended to neutralise mismatches that result from differences in the allocation of income or expenditure between the branch and the head office (or two parts of the same taxpayer). The rules should not apply when the reason for the mismatch is that the payee is exempt from tax, subject to a special tax regime or resident in a zero tax jurisdiction. Mismatches that arise solely due to differences in measurement or timing are also not within the intended scope of the recommendations.

Branch mismatch rules only to be applied after ordinary rules for allocating net income to the branch

28. Adjustments under the branch mismatch rules should only be made after applying the ordinary domestic rules for allocating branch income, subject to the requirements of any relevant treaty, but including any rules that restrict the scope of the branch exemption in accordance with the specific recommendations set out in Chapter 1. As branch mismatches are the result of taxpayers taking inconsistent positions in two jurisdictions on the same item of income or expenditure, there should generally be no need to apply branch mismatch rules where the taxpayer has adopted consistent positions and consistently applied the same standards to the allocation of branch income in both jurisdictions. The branch mismatch rules are intended to remove any incentive for a taxpayer to take inconsistent positions in

respect of where a payment is included or where functions are performed, assets are held and risks are assumed. The rules also eliminate the possibility of a taxpayer offsetting a deduction for the same expenditure against different items of income in two different jurisdictions. By neutralising these tax advantages, it is expected that taxpayers will adopt more consistent and coherent positions on the allocation of income and expenditure between the branch and the head office such that there will be little need to make many adjustments under these rules. Any adjustments under the recommendations set out in this report should not affect the allocation of taxing rights under a tax treaty.

29. The branch mismatch rules set out in this report introduce additional steps into the process of calculating the profit of the branch. This incremental compliance burden is likely to have a greater impact on substantial branches with commercial operations where there a large number of transactions in the branch with related and unrelated parties. Any such burden can, however, be minimised by taxpayers taking consistent positions on the allocation of income and expenditure between various parts of an enterprise and by jurisdictions ensuring that their existing domestic rules for allocating income and expenditure to a branch are clear, consistent and minimise the potential for both double taxation and double non-taxation. In the event that mismatches do arise, tax administrations should provide taxpayers with flexible and straight-forward implementation solutions that preserve the policy objectives behind the branch mismatch rules and that are based, as far as possible, on the taxpayer's existing domestic compliance and filing requirements. As with hybrid mismatch arrangements, the implementation solutions adopted by each jurisdiction should allow for effective and efficient co-ordination in the application of the branch mismatch rules in each jurisdiction without creating material gaps or the risk of double taxation.

30. Branch mismatches most frequently arise in the context of exempt branches (i.e. where the residence jurisdiction provides an exemption for branch income). Where a jurisdiction taxes residents on their worldwide income (including the income of any foreign branch), then any payments that are not included in income by the branch will generally be brought into charge in the residence jurisdiction (eliminating the risk of any branch payee mismatches). Furthermore, in the case of operating branches, the taxpayer will generally have sufficient dual inclusion income in the branch to avoid the need to make adjustments under the deemed branch payment or the double deduction rules described in Chapters 3 and 4 of this report (although there may still be scope for the operation of these rules where the branch jurisdiction permits the branch to join a tax group or provides some other mechanism, which allows the branch expenditure to be set off against non-dual inclusion income).

31. Branch mismatches can arise directly, where the same entity or person has taxable operations in a number of different jurisdictions, or indirectly through a taxpayer's participation through a transparent structure such as a partnership. Branch mismatch rules apply to a taxpayer in both these cases to neutralise the mismatch in tax outcomes.

Note

1. OECD Model Tax Convention on Income and Capital: Condensed Version 2014, OECD Publishing, Paris (Model Tax Convention, OECD 2014).

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Chapter 1

Limitation to the scope of the branch exemption

1. Limitation to the scope of the branch exemption

Jurisdictions that provide an exemption for branch income should consider limiting the scope and operation of this exemption so that the effect of deemed payments, or payments that are disregarded, excluded or exempt from taxation under the laws of the branch jurisdiction, are properly taken into account under the laws of the residence jurisdiction.

Overview

32. Branch payee and deemed branch payment mismatches most frequently arise where the net income of the branch is exempt from tax in the residence jurisdiction. These risks can be significantly reduced if the residence jurisdiction modifies the operation of its branch exemption so as to ensure that the net income eligible for exemption is not greater than the income actually included by the branch. This can be done by including any items of income that are not taxed by the branch jurisdiction and by making the necessary adjustments to take into account the effect of deemed payments made from the branch to the head office. Changes to the scope of a branch exemption that required the taxpayer to make an adjustment in the residence jurisdiction in respect of a deemed payment or an item of income that was not taxable at the branch level, would provide for a comprehensive and transparent way of addressing branch mismatches and alleviate the payer from any need to consider whether an adjustment was required under the branch mismatch rules. This report therefore recommends that jurisdictions consider modifying the scope and operation of their branch exemption regime in order to take into account payments that are not included in income by an exempt branch and deemed payments made by an exempt branch.

33. There are a number of advantages to bringing a branch payment or deemed branch payment into income in the residence jurisdiction rather than relying on the rules set out in Chapters 2 to 5 of the report to address any mismatch in tax outcomes. From a compliance perspective, it will usually be easier for the head office to identify the payment or deemed payment that gives rise to the mismatch than it will be for the payer jurisdiction to apply the branch payee mismatch rule under Recommendation 2 or imported mismatch rule under Recommendation 5. Changes to the scope of the branch exemption also have the potential to eliminate a wider range of mismatches, including D/NI payments received from outside the controlled group and mismatches that result from the fact that the branch is exempt from tax, subject to a special regime or located in a jurisdiction that does not impose an income tax.

34. Some of the advantages of applying Recommendation 1 are discussed in **Example 1** of this report. In that example, a group company makes a deductible payment to the branch of another group company. The example notes there may be a number of reasons why the payment is not subjected to tax in the branch jurisdiction (e.g. the branch jurisdiction may not impose a corporate income tax, the payment may qualify for special treatment under a tax regime or the foreign branch may treat the payment as being made to the head office). Recommendation 1 could be applied to neutralise any resulting mismatch in all these cases. **Example 4** describes a deemed branch payment where the branch is allowed a deduction for a notional royalty payment made to the head office. The example notes that are a variety of methods that the residence jurisdiction could adopt to eliminate the risk of mismatches arising in respect of such notional payments that may be less complicated than applying the deemed branch payment rule.

35. Recommendation 1.1 is based on the assumption that the intention of the residence jurisdiction in granting an exemption for branch income is to relieve that income from double taxation, so that income that is not, in fact, subject to net taxation in the branch jurisdiction should not benefit from this exemption. Recommendation 1 should not, however, be interpreted as requiring countries to make any change to deliberate policy decisions they have made, including in respect of the territorial scope of their tax regime. Accordingly, this recommendation only calls for jurisdictions to consider modifying the scope and operation of their branch exemption to neutralise branch mismatches and does not set out any limitations on the amount of the adjustment, or the mechanism for making

that adjustment, provided any adjustment is consistent with a jurisdiction's tax treaty obligations, and tax policy settings in that jurisdiction.

Recommendation 1.1 – Limitation to the scope of the branch exemption

36. Recommendation 1.1 suggests jurisdictions consider narrowing the scope and adjusting the operation of their branch exemption regime in order to reduce the frequency of branch payee and deemed branch payment mismatches. The recommendation encourages the residence jurisdiction to consider limiting the operation and scope of the branch exemption so that the effect of any deemed payment or any payment that is not included in income under the laws of the branch jurisdiction is properly taken into account for tax purposes by making appropriate adjustments in the residence jurisdiction. As with Recommendation 5.1 of the Action 2 Report (OECD, 2015), this recommendation is designed to ensure that the branch exemption operates in line with the intended tax policy settings in the residence jurisdiction in respect of the taxation of worldwide income, while preserving the ability of jurisdictions to determine the scope of their taxing jurisdiction consistent with their general system of taxation.

37. While the purpose and effect of Recommendation 1.1 is to reduce the frequency of branch mismatches, this recommendation is not a branch mismatch rule. Rules that adjust the scope of the branch exemption in order to reduce instances of double non-taxation could apply to any payment that would ordinarily give rise to income in the residence jurisdiction, regardless of whether that payment produces a mismatch in tax outcomes or whether the mismatch in question is attributable to differences in the rules for allocating such payments between the branch and the head office. This is illustrated in **Example 1** where it is noted that the residence jurisdiction may choose to bring untaxed branch income into the charge to tax not only in those cases where the reason for mismatch is due to a misallocation of the payment under the laws of the branch jurisdiction, but also where the payment qualifies for tax-free treatment in the branch on some other basis.

38. Requiring the taxpayer to bring make an adjustment in the residence jurisdiction that takes into account the effect of the deemed or untaxed payment will not automatically trigger an additional tax liability in that jurisdiction. For example, under this rule a payment, such as a dividend, that was not taxed at the branch level (and was therefore required to be brought into account for tax purposes by the head office) may still be eligible to benefit from a tax exemption or other type of tax relief in the residence jurisdiction that is provided for payments of that nature under domestic law (such as a participation exemption for foreign dividends).

39. As with Recommendation 5.1 there are a number of ways the residence jurisdiction could make an adjustment to include an appropriate amount of additional income under the laws of the residence jurisdiction in order to neutralise any double non-taxation outcome and accordingly Recommendation 1.1 does not extend to describing the way in which the payment of untaxed branch income may be taken into account in the head office. **Example 1** considers the case of a licence fee paid to another group company that is not brought into tax in either the branch or the residence jurisdiction. The example notes that there are a variety of adjustments the residence jurisdiction could take to expand the scope of its taxing regime to bring untaxed branch income into charge at the head office. **Example 4** describes a deemed branch payment where the branch jurisdiction allows the branch a deduction for a notional royalty payment made to the head office. That example notes that there are a variety of methods for allocating income and expenditure between the head office and branch that can be used in order to take into account the effect of

such a deemed payment. These include recognising additional income in the head office jurisdiction of an amount equal to the deemed payment, allocating expenditure of an equivalent category to the payer jurisdiction and adjusting the way in which exempt income of the branch is calculated so as to eliminate the risk of mismatches arising in respect of such notional payments. In all cases, the adjustments required by the residence jurisdiction should be consistent with a proper allocation of income and expenditure between the branch and the head office under agreed international standards and in line with the intended territorial scope of that jurisdiction's tax regime.

40. It should also be noted that the residence jurisdiction may be prevented from restricting the scope of the branch exemption in those cases where the tax treaty in effect between the residence and branch jurisdiction contains a provision equivalent to Article 23A of the Model Tax Convention (Model Tax Convention, OECD 2014).

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Chapter 2

Branch payee mismatch rule

1. Denial of deduction for branch payee mismatches

The payer jurisdiction should deny a deduction for a payment that gives rise to a D/NI outcome to the extent that the mismatch is a result of:

a. differences in the allocation of payments between the residence and the branch jurisdiction or between two branch jurisdictions; or

b. the fact that the payment is to a disregarded branch.

2. Disregarded branch

A disregarded branch is a branch that is treated as giving rise to a taxable presence under the laws of the residence jurisdiction (and thus is eligible for an exemption from income) but is not treated as giving rise to a taxable presence under the laws of the branch jurisdiction.

3. Scope

This recommendation shall only apply to payments made under a structured arrangement or between members of a controlled group.

Overview

41. A deductible payment made to a branch will give rise to a D/NI outcome where that payment is not included in ordinary income by either the residence or branch jurisdiction. The branch payee mismatch rule neutralises these types of mismatches where they result from both jurisdictions treating the payment as allocated to a taxpayer in the other jurisdiction.

42. Recommendation 2 specifically targets the two types of branch payee mismatches identified in the Introduction:

a. **Diverted branch payments**, where the mismatch arises, not because of a conflict in the characterisation of the branch, but rather, due to difference between the laws of two jurisdictions as to the attribution of payments to the branch.

b. **Disregarded branch structures**, where the mismatch arises due to the fact that a deductible payment received by a taxpayer is treated, under the laws of the residence jurisdiction, as being made to a foreign branch (and therefore eligible for an exemption from income) while the branch jurisdiction does not recognise the existence of the branch and therefore does not subject the payment to tax.

43. The mechanics and the resulting tax outcomes from the use of a disregarded branch structure and diverted branch payments are similar to the use of a reverse hybrid (discussed in Chapter 4 of the Action 2 Report (OECD, 2015)) in that both of the payee jurisdictions exempt or exclude a payment from income on the grounds that the payment should be treated as received (and therefore properly subject to tax) in the other jurisdiction. The branch payee mismatch rule set out in this chapter brings the treatment of diverted branch payments and disregarded branch structures into line with the outcomes provided for under the reverse hybrid rule by denying the deduction for such payments to the extent the allocation of payments between the two jurisdictions gives rise to a mismatch in tax outcomes.

Recommendation 2.1 – Denial of deduction for branch payee mismatches

Payment

44. The definition of payment set out in Recommendation 2.1 of this report is intended to have the same meaning as that set out in the Action 2 Report (OECD, 2015). It includes a broad range of current expenditures such as rents, royalties, interest, payments for services and other payments that may be set off against ordinary income under the laws of the payer jurisdiction. The term would not typically cover the cost of acquiring an asset and would not extend to an allowance for a depreciation or amortisation.

D/NI outcome

Branch payee mismatch rule applies in any jurisdiction where payment is deductible

45. The definition of deduction set out in Recommendation 2.1 of this report is intended to have the same meaning as that set out in the Action 2 Report (OECD, 2015). A payment is deductible to the extent a jurisdiction allows the taxpayer to offset expenditure against a taxpayer's ordinary income. The definition in the Action 2 Report (OECD, 2015) focuses on whether a payment falls into the category of a "deductible" item under the laws of the

relevant jurisdiction so that the specific details of the taxpayer's net income calculation should not generally affect the question of whether a payment is treated as "deductible" for tax purposes.

46. A payment may be treated as made from more than one jurisdiction in those cases where the payment is made through a tax transparent structure such as a branch or hybrid entity. In these cases the question of whether the payment gives rise to a D/NI outcome under the laws of the jurisdiction applying the branch payee mismatch rule is not affected by fact that the payment may also be deductible under the laws of another jurisdiction. This principle is the same as that illustrated in Example 4.4 of the Action 2 Report (OECD, 2015) where a hybrid entity makes a payment to a reverse hybrid. In this case the example concludes that the hybrid mismatch rule in Recommendation 4 of the Action 2 Report (OECD, 2015) should be applied in both the parent and subsidiary jurisdictions to neutralise the effect of the mismatch.

Not included in income in the head office or any branch

47. While the branch payee mismatch rule is the primary (and, in effect, only) branch mismatch rule for neutralising payments to a branch payee, this rule will not be triggered in the payer jurisdiction unless the payment actually gives rise to a D/NI outcome. As with the reverse hybrid rule described in Chapter 4 of the Action 2 Report (OECD, 2015), if the payment is brought into account as ordinary income in at least one jurisdiction then there will be no mismatch for the rule to apply to. This will be the case where the mismatch has been neutralised by a rule in the branch or head office jurisdiction which ensures that the payment that is not brought into account in one jurisdiction must be brought into account in the other. This would include any rule, consistent with Recommendation 1.1 of this report, that restricted the scope of branch exemption in the residence jurisdiction to payments that had actually been brought into the charge to taxation by the branch. **Example 1** considers the case of a licence fee that is paid to a branch of a company within the same control group as the payer. The example notes that the branch payee mismatch rule should not apply where the mismatch has been neutralised by a rule in the residence jurisdiction which ensures that any payment that is not brought into account in the branch must be brought into account in the head office. Thus if the residence jurisdiction, in accordance with Recommendation 1.1, restricts the scope of a branch exemption to payments that have actually been brought into the charge to taxation by the branch then the mismatch in tax outcomes would be neutralised and there will be no scope for the operation of the branch payee mismatch rule.

48. It should be borne in mind, when applying the branch payee mismatch rule, that the rule is not intended to address mere differences in timing, so that a deduction claimed for a payment in one taxable period should not be treated as giving rise to a mismatch simply because the payment will not be included until a subsequent period. It will be the payer who has the burden of establishing, to the reasonable satisfaction of the tax administration, that the rules of the payee jurisdiction require the payment to be brought into income, although it is expected that the tax position of the payee would usually be confirmed by means of a contractual representation.

49. The test for whether a payment has been "included" for tax purposes should be the same as that described in the Action 2 Report (OECD, 2015). A payment will be treated as included in the branch or head office (and therefore outside the scope of the branch payee mismatch rule) if, after a proper determination of the character and treatment of the payment under the laws of the relevant jurisdiction, the payment can properly be

considered to have been incorporated into a calculation of the payee's ordinary income. A payment that is taken into account by the payee under general law should not be treated as included if it benefits from a specific exclusion or exemption from tax on the grounds that the payment was made to a non-resident or a foreign branch.

50. In respect of commercial branch operations of a significant size, the volume of transactions and the complexity of the rules governing the calculation and allocation of income between the head office and branches may make it difficult for the taxpayer to establish to the satisfaction of a tax authority that a payment that has not been included in one jurisdiction, has been included in another. In these cases tax authorities may need to identify implementation solutions that are based, as much as possible, on existing domestic rules, administrative guidance, presumptions and tax calculations while still meeting the basic policy objectives of Recommendation 2. For example, a taxpayer may be able to demonstrate that the aggregate amount of income included for tax purposes in the head office and branch jurisdiction matches the (tax adjusted) income recognised in the accounts of the payee such that the tax authority is satisfied that all taxable payments made to such taxpayer have been recognised in at least one jurisdiction.

Inclusion under CFC or equivalent regime

51. The branch payee mismatch rule is only intended to operate where differences in the rules allocating payments between the branch and head office (or between two branches of the same person) give rise to a mismatch in tax outcomes. In certain cases, a payment to a branch that is not included by either the branch or head office may be included in the income of a parent company under a controlled foreign company (CFC) regime. Jurisdictions should consider the risk of economic double taxation in these cases and the extent of the adjustment that should be required under the branch payee mismatch rule in light of the fact that the payment is included in ordinary income under the CFC regime of a third country.

52. In those cases where the payer jurisdiction permits the taxpayer to rely on a CFC inclusion to limit the denial of the deduction in the payer jurisdiction, this exclusion should be limited to those cases where the taxpayer can satisfy the tax administration that the payment has been fully included under the CFC laws of the parent jurisdiction and is subject to tax at the full rate. This will include demonstrating that the payment is of a type that is ordinarily required to be brought into account under the relevant CFC rules and that the payment does not benefit from any exclusion (such as an active income exception). The taxpayer should also demonstrate that the quantification and timing rules of the CFC regime have actually brought that payment into account as ordinary income on the shareholder's return and may be required to show that the inclusion does not carry an entitlement to any unrelated foreign tax credit or other relief or even that the amount included is not set off against a deduction under another branch or hybrid mismatch arrangement (i.e. it does not give rise to an imported mismatch).

53. The treatment of payments that are included under a CFC regime is considered in **Example 1** in respect of a branch payee mismatch. In that case, although the intra-group payment is not included by either the residence or the branch jurisdiction, the example notes that it may be included in the income of the ultimate parent under a CFC (or equivalent) regime. If the payer jurisdiction wishes to avoid the risk of economic double taxation from denying a deduction for a payment that is, in fact, subject to tax under the CFC rules of another country, then it should consider the extent of the adjustment required under the branch payee mismatch rule in light of such CFC inclusion. The payer would

need, however, to satisfy the tax administration that the parent was actually required to include the payment under the relevant CFC rules and the payer may also need to satisfy the tax administration that the amount included under the CFC regime does not carry an entitlement to any unrelated foreign tax credit or other relief.

Counterfactual test to determine whether the mismatch is a result of misallocation of payment

54. As is the case for the reverse hybrid rule, the branch payee mismatch rule should not apply unless the payment would have been included as ordinary income if it had been paid directly to the head office. Example 4.1 of the Action 2 Report (OECD, 2015) provides an illustration of this principle in respect of an interest payment to a reverse hybrid. The example concludes that the reverse hybrid rule will not apply in cases where the investor is a tax exempt entity that would not have been subject to tax even if the payment had been made directly to the investor. The analysis and the outcomes described in that example are the same in the context of a diverted branch payment or a payment to a disregarded branch where the taxpayer is tax exempt under the laws of the residence jurisdiction. The same principle is applied in **Example 1** of this report in respect of branch payee mismatch. That example notes that the question of whether the mismatch is a result of the misallocation of payments between the branch and the head office can be answered by posing a counterfactual test that asks what the tax treatment of the payment would have been if it had been made directly to the head office. On the facts of **Example 1** it is the operation of the branch exemption that shelters the relevant payment from taxation under the laws of the residence jurisdiction, so that Recommendation 2 applies to deny a deduction for the payment in the payer jurisdiction if the payment is not subject to tax in the branch jurisdiction.

55. As with the reverse hybrid rule, this branch mismatch rule should not be used to circumvent the operation of the hybrid financial instrument rule and this rule should continue to apply to the extent a direct payment would have been subject to adjustment under Recommendation 1 of the Action 2 Report (OECD, 2015).[1]

Recommendation 2.2 – Disregarded branch

56. As described in detail in the Introduction of this report a disregarded branch is a branch that is treated as giving rise to a taxable presence under the laws of the head office jurisdiction (and thus is eligible for an exemption from income) but is not treated as giving rise to a taxable presence under the laws of the branch jurisdiction. Disregarded branch structures could be considered to be a subset of diverted branch payments given that the mismatch arises in respect of differences in the allocation of payments between the branch and head office. The difference between diverted branch payments and disregarded branches is that, in the case of disregarded branch structures, not only is there no inclusion of any payment by the branch jurisdiction, but there is nothing in the branch jurisdiction to attribute any payment to.

57. The "laws" referred to in Recommendation 2.2 include both domestic and treaty law. Therefore disregarded branches may arise in a situation where there are differences between the definition of a branch for domestic law and treaty purposes so that the branch is treated as constituting a permanent establishment (PE) under the relevant tax treaty (with the consequence that the head office is required to exempt the payment from tax under a provision equivalent to Article 23A of the Model Tax Convention) while the activities of

the branch do not result in the taxpayer having any taxable presence under the domestic laws of the branch jurisdiction. In these cases the residence jurisdiction may be prevented from restricting the scope of the branch exemption under Recommendation 1 owing to the overriding effect of the tax treaty. Alternatively the branch may not meet the legal definition of a permanent establishment under the tax treaty so that the payment of interest received by the branch is excluded from taxation by the branch jurisdiction because a provision equivalent to Article 7 of the Model Tax Convention (OECD, 2014) does not allow the branch jurisdiction to tax the payment in the absence of a PE as defined under that treaty. This may be the outcome provided for under the laws of the branch jurisdiction despite the fact that the residence jurisdiction treats the payment as received by a foreign branch and as eligible for an exemption from taxation under the domestic rules of the residence jurisdiction.

Recommendation 2.3 – Scope of the rule

58. The branch payee mismatch rule should only apply to payments made under a structured arrangement or between members of the same control group. In order to ensure consistency, the tests for "structured arrangement" and "control group" should be the same as those set out in the Action 2 Report (OECD, 2015). This would mean that a taxpayer would not be required to make an adjustment under the branch payee mismatch rule unless the payment was made to a person within the same control group or the payer was a party to a structured arrangement that was designed to produce a branch mismatch. As stated in the Action 2 Report (OECD, 2015):

> A person will be a party to a structured arrangement when that person has a sufficient level of involvement in the arrangement to understand how it has been structured and what its tax effects might be. A taxpayer will not be treated as a party to a structured arrangement, however, where neither the taxpayer, nor any member of the same control group, was aware of the mismatch in tax outcomes or obtained any benefit from the mismatch.[2]

59. A taxpayer may enter into a number of on-market transactions with unrelated parties that give rise to D/NI outcomes and the payer may not have the capacity to undertake due diligence on the transaction to determine whether there is a mismatch (or the reason for it). On-market transactions between unrelated parties will not, however, generally fall within the scope of the branch payee mismatch rules as the payer would generally be expected to enter these transactions on arm's length terms and could not be expected to make enquires as to a counterparty's tax position in the context of these type of trades.

60. Example 4.1 of the Action 2 Report (OECD, 2015) provides an illustration of the application of the reverse hybrid rule to an interest payment made by an unrelated third party. In that case, the example notes that the use of a reverse hybrid as a special purpose lending vehicle (SPV) may indicate that the arrangement between the investor and SPV has been engineered to produce a mismatch in tax outcomes. In that example, however, the payer is not treated as a party to that structured arrangement because it pays a market rate of interest under the loan and would not have been expected, as part of its ordinary commercial due diligence, to take into consideration the tax position of the counterparty when making the decision to borrow money. The same analysis and outcomes that apply to the reverse hybrid structure described in Example 4.1 should also apply to a similar example involving a diverted branch payment or a payment to a disregarded branch.

Notes

1. See Action 2 Report (OECD 2015) paragraph 167 and paragraph 11 of Example 4.4.
2. See Action 2 Report (OECD 2015), paragraph 342.

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Chapter 3

Deemed branch payment rule

1. Denial of deduction for deemed branch payments

The jurisdiction that recognises a deemed branch payment (payer jurisdiction) should deny a deduction for that payment to the extent it gives rise to a branch mismatch.

2. Deemed branch payments

A deemed branch payment is a deemed payment between the branch and the head office or between two branches of the same taxpayer that gives rise to a D/NI outcome as a result of the fact that such payment is disregarded under the laws of the jurisdiction that is treated as receiving the payment (the payee jurisdiction).

3. No branch mismatch to the extent set off against dual inclusion income

A deemed branch payment shall give rise to a branch mismatch only to the extent the payer jurisdiction allows the deduction to be set off against an amount that is not dual inclusion income.

Overview

61. As described in the Introduction, a deemed payment between the branch and the head office (or between two branches) will give rise to a D/NI outcome where that payment is disregarded by the payee. This type of mismatch can give rise to tax policy issues where the payer jurisdiction allows the resulting deduction to be set off against an item of income that is not included under the laws of the payee jurisdiction (i.e. against income that is not "dual inclusion income"). The deemed branch payment rule in Recommendation 3 only applies where the payer jurisdiction allows the taxpayer to recognise notional payments between various parts of the same taxpayer. The rule neutralises any potential branch mismatch arising in respect of such a deemed branch payment by restricting the payer's deduction to the amount of dual inclusion income.

62. The deemed branch payment rule is intended to bring the treatment of deemed branch payments into line with the rules that apply to disregarded payments made by a hybrid entity under Recommendation 3 of the Action 2 Report (OECD, 2015). Unlike disregarded hybrid payments, however, where the deduction is a consequence of an actual payment between separate entities and the mismatch results from differences in the legal treatment of the payer under the laws of the payer and payee jurisdictions, a deemed branch payment is a purely notional payment between two parts of the same taxpayer resulting in a mismatch in the allocation of expenditure between the payer and payee jurisdictions and, accordingly, the rule will only apply in those jurisdictions that recognise such notional payments.

63. The fact that deemed branch payment mismatches are the product of a conflict in the rules for allocating expenditure (rather than in the legal characterisation of the payer) leads to a number of differences in the way the deemed branch payment rules operate. In particular, it means that deemed branch payment mismatches can generally be avoided by the head office jurisdiction adopting rules, in line with Recommendation 1, that result in an overall allocation of net income to the head office that is consistent with recognising the effect of the deemed payment. It also means that there is little (if any) scope for the application of a secondary (forced inclusion) rule in the context of deemed branch payments (see the commentary to Recommendation 3.1 below). Furthermore, the fact that the mismatch results from the misallocation of expenditure means that such mismatches can be neutralised by the payee jurisdiction allocating expenditure of an equivalent category to the payer jurisdiction (see the commentary to Recommendation 3.2 below).

Recommendation 3.1 – Denial of deduction for deemed branch payments

Deemed branch payment rule does not apply to depreciation or allowances for corporate equity

64. The deemed branch payment rule applies to deductions that result from notional payments to another part of the same taxpayer. These notional payments are tax fictions, used for determining the income that is properly subject to tax in the payer jurisdiction. Like the disregarded hybrid payment rules in the Action 2 Report (OECD, 2015), the deemed branch payment rules are not intended to apply to deductions for depreciation or losses in the value of an asset or domestic concessions such as allowances for contributed equity. While such allowances may be structured as a deduction from corporate income tax and the amount of that deduction may be calculated by reference to a notional amount (such as a risk-free rate of return on investment), their purpose is not to arrive at an accurate determination of the income that is properly subject to tax in the payer jurisdiction but

rather to unilaterally lower the effective rate of tax in order to encourage equity investment in that jurisdiction by reducing the tax distortions associated with the use of debt rather than equity.

No secondary rule under Recommendation 3

65. While the deemed branch payment rule requires the payer jurisdiction to deny a deduction for a deemed payment to the extent it gives rise to a branch mismatch, there is no corresponding secondary rule requiring the deemed payment to be included in income in the payee jurisdiction, as this is already the outcome provided for under Recommendation 1. **Example 4** describes a case where the branch jurisdiction allows a deduction for a notional royalty payment made by the branch to the head office. The example notes there are a variety of measures that the residence jurisdiction could adopt under Recommendation 1 that will result in the effect of the deemed payment being taken into account under the laws of the residence jurisdiction. These include: recognising an additional amount of income in the head office jurisdiction equal to the deemed payment; allocating expenditure of an equivalent category to the payer jurisdiction and/or adjusting the calculation of the net income of the branch so as to eliminate the risk of mismatches arising in respect of notional payments. If the residence jurisdiction adopts one of these measures, then the branch mismatch will not arise and there will be no scope for the application of the deemed branch payments rule.

Recommendation 3.2 – Deemed branch payments

Deemed payment

66. A deemed payment is any notional payment that is not calculated by reference to an actual expenditure of the taxpayer.

Notional payment

67. A notional payment is a payment that is treated as made between the branch and head office (or two branches) of the same taxpayer as part of profit allocation mechanism intended to arrive at an accurate determination of the income that is properly subject to tax in the payer jurisdiction. The payer jurisdiction is treated as making a notional payment to a branch or head office in respect of functions performed, assets held or risks assumed in the payee jurisdiction. The terms under which a notional payment is made may be documented as if the arrangement was between separate entities and accounted for through the transfer of funds between jurisdictions, however these notional payments do not have any independent legal status beyond giving effect to a proper allocation of net income between the payer and payee jurisdiction for tax purposes.

Calculated by reference to actual expenditure of the taxpayer

68. A notional payment should not be treated as a deemed payment to the extent it represents or is calculated by reference to actual expenditure recognised in the accounts of the taxpayer. A payment that is treated (for tax purposes) as made between the branch and the head office but which, in practice, represents an underlying third party expense should be treated as an actual payment rather than a deemed payment and therefore as outside the scope of the deemed branch payment rule.

69. A notional payment that is not expressly calculated by reference to actual expenditure should be treated as an actual payment where that payment relates to specific functions performed, assets held or risks assumed by another part of the same taxpayer and there is itemised expenditure of the same type in the accounts of the taxpayer, in respect of the same functions, risks or assets, which can be directly attributed to that deemed payment. In this case, where the notional payment can be defined with sufficient precision such that the purpose of the payment can be traced to an item of expenditure recorded in the taxpayer's accounts, then the taxpayer may treat the notional payment as an actual payment of the underlying expenditure incurred by the payee.

70. The approach described in the paragraph above is illustrated in **Example 5**, where the taxpayer contracts for various services from third party service providers. Part of these services includes software licences and IT support services relating to software owned by the taxpayer. The branch makes a notional royalty payment to the head office in respect of the same software. In this case, the nature of that services expenditure is such that it can accurately and reliably be attributed directly to the deemed payment. On this basis the taxpayer treats a portion of the deemed royalty payment as an actual payment for services supplied by third parties. In **Example 8** the taxpayer uses its own equity and money borrowed from an unrelated bank to make loans to customers located in the residence and branch jurisdictions. The branch jurisdiction treats the interest paid on the loans as attributable to the branch and also allows the branch a deduction for a deemed interest payment to the head office. While this payment is treated by the branch as a notional payment, if, in practice, the payment is calculated by reference to a certain percentage of the taxpayer's external borrowing costs or there is itemised interest expenditure or borrowing costs in the tax accounts of the payee that can directly attributed to that deemed payment then the interest expense claimed under the laws of the branch jurisdiction should not be treated as a deemed payment for the purposes of the deemed branch payments rule.

71. The fact that this type of payment is not caught by the deemed branch payment rule does not necessarily mean that the branch mismatch rules will not apply to that payment. Such a payment can still be caught by the double deduction rules in Recommendation 4. In **Example 5**, the deemed royalty payment that is characterised as expenditure attributed to third party services is also deductible under the laws of the residence jurisdiction, which means that the deduction triggers an adjustment under the double deduction rule. As demonstrated by **Example 9**, the fact that a notional interest payment is treated as an actual financing cost under the branch mismatch rules may result in the same adjustment being made in the branch jurisdiction under the secondary rule in Recommendation 4.

Deemed payment must be "disregarded" in the payee jurisdiction

72. A deemed payment will not give rise to a mismatch unless it is "disregarded" under the laws of the payee jurisdiction. In the case of a deemed payment the payee jurisdiction is the jurisdiction where the deemed payment is received or is treated as received. The payee jurisdiction may recognise a deemed payment by including the amount of the deemed payment as income or by the residence jurisdiction allocating expenditure or loss of an equivalent category to the payer jurisdiction and therefore disallowing the expenditure to be taken into account in that jurisdiction.

Recognition of payment by allocating equivalent category of expenditure or loss

73. Jurisdictions that exempt foreign source income will usually have corresponding rules that limit the deductibility of a taxpayer's expenses that are incurred in deriving that income. Where the residence jurisdiction has domestic rules limiting the deductibility of expenditure that has been incurred in deriving branch income then the effect of this limitation should be taken into account in determining the extent to which a deemed payment has been disregarded under the deemed branch payment rule. A residence jurisdiction that does not include a deemed payment directly in income should be treated as having recognised that payment as a payee jurisdiction to the extent it denies the head office a deduction for an equivalent category of expenditure, on the grounds that such expenditure has been allocated to the payer jurisdiction, provided such expenditure is not already treated as deductible in the branch.

74. The rules limiting deductibility of expenditure or loss may be applied by the head office jurisdiction on a case by case basis to each item of expenditure or loss or they may be the result of an allocation of a general category of expenditure between the head office and its branches. This allocation may be in accordance with a statutory or administrative formula that takes into account such factors as: the nature of the expenditure or loss (including the terms under which that expenditure or loss is incurred); the nature and extent of the activities in the branches and head office and the balance of assets and income in each jurisdiction.

75. Unlike the tracing approach described above, which is used to determine whether a notional payment represents or is calculated by reference to actual expenditure of the taxpayer, the determination of whether a deemed payment belongs to an equivalent category as an item of expenditure or loss in the head office jurisdiction is a broader test that should be done on a like-kind basis. Provided the deemed payment and allocated expenditure pertain to the same general category of assets, functions or risks (i.e. a straightforward explanation can be given for the relationship between the deemed payment and the allocated expenditure or loss) then the two items should be treated as belonging to an equivalent category for the purposes of Recommendation 3.

76. The deemed payment does not need to be of the same specific type as the expenditure or loss allocated by the head office and does not need to be calculated on the same basis in order to belong to an equivalent category. A deemed payment should only, however, be treated as recognised by the allocation of an equivalent category of expenditure or loss to the extent of the amount actually allocated to the payer jurisdiction and that the expenditure or loss has been denied in the payee jurisdiction as a result of such allocation.

77. In **Example 4** the taxpayer provides computer services to foreign customers through an exempt branch located in that country. Under the laws of the branch jurisdiction, the branch is permitted a deduction for a notional royalty payment made to the head office. This payment is intended to reflect an arm's length compensation for intellectual property that is exploited by the branch in the course of providing services to branch customers. The residence jurisdiction would have ordinarily allowed the head office a deduction for research and development (R&D) costs in respect of intellectual property used by the branch. In this case, however, the deduction is denied on the grounds that the income of the branch is exempt from tax under the laws of the residence jurisdiction. In this case, the deemed payment and allocated R&D costs pertain to the same general category of assets (the intellectual property that is being exploited by the branch) and the basis on which the R&D costs have been denied in the payer jurisdiction indicates that there is straightforward connection between the deemed payment and the allocated expenditure

or loss. Accordingly these two items are treated as being in an equivalent category for the purposes of deemed branch payment rule notwithstanding that the deemed payment (a royalty) is not the same type of expenditure that is allocated by the head office (R&D costs) and has not been calculated on the same basis.

78. In **Example 8** the branch jurisdiction allows the branch a deduction for a deemed interest payment to the head office. At the same time, the rules in the residence jurisdiction require the head office to treat a portion of the taxpayer's interest expense as attributable to the branch (and that portion is therefore non-deductible under the laws of the residence jurisdiction). In this case, both the deemed payment and the allocation of interest expenditure relate to the same general category of financing costs and accordingly the two items should be treated as being in an equivalent category for the purposes of the deemed branch payment rule. The example notes that even if the allocated financing costs in the residence jurisdiction relate to swap, derivative or guarantee fees they should still be treated as expenditure of an equivalent category, despite the fact that they are of a different type and calculated on a different basis.

79. As the domestic rules limiting deductibility will not necessarily be designed to accurately apportion expenditure to other jurisdictions, the taxpayer should be permitted to use the formula that is used to restrict the deductibility of expenditure (with any necessary adjustments) to calculate the amount that can be treated as allocated to a branch jurisdiction. This could be done, for example, by determining what the limitation on deductibility would have been in the branch jurisdiction had those limitation rules applied in that jurisdiction. For example, the head office may be subject to restrictions on interest deductibility on the basis that a portion of the borrowed funds have been used to support the activities of exempt foreign branches. In such a case the taxpayer could be permitted to apply the same interest limitation formula (with necessary adjustments) to the branch on a standalone basis to determine the amount of interest deduction that has been allocated to that branch.

Mismatch must be as a result of the fact that payment is disregarded

80. The deemed branch payments rule only applies where the reason for the D/NI outcome is the fact that the payment has not been recognised in the payee jurisdiction. This means that the rule should not apply, for example, where the payee would have benefitted from an exemption or exclusion in respect of that payment under the laws of the payee jurisdiction. In the context of the branch payee mismatch rule, this report applies a counterfactual test, which looks to what the tax treatment of the misallocated payment would have been, had it been included by the head office. The same counterfactual test cannot be applied in the context of Recommendation 3, where the payment does not have any independent legal status. Nevertheless, in order to achieve a parity of outcomes with the branch payee and disregarded hybrid payments rules, an adjustment should only be made where the payee is a person that is subject to tax under the laws of the payee jurisdiction.

Recommendation 3.3 – Rule only applies to payments that result in a branch mismatch

81. A deemed branch payment will not be treated as giving rise to a mismatch in tax outcomes if the deduction resulting from that payment, does not exceed dual inclusion income. The identification of whether an item should be treated as dual inclusion income

is primarily a legal question that requires an analysis of the treatment of the income under the laws of both jurisdictions. An amount should be treated as dual inclusion income if it is included in income under the laws of both jurisdictions even if there are differences in the way those jurisdictions value that item or in the accounting period in which the income is derived. In most cases it will be relatively straightforward for the payer jurisdiction to identify the items of income that are subject to tax under the laws of the payer and payee jurisdictions.

82. The set off of a deemed branch payment against an item of dual inclusion income is illustrated in **Example 2**. In that example, a deemed payment is made to the head office by a taxable branch (i.e. a branch whose income is fully subject to tax under the laws of the residence jurisdiction). The example notes that, in this case, where the operating income of the branch is included as ordinary income in both jurisdictions, there is likely to be limited scope for the application of the deemed branch payment rule because the deemed payment will generally be offset against dual inclusion income. In **Example 3**, the taxpayer restructures its operations in the branch jurisdiction and establishes a reverse hybrid entity to provide certain services to former branch customers. Although the restructuring reduces the amount of dual inclusion income under the structure, there is still no requirement for the branch jurisdiction to deny a deduction for the deemed payment under Recommendation 3 as the total amount of dual inclusion income under the structure still exceeds the amount of the deemed payment.

Foreign tax credits

83. An item that is treated as taxable income of a taxable branch should continue to be treated as dual inclusion income even when the residence jurisdiction allows a foreign tax credit for tax paid at the level of the branch. As stated in the Action 2 Report (OECD, 2015), in respect of disregarded hybrid payments:

> "Double taxation relief, such as a domestic dividend exemption granted by the payer jurisdiction or a foreign tax credit granted by the payee jurisdiction should not prevent an item from being treated as dual inclusion income where the effect of such relief is simply to avoid subjecting the income to an additional layer of taxation in either jurisdiction." [1]

The report notes, however, that such double taxation relief may give rise to policy concerns where it has the effect of generating surplus relief that may be offset against non-dual inclusion income.

84. While the payment of tax in the branch may give rise to a claim for direct foreign tax credits under the laws of the residence jurisdiction, these credits should not give rise to policy issues provided the residence jurisdiction has rules that limit the amount of direct foreign tax credits by reference to the total amount of foreign income in the branch. Such rules will generally prevent any surplus credit being offset against unrelated non-dual inclusion income. Direct foreign tax credits can, however, give rise to such surplus tax relief where the branch has both dual inclusion and non-dual inclusion income and the deemed payment results in a different basis for calculating the income of the branch under the laws of payer and payee jurisdictions. In this case, the payee jurisdiction could consider adjusting the amount of foreign income taken into account in determining the taxpayer's eligibility for a foreign tax credit to reflect the deduction claimed under the disregarded payment. The limitation on foreign tax credits in the payee jurisdiction is discussed in **Example 3** where it is noted that the residence jurisdiction may seek to limit the amount of the direct foreign tax credit the head office can claim in respect of income

from a taxable branch to the (adjusted) net income of the branch after taking into account the effect of any notional payments that have not been recognised by the head office. In the absence of any such limitation in the residence jurisdiction, the branch jurisdiction may consider restricting the definition of dual inclusion income, so as not to include income that has been sheltered from tax in the residence jurisdiction by surplus foreign tax credits (i.e. tax credits on income that has not, in fact, been included under the laws of the branch jurisdiction). Countries that introduce rules limiting the availability of foreign tax credits or restricting the definition of dual inclusion income in these cases should seek to strike a balance between rules that minimise compliance costs, preserve the intended effect of such double taxation relief and prevent taxpayers from entering into structures that undermine the integrity of the branch mismatch rules. Recommendation 3 should not, however, be interpreted as requiring countries to make any change to deliberate policy decisions they have made regarding the territorial scope of their tax regime. Accordingly, this recommendation only calls for jurisdictions to consider modifying the scope of their foreign tax credit rules to eliminate branch mismatches so far as those changes are consistent with the other tax policy settings in that jurisdiction.

Note

1. See Action 2 Report (OECD, 2015), paragraph 126.

Bibliography

OECD (2015), *Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2 – 2015 Final Report*, OECD Publishing, Paris, http://dx.doi.org/10.1787/9789264241138-en.

Chapter 4

Double Deduction Rule

1. Treatment of Double Deduction Outcomes

To the extent a double deduction outcome gives rise to a branch mismatch:

a. the deduction should be denied in the investor jurisdiction; and

b. where the deduction is not denied in the investor jurisdiction, then the deduction should be denied in the payer jurisdiction.

Any deduction should, however, be eligible to be offset against dual inclusion income whether arising in a current or subsequent period.

2. Double Deduction Outcome

A double deduction outcome means a deduction of the same payment, expense or loss in both the jurisdiction where such payment is made, expense is incurred or loss is suffered (the payer jurisdiction) and another jurisdiction (the investor jurisdiction).

3. No branch mismatch to the extent set off against dual inclusion income

A double deduction will give rise to a branch mismatch only to the extent the payer jurisdiction allows the deduction to be set off against an amount that is not dual inclusion income.

Overview

85. A taxpayer which incurs expenditure under a cross-border structure (including through a foreign branch) may be entitled to deduct that expenditure under the laws of two or more jurisdictions. This double deduction (DD) outcome will give rise to tax policy concerns where the laws of both jurisdictions permit the deduction to be set off against an amount that is not treated as income under the laws of the other jurisdiction (i.e. against income that is not "dual inclusion income"). The policy of the double deduction rule is to limit a taxpayer's deduction to the amount of dual inclusion income in circumstances where the deduction that arises in the other jurisdiction is not subject to equivalent restrictions.

86. As noted in the Introduction, the issues raised by DD outcomes are addressed in Chapter 6 of the Action 2 Report (OECD, 2015) which sets out hybrid mismatch rules neutralising their effect. While the recommendations set out in Chapter 6 are drafted broadly enough to cover DD outcomes arising in respect of branch structures, the Action 2 Report (OECD, 2015) does not consider, in any detail, the application of the deductible hybrid payments rule to expenditure incurred through a branch.

87. Recommendation 4 of this report clarifies the intended scope of the deductible hybrid payments rule in the Action 2 Report (OECD, 2015) by restating and clarifying the operation of that rule in the context of branch structures. This recommendation supplements, and does not replace, Chapter 6 of the Action 2 Report (OECD, 2015) and uses language that is consistent with ATAD 2[1]. In most cases, it is expected that countries would address DD outcomes involving the use of hybrid entities and branches under the same rules.

Recommendation 4.1 – Treatment of DD outcomes

88. The primary recommendation under the double deduction rule is that the investor (i.e. residence) jurisdiction should restrict the deductibility of any payment, expense or loss that is also deductible under the laws of the payer (i.e. branch) jurisdiction so that such amount can only be set off against dual inclusion income. The defensive rule, which imposes the same type of restriction in the payer jurisdiction, will only apply in the event that the effect of the mismatch is not neutralised in the investor jurisdiction. These rules apply when there is a branch under the laws of the payer jurisdiction regardless of whether the residence jurisdiction also recognises a branch in the payer jurisdiction.

89. Recommendation 4.1 allows excess deductions that are subject to restriction under the double deduction rule to be carried-forward to another period, in accordance with a jurisdiction's ordinary rules for the treatment of net losses, and applied against dual inclusion income in that period. This mirrors Recommendation 6 in Action 2 Report (OECD, 2015) for the deductible hybrid payments rule. Because the rule only applies to double deductions to "the extent the payer jurisdiction allows the deduction to be set off against" non-dual inclusion income, the rule does not limit the deductibility of stranded losses (see discussion under Recommendation 4.3 below).

Recommendation 4.2 – DD outcome

90. Unlike Recommendations 2 and 3, which apply to payments or deemed payments that give rise to D/NI outcomes, double deductions can also arise in respect of non-cash items such as depreciation or amortisation.

91. The double deduction rule should only operate to the extent a taxpayer is actually entitled to a deduction for a payment under local law. Accordingly the rule will not apply to the extent the taxpayer is subject to transaction or entity specific rules in the investor or payer jurisdictions that prevents the payment from being deducted. These restrictions on deductibility may include hybrid or branch mismatch rules that deny the taxpayer a deduction in order to neutralise a direct or indirect D/NI outcome.

92. If a payment has triggered a deduction under the laws of two or more jurisdictions, then differences between the rules used in the payer and investor jurisdictions for determining the value of that payment will not generally impact on the extent to which a payment has given rise to a mismatch in tax outcomes. Similarly the operation of the double deduction rule is not dependent on the timing of the deduction or receipt in the other jurisdiction.

93. Determining which payments have given rise to a double deduction (and which items are dual-inclusion income) requires a comparison between the domestic tax treatment of these items and their treatment under the laws of the other jurisdiction. It may be possible to undertake a line-by-line comparison of each item of income or expense in straightforward cases where the branch is performing limited functions (see **Example 9**). In more complex cases, however, where the taxpayer has entered into a number of transactions through the branch that give rise to different types of income and expense, countries may wish to adopt a simpler implementation solution for tracking double deductions and dual inclusion income. The way in which double deduction outcomes will arise will differ from one jurisdiction to the next and countries should choose an implementation solution that is based, as much as possible, on existing domestic rules, administrative guidance, presumptions and tax calculations while still meeting the basic policy objectives of Recommendation 4.

94. In the case of commercial branch operations it will generally be impractical for a taxpayer to adopt a line-by-line comparison of income and expenditure to determine whether the amount of double deductions exceeds the amount of dual inclusion income. In this case, the taxpayer could determine the amount of double deductions on an aggregate basis by comparing the total deductions claimed for actual expenditure and loss in each jurisdiction against the taxpayer's total relevant expenditures. This excess may be treated as a double deduction (subject to adjustment under Recommendation 4) to the extent it cannot be explained by reference to differences in timing or valuation. This comparison could be done on a category by category basis, a branch by branch or a whole of entity basis, however, the taxpayer should only be expected to make the adjustment in one jurisdiction.

95. **Example 6** and **Example 7** both illustrate the application of the double deduction rule to an entity with operating branches. These branches incur expenditure which gives rise to excess deductions. In both cases, the relevant excess is treated as a double deduction (subject to adjustment under Recommendation 4) to the extent it cannot be explained solely by reference to differences in timing or valuation. In **Example 6** the head office applies the primary rule under Recommendation 4 by aggregating the deductions claimed for actual expenditure and loss in each jurisdiction and comparing this against the total (tax adjusted) expenditures of the taxpayer. This adjustment has the effect of neutralising the mismatch associated with all duplicate expenditure claimed across the jurisdictions where the taxpayer operates. Similarly, in **Example 7**, the branch jurisdiction applies the secondary rule by comparing the aggregate tax deductions claimed for actual expenditure and loss in the branch and head office jurisdictions with the actual expenditures in those jurisdictions. This adjustment, under the secondary rule in Recommendation 4, has the effect of neutralising only those mismatch associated with all duplicate expenditure claimed in the relevant branch and head office jurisdiction.

Recommendation 4.3 – No branch mismatch to the extent set off against dual inclusion income

96. Recommendation 4.3 limits the operation of the double deduction rule to those cases where the payer jurisdiction permits the deduction to be set off against non-dual inclusion income.

97. Where the residence jurisdiction provides a general exemption from branch income then any deduction in the branch (that is also deductible in the residence jurisdiction) is likely to end up being set off against income that is not subject to tax in the residence jurisdiction. DD branch payments can also arise, however, in the context of taxable branches where the branch is permitted to join a tax group or there is some other mechanism in place in the branch jurisdiction that allows expenditure or loss to be set off against income derived by another person that is not taxable under the laws of the residence jurisdiction. A DD branch structure involving a taxable branch is illustrated in **Example 3** where the taxpayer restructures its branch operations and establishes a reverse hybrid entity to provide certain services to former branch customers. Another example of such a structure is illustrated in **Example 10** where the taxpayer establishes both a branch operation and an offshore subsidiary in a foreign jurisdiction that allows the subsidiary and the branch to form a group for tax purposes.

Timing of disallowance

98. Recommendation 6.3 of the Action 2 Report (OECD, 2015) requires an adjustment to be made under the deductible hybrid payments rule in those cases where the deduction may be set off against non-dual inclusion income in the payer jurisdiction. The Action 2 Report (OECD, 2015) states that is not necessary for a tax administration to know whether the deduction has actually been applied against non-dual inclusion income in the other jurisdiction before it is subject to restriction under the rule. The rules also, however, include a mechanism that allows jurisdictions to carry-forward deductions to a period where they can be set off against surplus dual inclusion income.

99. In certain cases the deductible hybrid payments rule may generate stranded losses by restricting a deduction in one jurisdiction even though the deduction that arises in the other jurisdiction cannot, in practice, be used to offset any income in that jurisdiction (because, for example, the business in that jurisdiction is in a net loss position). In this case Recommendation 6.1(d)(ii) of the Action 2 Report (OECD, 2015) provides that a tax administration may permit excess deductions to be set off against non-dual inclusion income where the taxpayer can establish that the deduction in the other jurisdiction cannot be offset against any income that is not dual inclusion income. The treatment of stranded losses is discussed in Example 6.2 of the Action 2 Report (OECD, 2015) where a taxpayer incurs losses in a foreign branch. In that example, the deductible hybrid payments rule has the potential to generate “stranded losses” if the taxpayer abandons its operations in the payer jurisdiction and winds up the branch at a time when it still has unused carry-forward losses from a prior period. The example notes that the tax administration may permit the taxpayer to set off any excess against non-dual inclusion income provided the taxpayer can establish that the winding up of the branch will prevent the taxpayer from using those losses anywhere else.

100. Denying (or restricting) the deduction at the time it arises (as contemplated under the Action 2 Report (OECD, 2015)) may have an unintended impact on direct investment through taxable branches and transparent entities. In particular, denying the taxpayer a

benefit of a loss suffered by the branch or hybrid entity until that taxpayer derives dual inclusion income may undermine one of the key tax objectives behind operating in branch form or through a tax transparent entity. Such a rule could discourage investment through foreign branches or transparent entities where losses may be incurred in early years. This issue could be addressed if the DD rule limited the deduction only to the extent the duplicate deduction was actually applied against non-dual inclusion income in the counterparty jurisdiction. This would mean that taxpayers with taxable branch operations (or investments through a transparent entity) could continue to deduct losses in respect of their offshore investment and that adjustments would only need to be made if and when the loss was used against non-dual inclusion income in the counterparty jurisdiction. It would also eliminate the need to allow for adjustments in respect of stranded losses.

101. Recommendation 4.3 accordingly provides that a double deduction will give rise to a branch mismatch only to the extent the payer jurisdiction allows the deduction to be set off against an amount that is not dual inclusion income. This ambiguity as to the timing of the disallowance gives the jurisdiction the flexibility to make the adjustment under the double deduction rule at the time the deduction arises (consistent with the treatment set out in Recommendation 6.3 of the Action 2 Report (OECD, 2015)) or at the time the deduction is actually offset against dual inclusion income under the laws of the payer jurisdiction. The domestic rules implementing the recommendations for neutralising DD outcomes in respect of hybrid entities and branches are likely to be the same (or similar) and jurisdictions may consider that any deferral of the adjustment under the DD rule that is permitted in respect of deductions claimed through a taxable branch, should also apply to DD outcomes arising through the use of a hybrid entity.

102. The difference in the timing of the adjustment under Recommendation 4 is illustrated in **Example 10**. In that example, a profitable parent company establishes both a subsidiary and a branch operation in another jurisdiction. The laws of that foreign jurisdiction permit the branch and the subsidiary to form a group for tax purposes. The branch incurs expenditure which results in net branch losses in the first two years of its operation. The branch then becomes profitable in the third year. Under the laws of the foreign jurisdiction these initial losses are partly available to be offset against the income of the subsidiary. The example illustrates the difference in the adjustments that could be made in order to give effect to the double deduction rule in the residence jurisdiction.

a. Under the method set out in the Action 2 Report (OECD, 2015) (which requires an adjustment whenever the deduction may be set off against non-dual inclusion income in the foreign jurisdiction) the head office makes an adjustment under the laws of the residence jurisdiction for the full amount of the branch loss in each of the two years and carries the branch-loss forward to be set off against dual inclusion income of the branch in Year 3.

b. Under the alternative method permitted under Recommendation 4.3 above (which requires an adjustment only when the payer jurisdiction allows the deduction to be set off against non-dual inclusion income) the head office can claim a portion of the branch loss in the initial period (to the extent it has not been used in the payer jurisdiction to offset income of the subsidiary) but is required to include additional amounts of income in subsequent years as the carry-forward loss in the payer jurisdiction is applied against non-dual inclusion income.

Note

1. Council Directive amending Directive (EU) 2016/1164 as regards hybrid mismatches with third countries dated 12 May 2017 ("ATAD 2").

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Chapter 5

Imported branch mismatch rule

1. Treatment of Imported Branch Mismatches

The payer jurisdiction should deny a deduction for any payment made under an imported branch mismatch arrangement to the extent that such payment directly or indirectly funds deductible expenditure under a branch mismatch arrangement.

2. Imported Branch Mismatch

An imported branch mismatch arrangement is a transaction or series of transactions that is entered into:

a. between members of a controlled group; or

b. as part of a structured arrangement to which the payer is a party,

that directly or indirectly funds deductible expenditure under a branch mismatch arrangement.

3. Limitation on Scope

This recommendation shall not apply to the extent that one of the jurisdictions involved in the transactions or series of transactions has made an equivalent adjustment in respect of such branch mismatch.

Overview

103. As described in the Introduction, a deductible payment can give rise to an imported branch mismatch where such payment directly or indirectly funds deductible expenditure under a branch mismatch arrangement. The policy behind the imported mismatch rule is to prevent taxpayers from entering into structured arrangements or arrangements with group members that shift the effect of an offshore branch mismatch into the domestic jurisdiction through the use of an instrument such as an ordinary loan.

104. Recommendation 5 of this report extends the scope of the imported mismatch rule in the Action 2 Report (OECD, 2015) to cover imported branch mismatches. This recommendation supplements, and does not replace, the imported mismatch recommendations in the Action 2 Report (OECD, 2015). It also uses language that is consistent with ATAD 2.[1]

105. Imported branch mismatches rely on the absence of effective branch mismatch rules in offshore jurisdictions in order to generate the mismatch in tax outcomes which can then be imported into the payer jurisdiction. The most reliable protection against imported branch mismatches will be for all jurisdictions to introduce branch mismatch rules recommended in this report. Such rules will neutralise the effect of the branch mismatch arrangement in the jurisdiction where the mismatch arises and prevent the effect of that mismatch being imported into a third jurisdiction.

106. The key objective of the imported branch mismatch rule is to maintain the integrity of the other branch mismatch rules by removing any incentive for multinational groups to enter into these arrangements. While these rules involve an unavoidable degree of co-ordination and complexity, they only apply to the extent a multinational group generates an intra-group deduction under a branch mismatch arrangement and will not apply to any payment that is made to a taxpayer in a jurisdiction that has implemented the full set of recommendations set out in this report.

107. In order to limit compliance costs and the risk of double taxation, each country that implements the recommendations set out in this report should make reasonable endeavours to implement an imported branch mismatch rule that adheres to the methodology set out in this report and to apply this methodology in the same way. This will allow the adjustments required under the imported mismatch rules in each jurisdiction to be calculated consistently for the whole group and in a way that avoids any unnecessary duplication of compliance obligations.

Recommendation 5.1 – Treatment of imported branch mismatches

Payment

108. The definition of payment used in Recommendation 5 is the same as that used for the other recommendations. A payment will only be treated as made under an imported branch mismatch arrangement if it is both deductible under the laws of the payer jurisdiction and gives rise to ordinary income under the laws of the payee jurisdiction. Payments will therefore include rents, royalties, interest and fees paid for services but will not generally include amounts that are treated as consideration for the disposal of an asset. A payment made to a person who is not a taxpayer in any jurisdiction will not be treated as an imported mismatch payment.

109. A payment should be treated as funding expenditure under a branch mismatch arrangement where the income from the payment is directly set off against a deduction under a branch mismatch arrangement or where the payment is indirectly set off against

that deduction through a chain of interconnected payments or group relief surrenders between intermediate taxpayers. A payment that is set off against a deduction under a deemed branch payment or a DD branch payment should not, however, be treated as having funded expenditure under an imported mismatch arrangement where that payment is treated as dual inclusion income.

110. This principle is illustrated in **Example 11** in the case of an intra-group payment made to a branch that is set off against a deemed branch payment. The example notes that the intra-group payment will not be subject to adjustment under Recommendation 5 if it was made to a taxable branch so that such payment is included in the income of both the residence and branch jurisdictions.

Tracing and priority rules

111. The guidance set out in the Action 2 Report (OECD, 2015) describes tracing and priority rules to be used by taxpayers and tax administrations to determine the extent to which a payment should be treated as set off against a deduction under an imported mismatch arrangement. These rules start by identifying the payment that gives rise to a hybrid mismatch (a "direct hybrid deduction") and then determine the extent to which that hybrid deduction has been funded (either directly or indirectly) out of payments made by taxpayers that are subject to the imported mismatch rule ("imported mismatch payments"). The same tracing and priority rules should be applied for determining the extent to which a payment directly or indirectly funds deductible expenditure under a branch mismatch arrangement (a "branch mismatch deduction").

112. In order to account for timing differences between jurisdictions and to prevent groups manipulating that timing in order to avoid the effect of the imported mismatch rule, a branch mismatch deduction should be taken to include any net loss that has been carried-forward to a subsequent accounting period, to the extent that loss results from a hybrid deduction. In order to reduce the complexity associated with the need to identify imported branch mismatches that arose prior to the publication of this report, any carry-forward loss from periods ending on or before 31 December 2016 should be excluded from the operation of this rule.

113. It will be the domestic taxpayer who has the burden of establishing, to the reasonable satisfaction of the tax administration, that the imported mismatch rule has been properly applied in that jurisdiction. This initial burden may be discharged by providing the tax administration with copies of the group calculations together with supporting evidence of the adjustments that have been made under the imported mismatch rules in other jurisdictions. Tax administrations will generally be relying on the taxpayer to provide them with these calculations and supporting evidence. In the absence of such information, a tax administration may consider issuing its own assessment of the extent to which income from an imported mismatch payment has been directly or indirectly set off against a branch mismatch deduction or hybrid deduction of another group member.

Recommendation 5.2 – Imported branch mismatch definition

114. The imported mismatch rule applies to both structured arrangements and imported mismatch arrangements that arise within a control group.

115. An imported branch mismatch arrangement should be treated as structured if the branch mismatch arrangement is structured and the deduction under the branch mismatch

and the imported mismatch payment form part of the same arrangement. The definition of arrangement is set out in Recommendation 12 of the Action 2 Report (OECD, 2015) and includes any agreement, plan or understanding and all the steps and transactions by which it is carried into effect. A structured imported mismatch arrangement therefore includes not only those payments and transactions that give rise to the branch mismatch but also all the other transactions and imported mismatch payments that are entered into as part of the same scheme, plan or agreement.

Recommendation 5.3 – Limitations on scope

116. As noted above, the most reliable protection against imported mismatches will be for jurisdictions to introduce hybrid and branch mismatch rules under the common approach set out in the Action 2. Such rules will address the effect of the hybrid or branch mismatch arrangement in the jurisdictions where it arises, and therefore prevent the effect of such mismatch being imported into a third jurisdiction. The imported mismatch rule therefore will not apply to any payment that is made to a taxpayer in a jurisdiction that has implemented the full set of Action 2 recommendations.

Note

1. See: Council Directive amending Directive (EU) 2016/1164 ("ATAD 2").

Bibliography

Council of the European Union (2017), Council Directive amending Directive (EU) 2016/1164 as regards hybrid mismatches with third countries dated 12 May 2017 ("ATAD 2"), http://dsms.consilium.europa.eu/952/Actions/Newsletter.aspx?messageid=13108&customerid=37917&password=enc_643345636135526A32344361_enc (accessed on 13 June 2017).

OECD (2015), *Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2 – 2015 Final Report*, OECD Publishing, Paris, http://dx.doi.org/10.1787/9789264241138-en.

Annex A

Summary of recommendations

Recommendation 1 – Limitation to the scope of the branch exemption

1. Limitation to the scope of the branch exemption

Jurisdictions that provide an exemption for branch income should consider limiting the scope and operation of this exemption so that the effect of deemed payments, or payments that are disregarded, excluded or exempt from taxation under the laws of the branch jurisdiction, are properly taken into account under the laws of the residence jurisdiction.

Recommendation 2 – Branch payee mismatch rule

1. Denial of deduction for branch payee mismatches

The payer jurisdiction should deny a deduction for a payment that gives rise to a D/NI outcome to the extent that the mismatch is a result of:

a. differences in the allocation of payments between the residence and the branch jurisdiction or between two branch jurisdictions; or

b. the fact that the payment is to a disregarded branch.

2. Disregarded branch

A disregarded branch is a branch that is treated as giving rise to a taxable presence under the laws of the residence jurisdiction (and thus is eligible for an exemption from income) but is not treated as giving rise to a taxable presence under the laws of the branch jurisdiction.

3. Scope

This recommendation shall only apply to payments made under a structured arrangement or between members of a controlled group.

Recommendation 3 – Deemed branch payment rule

1. Denial of deduction for deemed branch payments

The jurisdiction that recognises a deemed branch payment (payer jurisdiction) should deny a deduction for that payment to the extent it gives rise to a branch mismatch.

2. Deemed branch payments

A deemed branch payment is a deemed payment between the branch and the head office or between two branches of the same taxpayer that gives rise to a D/NI outcome as a result of the fact that such payment is disregarded under the laws of the jurisdiction that is treated as receiving the payment (the payee jurisdiction).

3. No branch mismatch to the extent set off against dual inclusion income

A deemed branch payment shall give rise to a branch mismatch only to the extent the payer jurisdiction allows the deduction to be set off against an amount that is not dual inclusion income.

Recommendation 4 – Double Deduction Rule

1. Treatment of Double Deduction Outcomes

To the extent a double deduction outcome gives rise to a branch mismatch:

a. the deduction should be denied in the investor jurisdiction; and

b. where the deduction is not denied in the investor jurisdiction, then the deduction should be denied in the payer jurisdiction.

Any deduction should, however, be eligible to be offset against dual inclusion income whether arising in a current or subsequent period.

2.Double Deduction Outcome

A double deduction outcome means a deduction of the same payment, expense or loss in both the jurisdiction where such payment is made, expense is incurred or loss is suffered (the payer jurisdiction) and another jurisdiction (the investor jurisdiction).

3. No branch mismatch to the extent set off against dual inclusion income

A double deduction will give rise to a branch mismatch only to the extent the payer jurisdiction allows the deduction to be set off against an amount that is not dual inclusion income.

Recommendation 5 – Imported branch mismatch rule

1. Treatment of Imported Branch Mismatches

The payer jurisdiction should deny a deduction for any payment made under an imported branch mismatch arrangement to the extent that such payment directly or indirectly funds deductible expenditure under a branch mismatch arrangement.

2. Imported Branch Mismatch

An imported branch mismatch arrangement is a transaction or series of transactions that is entered into:

a. between members of a controlled group; or

b. as part of a structured arrangement to which the payer is a party,

that directly or indirectly funds deductible expenditure under a branch mismatch arrangement.

3. Limitation on Scope

This recommendation shall not apply to the extent that one of the jurisdictions involved in the transactions or series of transactions has made an equivalent adjustment in respect of such branch mismatch.

Annex B

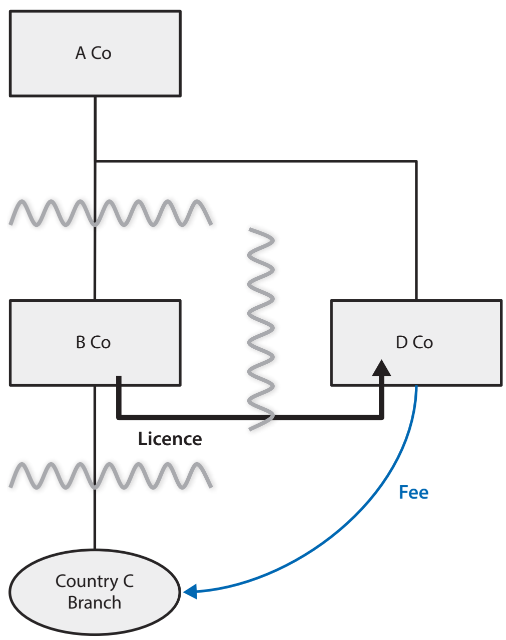
Examples

Example 1

Branch payee mismatches

Facts

1. In the example illustrated in the figure below, A Co (a company established and resident in Country A) establishes B Co, a software development company that is resident in Country B. B Co establishes a branch in Country C. B Co licences software to D Co (another group company) resident in Country D for use in its business of providing services to third party customers. D Co pays a deductible licence fee to B Co which is treated, under Country B law, as paid to the Country C Branch.



2. Country B provides an exemption for income derived by a foreign branch which means that the licence fee income is not subject to tax in Country B. The fee is not subject to tax in Country C. This creates an intra-group D/NI outcome. There could be a number of reasons why the payment of the licence fee is not subject to tax in Country C:

a. Country C does not tax corporate taxpayers or only taxes residents of Country C.

b. License fee income paid to the Country C Branch is eligible for a nil-rate of taxation under a special regime (such as a patent box).

c. The branch does not give rise to a taxable presence for B Co under the domestic laws of Country C.

d. The branch does not meet the legal definition of a permanent establishment under the Country B-C tax treaty, so that the payment received by the branch is excluded from Country C taxation under the relevant provisions of that treaty.

e. Country C has different rules for allocating income to the branch or specific rules that exclude or exempt this type of income from taxation when paid to a non-resident.

Question

3. Does the mismatch identified in the arrangement above fall within any of the recommendations in this report?

Answer

4. The licence fee is not subject to tax in Country C. Accordingly, under Recommendation 1, Country B is encouraged (but not required) to consider narrowing the scope of its branch exemption to bring the licence fee into the charge to taxation. Having B Co take this payment into account for tax purposes under Country B law:

a. will not necessarily trigger any additional Country B tax liability if the licence fee independently qualifies for an exemption from tax under the laws of Country B and

b. may result in B Co recognising additional deductible expenditure under Country B law in connection with earning the licence fee.

5. In the case where the branch is treated as constituting a permanent establishment under the Country B-C tax treaty then the treaty may require Country B to exempt the licence fee from tax to the extent it is properly attributable to the branch and will prevent Country B from bringing the licence fee into ordinary income under Country B law.

6. In the event that there is no adjustment made in Country B under rules consistent with Recommendation 1 then Recommendation 2 shall apply to deny the deduction in Country D to the extent the payment gives rise to a D/NI outcome that is the result of a branch payee mismatch.

7. Therefore, the overall effect of the recommendations in this report is that:

a. these type of payments should properly be subject to tax in the head office (if not included in income by the branch)

b. if such payments are not included in income in any jurisdiction and the reason for this mismatch is either a result of:

- a misallocation of that payment between the branch and the head office
- the payment being made to a disregarded branch

then a deduction for that payment should be denied where the payment is made intra-group or as part of a structured arrangement intended to produce a mismatch in tax outcomes.

Analysis

Country B should consider adjusting the scope of its branch exemption

8. Recommendation 1 of this report provides that jurisdictions, such as Country B, which exempt the income of foreign branches should consider narrowing the scope of this exemption so that it does not apply to payments that are not subject to tax under the laws of the branch jurisdiction. Recommendation 1 is not a branch mismatch rule, but rather a specific recommendation for changes to the scope and operation of the branch exemption in the residence jurisdiction intended to ensure that it does not have the effect of providing double taxation relief for payments that have not borne any tax.

9. Accordingly, under Recommendation 1, Country B is encouraged (but not required) to consider adjusting the scope and operation of the branch exemption to bring the licence fee into the charge to taxation under Country B law. Recommendation 1 could apply, not only in those cases where the reason for the mismatch is due to a misallocation of the payment under the laws of the branch jurisdiction, but also where the payment qualifies for tax-free treatment in the branch on some other basis.

10. There are a number of ways the residence jurisdiction could make an adjustment in order to include the payment in income under the laws of the residence jurisdiction that are consistent with a proper allocation of income and expenditure between the branch and the residence jurisdiction under agreed international standards. For example, Country B could expand the scope of its taxing regime to bring untaxed branch income into charge at the head office either by:

a. requiring that any payment, which is derived by a resident taxpayer and not subject to tax in the branch jurisdiction, be brought into charge to taxation in the head office

b. limiting the branch exemption to the amount of net income actually brought into the charge to tax by the branch.

11. In all cases, the adjustments required by Country B should be consistent with a proper allocation of income and expenditure between the branch and the residence jurisdiction and in line with the intended territorial scope of Country B's tax regime.

12. Requiring B Co to bring the licence fee into account in Country B under one of these methods will not automatically trigger an additional tax liability for B Co, if B Co can separately claim the benefit of a specific exemption for such payment under Country B law. Once brought into account under Country B law, for example, the licence fee could still be eligible for taxation at a nil or reduced rate, due to the fact that it relates to exploitation of intellectual property that is held subject to a preferential tax regime that is established under Country B law to encourage research and development (i.e. a "patent box" regime).

13. It is noted that in a case where the branch is treated as constituting a PE under the Country B-C tax treaty (and that treaty contains a provision equivalent to Article 23A of the Model Tax Convention) then the treaty may require Country B to exempt the licence fee from tax to the extent it is properly attributable to the branch, which will prevent Country B from bringing the licence fee into ordinary income under Country B laws.

Recommendation 2 only applies to the extent the payment gives rise to a D/NI outcome

14. A D/NI outcome arises where a payment is deductible under the laws of one jurisdiction and not included in ordinary income under the laws of any other jurisdiction. Although the licence fee may not be included directly in income by A Co it may be included in A Co's income under a CFC (or equivalent) regime. If Country D wishes to avoid the risk of economic double taxation from denying a deduction with respect to a licence fee that is, in fact, subject to tax under the CFC rules in Country A, then Country D should consider the extent of the adjustment required under the branch payee mismatch rule in light of such CFC inclusion. In this case D Co would need to satisfy the tax administration in Country D that the quantification and timing rules for the inclusion of CFC income under Country A law actually required that payment to be brought into account as ordinary income on A Co's tax return and D Co may be further required to demonstrate that the amount that is included does not carry an entitlement to any unrelated

foreign tax credit or other relief that would undermine the objectives of the branch mismatch rules.

Recommendation 2 only applies to the extent the D/NI outcome is the result of a branch payee mismatch

15. Whether Recommendation 2 applies to the facts of this example will also depend upon the reason why the payment is not subject to tax under Country C law. Recommendation 2 only applies to neutralise a D/NI outcome where the mismatch results from a payment to a disregarded branch or from differences in the allocation of payments between the residence and the branch jurisdictions. If the reason for the mismatch is because Country C does not impose corporate income tax or because the licence fee benefits from a preferential regime open to all taxpayers in Country C (such as a patent box regime) then the branch payee mismatch rules will not apply because the mismatch is not a result of any conflict in the allocation of payments between the branch and head office.

The fact that the payment is a diverted branch payment or a payment to a disregarded branch results in a D/NI outcome

16. If the Country C Branch does not give rise to a taxable presence under the domestic laws of Country C or does not meet the legal definition of a permanent establishment under the Country B-C tax treaty then Country C Branch may be considered a disregarded branch for tax purposes. Furthermore, if Country C law treats the licence fee as paid to the head office (or exempts or excludes the payment from tax on the grounds that the payment is made to a non-resident) then there is difference between Country B and Country C in the allocation of the licence fee and the licence fee should be treated as a diverted branch payment. In both cases the payment will be subject to adjustment under Recommendation 2 if it can be established that the mismatch is a result of the fact that the payment was a diverted branch payment or made to a disregarded branch.

17. As described in Chapter 2 of this report, this question can be answered by posing a counterfactual test that asks what the tax treatment of the payment would have been if it had been made directly to the head office. In this case the facts indicate that it is the operation of the branch exemption that shelters the licence fee from taxation under the laws of Country B, so that the payment would have been taxable if it was treated as paid to the head office. Accordingly, Recommendation 2 will operate to deny a deduction for the payment in the payer jurisdiction if the payment is to a disregarded branch or otherwise not subject to tax in the branch jurisdiction due to the fact that the same payment was treated as properly allocable to (and taxable in) the head office.

Recommendation 2 will not apply if Recommendation 1 applies

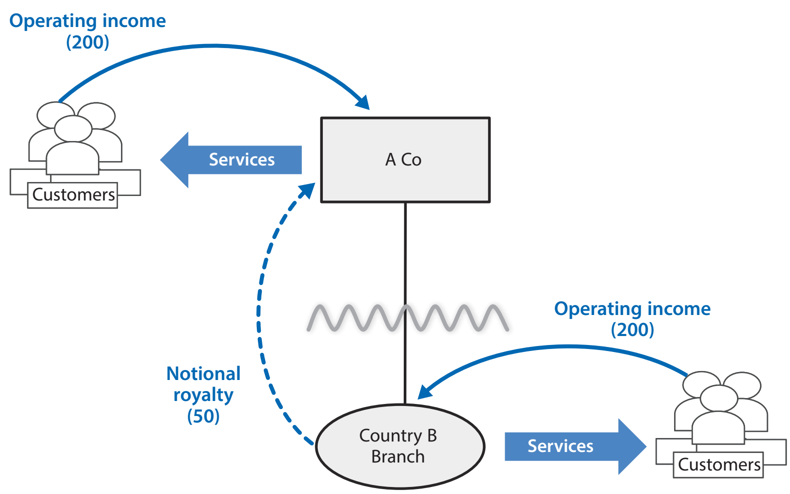
18. The disregarded branch or diverted branch payment rules will not apply, however, where the mismatch has been neutralised by a rule in Country B which ensures that a payment that is not brought into account in the branch must be brought into account in the head office. Thus if Country B, in accordance with Recommendation 1, restricts the scope of a branch exemption to payments that have actually been brought into the charge to taxation by the branch then the mismatch in tax outcomes would be neutralised and there should generally be no scope for the operation of the branch payee mismatch rule.

Example 2

Notional payment by taxable branch

Facts

1. A Co is a company that is established and tax resident in Country A. A Co provides computer services to customers located in Country A and B. Country B customers receive their services through a branch of A Co located in that country (i.e. Country B Branch).



2. Under the laws of Country B, the income of the branch is fully taxable and the branch is permitted a deduction for a notional royalty payment made to the head office. This payment is intended to reflect an arm's length compensation for intellectual property that is owned by the head office and exploited by the branch in the course of providing services to Country B customers. The rules in Country A treat the income of the branch as fully taxable but do not recognise any notional payments between the branch and the head office.

Question

3. Does the notional royalty payment described above fall within Recommendation 3 of this report?

Answer

4. Recommendation 3 will not apply to adjust the deduction in respect of the notional royalty payment where the branch is treated as fully taxable under Country A law and the operating income of the branch exceeds the amount of the deemed payment.

Analysis

No branch mismatch if income of branch is fully taxable under Country A law

5. The deemed branch payment rule limits the ability of a taxpayer to set off a deduction from a deemed branch payment against non-dual inclusion income. However, in this case, where the amounts paid by Country B customers are treated as taxable income in both jurisdictions there is likely to be limited scope for the application of the deemed branch payment rule. Table B.2.1 provides an illustration of the position of the head office and the branch once all the branch income has been brought into account for tax purposes under Country A law.

Table B.2.1. **Taxable Branch**

Country A (Head Office)				Country B (Branch)			
Income		**Tax**	**Book**	**Income**		**Tax**	**Book**
Country A Customers		200	200				
Country B Customers		200	-	Country B Customers		200	200
Expenses				**Expenses**			
Employment		(40)	(10)	Employment		(30)	(30)
Administration costs		(40)	(20)	Administration costs		(20)	(20)
Research and development		(10)	(10)				
				Notional royalty payment		(50)	-
Net return before tax			160	Net return before tax			150
Taxable income		310		Taxable income		100	
Tax at 30%	(93)			Tax at 30%	(30)		
Credit	30						
Net tax to pay			(63)	Net tax to pay			(30)

6. As shown in Table B.2.1, A Co derives 200 of operating income from the respective computer service sales made in each of Country A and B and incurs 40 of administration costs (split evenly between the branch and the head office) and employment costs of 30 in the branch and 10 in the head office. The head office also recognises research and development expenses of 10 in respect of intellectual property (IP) that is used by the branch in providing services to customers. In total A Co has 400 of income and 90 of expenses leaving it with net income of 310 from its global operations.

7. A Co also has 310 of taxable income (because the full amount of the branch profits are taken into account under Country A law). Country A provides a full tax credit for the Country B tax imposed on income earned through the branch so that the final amount of tax payable under the laws of both jurisdictions is 30% of the net return.

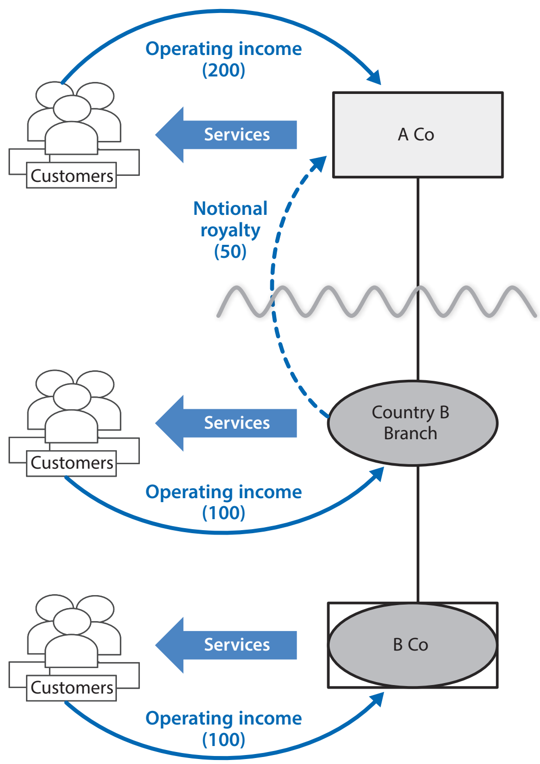
8. Because all the operating income of the Country B Branch is taken into account as ordinary income under the laws of Country A, the deemed royalty payment recognised by the Country B Branch is deducted against dual inclusion income and no branch mismatch arises under Recommendation 3.

Example 3

Taxable branch with non-dual inclusion income

Facts

1. The facts are the same as in Example 2 except that in this case A Co restructures its operations in Country B by establishing a separate entity (B Co) to provide certain services to Country B customers that were previously supplied directly through the Country B Branch. B Co is a reverse hybrid (an entity that is treated as transparent under the laws of Country B but as a separate entity under Country A law). Country B branch continues to provide certain services to Country B customers after the restructure. A Co's and B Co's operations in Country B are illustrated in the figure below:



2. Following the restructuring, half of the operating income derived from Country B customers is now derived through B Co, which is a separate entity that is not subject to tax under Country A law. The total employment and administration expenses incurred in Country B are the same as in Example 2 but half of these expenses are now incurred by B Co. Country B Branch continues to claim a deduction for a deemed royalty payment paid to the head office and the amount of this deemed payment is the same as in Example 2.

3. Because B Co is disregarded under Country B law the income of B Co and the Country B Branch are treated as income of single entity so that the income and expenses of both the branch and company are recorded on a single tax return with any payments between them being disregarded for tax purposes. Table B.3.1 provides an illustration of the position of the head office and the Country B Branch following the restructuring:

Table B.3.1. **Taxable Branch with non-dual inclusion income**

Country A (A Co)				Country B (Country B Branch and B Co)			
Income		**Tax**	**Book**	**Income**		**Tax**	**Book**
Country A Customers		200	200				
Country B Customers		100	-	Country B Customers		200	200
Expenses				**Expenses**			
Employment		(25)	(10)	Employment		(30)	(30)
Administration costs		(30)	(20)	Administration costs		(20)	(20)
Research and development		(10)	(10)	Notional royalty payment		(50)	-
Net return before tax			160	Net return before tax			150
Taxable income		235		Taxable income		100	
Tax at 30%	(70.5)			Tax at 30%	(30)		
Credit	22.5*						
Net tax to pay			(48)	Net tax to pay			(30)

* Amount of credit may be subject to further limitation under Country A law.

4. There is no change to the overall tax position in Country B following the restructuring. All the tax payable under the laws of Country B is taxable at the level of the branch because B Co is not treated as a separate taxpayer for Country B tax purposes.

5. Under Country A law there is a decrease in the amount of Country B income and expenses included on A Co's return. A Co would ordinarily be expected to make a corresponding adjustment to the amount of foreign tax credits claimed in respect of its branch operations to reflect the fact that, following the restructuring, there are lower amounts of income and tax paid at the level of the branch.

Question

6. Will the notional royalty payment or any of the employment or administration expenses described above be subject to adjustment under the laws of the branch jurisdiction?

Answer

7. Following the restructuring, the dual inclusion income of the branch still exceeds the total amount of branch payments (including the deemed royalty payment and the employment and administration costs claimed in respect of the branch operations under both Country A and B law). Accordingly, the Country B Branch would not be expected to make any adjustment under the branch mismatch rules.

8. Country A could, however, consider applying rules that limit the amount of A Co's direct foreign tax credit to the (adjusted) net income of the branch after taking into account the effect of the notional royalty payment.

Analysis

No adjustments required under Country B law

9. The restructuring reduces the amount of income that is included under both Country A and B law, however the total amount of dual inclusion income still exceeds the amount of the deemed royalty payment and there is therefore no requirement for A Co to make an adjustment under Recommendation 3.

10. A Co might further consider whether any adjustment was required under Country B law in respect of the employment and administration costs claimed in both Country A and Country B (i.e. whether an adjustment is required in Country B under the double deduction rule in Recommendation 4.1(b). Again, however, no adjustment should be required under the branch mismatch rule because the branch is profitable on a stand-alone basis. The dual inclusion income of the branch exceeds the total amount of branch payments (including the deemed royalty payment of 50 and the 25 of employment and administration costs claimed in respect of the branch operations under both Country A and B law). Accordingly from Country B's perspective, branch payments do not exceed dual inclusion income and there should be no requirement to make any adjustment under the branch mismatch rules.

Calculation of direct foreign tax credits under Country A law

11. In this case Country A limits the amount of the foreign tax credit to the lesser of the amount of tax payable by the branch under Country B law and the marginal rate of tax under Country A law on branch income as calculated under Country A law. In this case the net income of the branch (as calculated under Country A law) is as follows:

Operating income	100
Employment costs	(15)
Admin costs	(10)
Net income (under Country A law)	75

The resulting limitation on the amount of direct foreign tax credits is therefore ($75 \times .30 =$) 22.5.

12. In this case, the effect of calculating the foreign tax credit using the principles governing the recognition of income and expenditure under Country A law, is that Country A does not take into account the impact of the D/NI outcome arising in respect of the deemed branch payment. This D/NI payment has the effect of reducing the amount of income subject to tax under Country B law without impacting on the calculation of the net income of the branch under Country A law.

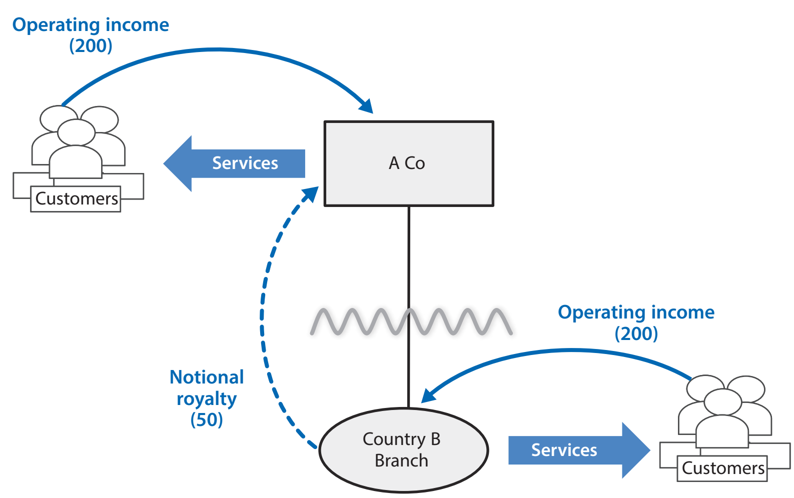
13. While the branch mismatch rules do not directly impact on the amount of direct foreign tax credits a taxpayer may claim in respect of its branch operations, the calculation of these credits may give rise to tax policy concerns in the residence jurisdiction where they permit surplus tax relief to reduce or offset the tax on non-dual inclusion income. This issue could be addressed in Country A by limiting the amount of the direct foreign tax credit by reference to the (adjusted) net income of the branch, after taking into account the effect of the notional payments that have not been taken into account by the head office. In the absence of any such limitation in Country A, Country B may consider restricting the definition of dual inclusion income, so as not to include income that has been sheltered from tax by surplus foreign tax credits that have been recognised under Country A law.

Example 4

Notional payment by exempt branch

Facts

1. The facts are the same as in Example 2. A Co provides computer services to Country B customers through a branch located in that country (i.e. Country B Branch). In this case, however, Country A exempts branch income from taxation. A Co's operations in Country B are illustrated in the figure below:



2. Under the laws of Country B, the income of the branch is fully taxable and the branch is permitted a deduction for a notional royalty payment made to the head office. This payment is intended to reflect an arm's length compensation for intellectual property that is owned by the head office and exploited by the branch in the course of providing services to Country B customers. The rules in Country A do not recognise any notional payments between the branch and the head office. Table B.4.1 provides an illustration of the position of the head office and the branch in respect of the deemed royalty payment.

3. The figures are the same as in Table B.2.1 except that the head office is only required to bring the income from its local operations in Country A into tax. The income derived by Country B Branch is exempt from tax under the laws of Country A. In this case, Country A denies a deduction for the research and development (R&D) expenses that would otherwise have been deductible under Country A law. This deduction is denied on the grounds that the intellectual property (IP) generated through such R&D is used solely in the Country B branch to derive income that is exempt from taxation under Country A law. As shown in the above Table B.4.1, A Co's net return (before tax) is 310 while the total taxable income under the laws of both jurisdictions is 270. The mismatch of 40 is the product of the D/NI outcome in respect of the notional royalty payment (50) adjusted by the denial of the R&D costs under Country A law (10).

Table B.4.1. **Exempt branch**

Country A				Country B			
Income		**Tax**	**Book**	**Income**		**Tax**	**Book**
Country A Customers		200	200	Country B Customers		200	200
Expenses				**Expenses**			
Employment		(10)	(10)	Employment		(30)	(30)
Administration costs		(20)	(20)	Administration costs		(20)	(20)
Research and development		-	(10)				
				Notional royalty payment		(50)	-
Net return before tax			160	Net return before tax			150
Taxable income		170		Taxable income		100	
Tax at 30%	(51)			Tax at 30%	(30)		
Net tax to pay			(51)	Net tax to pay			(30)

Questions

4. Does the notional royalty payment fall within Recommendation 1 of this report?

5. If there is no adjustment in Country A to take account of the notional royalty payment, is A Co required to make an adjustment to the net income of Country B Branch under Recommendation 3?

Answer

6. Recommendation 1 provides that Country A should consider making appropriate adjustments to the amount of income recognised by the head office so that the effect of any deemed payment made to the head office is properly taken into account under the laws of the residence jurisdiction. There are a variety of methods that Country A could adopt to eliminate the risk of mismatches arising in respect of notional payments. These methods may be less complicated than applying the deemed branch payment rule and may result in adjustments to items other than the deemed payment in order to properly reflect the allocation of income between the branch and the head office.

7. If Country A does not make an adjustment to properly reflect the notional royalty payment then A Co would be required to make an adjustment to the amount of net income recognised in the Country B Branch under Recommendation 3. This adjustment would take account of the fact that a portion of the deemed royalty payment had been recognised in Country A in the form of a denial of the deduction for research and development expenses in respect of IP assets that have been allocated to the branch.

Analysis

Application of Recommendation 1

8. Recommendation 1 provides that Country A should consider making modifications to the scope and operation of its branch exemption so that the effect of any deemed payments made to the head office are properly taken into account under the laws of the residence jurisdiction. This report does not set out any limitations on the amount of the adjustment or provide any detail on the most appropriate mechanism for making that adjustment provided it remains consistent with the relevant tax treaty obligations and tax policy settings in that jurisdiction. One example of the type of adjustment that could be made in the residence jurisdiction is shown in Table B.4.1 above where Country A has denied a deduction for certain R&D expenses associated with an IP asset that has been used in the branch to generate exempt income. This denial of an "equivalent category of expenditure" as described below, could be considered as one way in which the residence jurisdiction takes into account the effect of the deemed payment by the branch. The residence jurisdiction could adopt other methods for recognising additional income in the head office jurisdiction in an amount equal to the deemed payment.

Recognising the deemed payment as an item of additional income

9. Country A could, for example, introduce a rule requiring taxpayers in the position of A Co to include the deemed payment made by an exempt branch as ordinary income. This type of adjustment is illustrated in Table B.4.2.

Table B.4.2. **Exempt branch recognising deemed payment in payee jurisdiction**

Country A				**Country B**			
Income		**Tax**	**Book**	**Income**		**Tax**	**Book**
Country A Customers		200	200	Country B Customers		200	200
Expenses				**Expenses**			
Employment		(10)	(10)	Employment		(30)	(30)
Administration costs		(20)	(20)	Administration costs		(20)	(20)
Research and development		(10)	(10)				
				Notional royalty payment		(50)	-
Adjustment		50					
Net return before tax			160	Net return before tax			150
Taxable income		210		Taxable income		100	
Tax at 30%	(63)			Tax at 30%	(30)		
Net tax to pay			(63)	Net tax to pay			(30)

10. The mismatch in tax outcomes is eliminated by the head office recognising the amount of the deemed branch payment in income. Country A has also permitted the head office to make a corresponding adjustment to the deductibility of the R&D expenses in order to properly reflect the fact that the underlying IP asset is now treated as giving rise to taxable income in the residence jurisdiction (in the form of the adjustment for the deemed payment).

Granting head office a deduction for the net income of the branch

11. A deemed branch payment will not give rise to a mismatch where the rules for calculating branch income in the residence jurisdiction operate in such a way as to ensure that the scope of the branch exemption only covers income that is subject to tax in the branch jurisdiction. Table B.4.3 illustrates an alternative mechanism for calculating branch income which limits the scope of the exemption to the amount of income that is actually subject to tax in the branch jurisdiction. This methodology ensures that any income that is sheltered by the deemed royalty payment will be subject to tax in the head office.

Table B.4.3. **Exempt branch with deduction for branch income**

Country A			Country B		
Income	**Tax**	**Book**	**Income**	**Tax**	**Book**
Country A Customers	200	200			
Country B Customers	200	200	Country B Customers	200	200
Expenses			**Expenses**		
Employment	(40)	(10)	Employment	(30)	(30)
Administration costs	(40)	(20)	Administration costs	(20)	(20)
Research and development costs	(10)	(10)			
Deduction for net branch income	(100)		Notional royalty payment	(50)	-
Net return before tax		160	Net return before tax		150
Taxable income	210		Taxable income	100	
Tax at 30% (63)			Tax at 30% (30)		
Net tax to pay		(63)	Net tax to pay		(30)

Application of Recommendation 3

12. If A Co does not make an adjustment that takes into account the payment of the deemed royalty under rules consistent with Recommendation 1, then A Co should consider the extent to which Recommendation 3 applies to neutralise the mismatch in tax outcomes under the laws of Country B.

13. The deemed branch payment rule limits the ability of a taxpayer to set off the deduction from a deemed branch payment against non-dual inclusion income when such payment is not included in income by the payee.

Notional royalty is a deemed payment

14. In this example, the notional royalty payment falls within the definition of a deemed payment under Recommendation 3 as it is a notional payment between the branch and head office that does not represent (and is not calculated by reference to) an actual expenditure of the taxpayer. While, in this case, A Co's accounts do recognise expenditure on R&D, the facts do not indicate that the notional royalty payment (or any part of the payment) has been calculated by reference to those R&D costs. The R&D expenditure is not the same type of outgoing as a notional royalty payment. The former is in respect of the development of an

IP asset while the latter is a payment for use of that IP asset. It would therefore be difficult to trace, with precision, the notional royalty payment into the R&D expense such that it can be reliably determined that both items are (in reality) deductions for the same expense. Accordingly, it cannot be said that the R&D expenditure recognised in A Co's accounts is itemised expenditure which can directly be attributed to the notional royalty payment.

Deemed payment is disregarded (other than to the extent it is recognised by an allocation of expenditure or loss of an equivalent category)

15. A deemed payment will not give rise a mismatch unless it is "disregarded" under the laws of the payee jurisdiction. The head office may recognise a deemed payment by including it directly in income or by allocating expenditure or loss of an equivalent category to the payer jurisdiction.

16. In this case (and as illustrated in Table B.4.1) Country A limits the deductibility of the R&D expense on the grounds that the resulting IP asset is used in deriving exempt branch income. Where the payee jurisdiction has domestic rules limiting the deductibility of expenditure on the basis that such expenditure is allocable to the branch then the effect of this limitation should be taken into account in determining the extent to which a deemed payment has been disregarded under the deemed branch payment rule.

17. In this case, the deemed payment and allocated expenditure pertain to the same general category of assets (being the IP used in providing services to customers) and the basis on which the R&D expense has been denied in the residence jurisdiction indicates that there is a straightforward connection between the deemed payment and the allocated expenditure or loss. Accordingly, these two items should be treated as being in an equivalent category for the purposes of the deemed branch payment rule. It is noted that the deemed payment (a royalty for the use of an IP asset) does not need to be of the same specific type as the expenditure or loss allocated by the payee (R&D costs) and does not need to be calculated on the same basis. However, a deemed payment should only be treated as recognised by the allocation of an equivalent category of expenditure or loss to the extent of the amount actually allocated to the payer jurisdiction and that the expenditure or loss has been denied in the residence jurisdiction as a result of such allocation.

Mismatch is a result of the payment being disregarded

18. A branch mismatch only arises where the D/NI outcome is a result of the fact that the deemed payment is disregarded under the laws of the payee jurisdiction. This is a counterfactual test that asks what the tax treatment of the payment would have been if it had been recognised by A Co. In this case the facts indicate that A Co is a taxable entity so the resulting mismatch is one that arises as a result of the deemed payment. Table B.4.4 shows the position of the head office and the branch following the adjustment under Recommendation 3.

19. In total A Co has 400 of income and 90 of expenses leaving it with net income of 310 from its global operations. All the operating income of the Country B Branch is exempt from tax under the laws of Country A so that the deemed royalty payment recognised by the Country B Branch is deducted against non-dual inclusion income. The deemed royalty payment is not properly taken into account under the laws of Country A so that Country B denies a deduction for the amount of the deemed royalty except to the extent that Country A has allocated an equivalent category of expenditure to the branch in the form of a denial of a deduction for the R&D expenses.

Table B.4.4. **Adjustment under Recommendation 3 for Exempt Branch**

Country A				Country B			
Income		**Tax**	**Book**	**Income**		**Tax**	**Book**
Country A Customers		200	200	Country B Customers		200	200
Expenses				**Expenses**			
Employment		(10)	(10)	Employment		(30)	(30)
Administration costs		(20)	(20)	Administration costs		(20)	(20)
Research and development		-	(10)				
				Notional royalty payment		(50)	-
				Rec. 3 Adjustment		50	
				Research and development costs (allocated by head office)		(10)	
Net return before tax			160	Net return before tax			150
Taxable income		170		Taxable income		140	
Tax at 30%	(51)			Tax at 30%	(42)		
Net tax to pay			(51)	Net tax to pay			(42)

20. The overall impact of the recommendations in this report is that, if the head office does not properly take into account the effect of the notional payment, the jurisdiction that allows for the notional payment should not provide a deduction for such payment to the extent that the income or expenses associated with that payment are not taken into account under the laws of the payee jurisdiction.

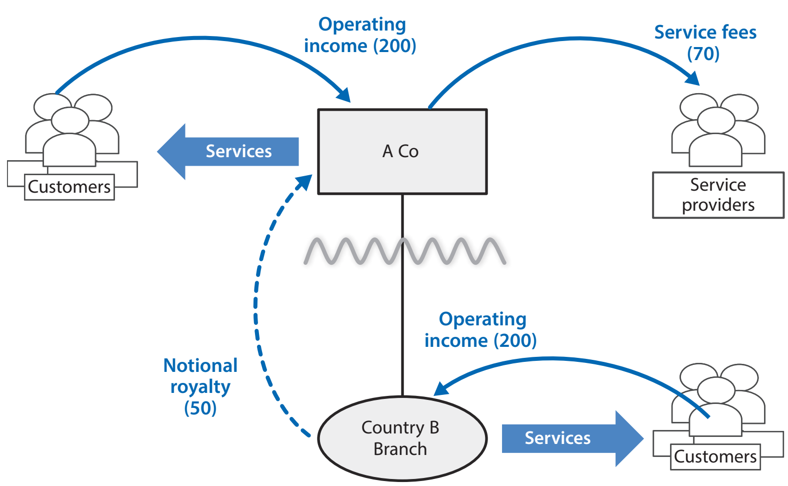
21. The net effect of these rules is to ensure that the deduction for the deemed payment is only available when (and to the extent) the taxpayer has taken the effect of that payment into account in the counter-party jurisdiction. An adjustment under the branch mismatch rules ensures that the full amount of the taxpayer's net income is brought into charge under the laws of either the branch or the residence jurisdiction while ensuring that the adjustments do not result in double taxation.

Example 5

Application of Recommendations 3 and 4 to notional payment

Facts

1. The facts of this example are the same as in Example 4 except that, in addition, A Co contracts for various services from third party service providers. A Co's operations (including the service fees paid to third party service providers) are illustrated in the figure below.



2. Table B.5.1 provides an illustration of the position of the head office and the branch. The figures in the table below are the same as those in Table B.4.1 except that:

   a. the head office recognises an additional 70 of third party expenses for accounting purposes (only 50 of which is deductible under Country A law)

   b. the Country B Branch treats 30 of these third party expenses as incurred directly by the branch.

3. As in Table B.4.1, A Co derives 200 of operating income from the respective computer service sales made in each of Country A and B and incurs 40 of administration costs (split evenly between the branch and the head office) and employment costs of 30 in the branch and 10 in the head office. Country A also denies a deduction for the research and development (R&D) costs on the grounds that the intellectual property (IP) generated by such R&D is used solely to derive exempt income in Country B Branch.

4. In total A Co has 400 of income and 160 of expenses leaving it with net income of 240 from its global operations, however the net effect of the allocation of the R&D costs, deemed royalty and additional third party expenditure between the branch and head office is that A Co only recognises 190 of taxable income across both jurisdictions (i.e. a mismatch of 50).

Table B.5.1. **Mismatch arising in respect of deemed and actual payments**

Country A			Country B		
Income	**Tax**	**Book**	**Income**	**Tax**	**Book**
Country A Customers	200	200	Country B Customers	200	200
Expenses			**Expenses**		
Employment	(10)	(10)	Employment	(30)	(30)
Administration costs	(20)	(20)	Administration costs	(20)	(20)
Research and development	-	(10)			
Third party services	(50)	(70)			
			Notional royalty payment	(50)	-
			Third party services	(30)	-
Net return before tax		90	Net return before tax		150
Taxable income	120		Taxable income	70	

Question

5. How do the recommendations in this report apply to neutralise the mismatch in tax outcomes arising from the use of this structure?

Answer

6. A Co should apply Recommendation 3 before determining the amount of any double deduction subject to adjustment under Recommendation 4.

7. If the notional payment can accurately and reliably be traced through to an item of expenditure of the same type recorded in the taxpayer's accounts then the Country B Branch should treat the notional payment (to that extent) as an actual payment of the underlying expenditure incurred by A Co. The balance of the notional royalty payment that does not directly relate to actual expenditure of the taxpayer should be subject to adjustment under Recommendation 3.

8. Consistent with the analysis set out in Example 4, Country B should deny a deduction for the amount of the deemed royalty except to the extent that Country A has allocated an equivalent category of expenditure to the branch in the form of a denial of a deduction for R&D costs.

9. There is still a mismatch in tax outcomes under the branch structure following the application of the deemed branch payment rule in Country B. This mismatch arises due to the fact the branch and the head office are claiming deductions for third party services that exceed, in aggregate, the actual amount of expenditure on these services (i.e. a double deduction outcome). This mismatch will be subject to adjustment in Country A under the primary rule in Recommendation 4.

Analysis

Apply Recommendation 3 (deemed branch payments rule) before Recommendation 4 (DD rule)

10. The mismatch that arises in this example is due to differences in the allocation of actual and deemed expenditure between various parts of the same enterprise. There are two recommendations dealing with mismatches that arise in these circumstances:

a. Recommendation 3 which requires the branch jurisdiction to deny a deduction for a deemed payment to the extent such payment is disregarded by the head office.

b. Recommendation 4 which requires the residence jurisdiction to deny a deduction to the extent the same expense is deductible under the laws of the branch jurisdiction.

11. Consistent with the Action 2 Report (OECD, 2015), the taxpayer should apply Recommendation 3 before determining the amount of any double deduction subject to adjustment under Recommendation 4. This, in turn, requires A Co to determine the extent to which any deduction claimed by Country B Branch represents an allocation of an actual expense of the taxpayer.

Apply Recommendation 3 to notional royalty payment to the extent such payment does not represent an allocation of third party expenses

12. In the previous example, the notional royalty payment was treated as a deemed payment under Recommendation 3 because it did not represent (and was not calculated by reference to) an actual expenditure of the taxpayer. In this example, however, the facts indicate that A Co has incurred additional expenses in respect of third party services and it is possible that some of these expenses can be directly attributed to the notional royalty payment recognised by Country B Branch.

13. A notional payment should be treated as an actual payment where the payment relates to specific functions performed, assets held or risks assumed by another part of the same taxpayer and there is itemised expenditure in the tax accounts of the payee of the same type that can be directly attributed to the notional payment. Assume, for example, that part of the third party services supplied to A Co includes information technology (IT) licences and support services that relate to software owned by A Co (which, in turn, forms part of the basis for the notional royalty paid by Country B Branch). Assume further that these third party services are charged on a per-user basis so that A Co can determine (without the need to collect any further information or perform complex calculations) the portion of the expenditure that is attributable to Country B Branch.

14. In this case, even though the notional royalty payment is not expressly calculated by reference to such third party services, the notional payment can be defined with sufficient precision such that it can be traced through to an item of expenditure of the same type recorded in the payee's accounts and the nature of that expenditure is such that it can reliably and directly be attributed to the deemed payment. If this is the case then Country B Branch should treat the notional payment (to that extent) as an actual payment of the underlying expenditure incurred by A Co.

15. Table B.5.2 indicates the position of A Co under Country A and Country B law following the adjustment required under Recommendation 3.

16. In this case A Co can determine that the notional royalty payment treated as made by Country B Branch is attributable (in part) to software owned by A Co and that a portion

of the third party services expenditure is directly attributable to the costs of using (and supporting the use) of that software. Furthermore there is itemised expenditure in A Co's management accounts that accurately allows a portion of these third party service costs (10) to be attributed to the activities of the Country B Branch. Accordingly A Co treats a portion of the notional royalty payment as actual third party expenditure on software and support services.

Table B.5.2. **Adjustment under Recommendation 3**

Country A			Country B		
Income	**Tax**	**Book**	**Income**	**Tax**	**Book**
Country A Customers	200	200	Country B Customers	200	200
Expenses			**Expenses**		
Employment	(10)	(10)	Employment	(30)	(30)
Administration costs	(20)	(20)	Administration costs	(20)	(20)
Research and development	-	(10)	Deemed Royalty	(40)	-
Third party services	(50)	(70)	Software license and IT support	(10)	-
			Other third party services	(30)	-
			Rec. 3 Adjustment	40	
			Research and development costs (allocated by head office)	(10)	-
Net return before tax		90	Net return before tax		150
Taxable income	120		Taxable income	100	

17. The balance of the notional royalty payment does not directly relate to actual expenditure of the taxpayer and should be subject to adjustment under Recommendation 3. Consistent with the analysis set out in Example 4, Country B should deny a deduction for the amount of the deemed royalty except to the extent that Country A has allocated an equivalent category of expenditure to the branch in the form of a denial of a deduction for the R&D costs. The allocation of deductible expenditure should only be treated as equivalent to an adjustment under Recommendation 3 where the head office has been denied a deduction for such expenditure due to the fact that such amount has actually been allocated to the payer jurisdiction. In this case, the facts indicate that R&D costs are entirely attributable to the intellectual property used by Country B Branch and therefore should be wholly taken into account by the Country B Branch when determining the amount of the adjustment under Recommendation 3.

Remaining mismatch is attributable to DD outcome and subject to adjustment under the primary rule in Recommendation 4

18. Following the application of the deemed branch payment rule there is still a mismatch in tax outcomes under the branch structure. This is because both the branch and the head office are claiming deductions for third party services and those deductions exceed, in aggregate, the actual amount of expenditure on these services.

19. It may be possible for A Co to identify, on an item by item or category by category basis, the extent to which the amount of deductible expenditure claimed in the branch jurisdiction exceeds the amount that has been allocated to the branch by the head office. In more complex commercial branch operations, however, it will generally be impractical for a taxpayer to undertake this kind of detailed analysis. In these cases A Co should be permitted, under the laws of the relevant jurisdiction, to adopt a simpler implementation solution for tracking double deductions and dual inclusion income that is based, as much as possible, on existing domestic rules, administrative guidance, presumptions and tax calculations while still meeting the basic policy objectives of Recommendation 4.

20. For example, under Country A law, A Co could determine the total amount of double deductions on an aggregate basis by comparing the deductions claimed for actual expenditure and loss in the branch and head office jurisdictions against the taxpayer's total expenditures (excluding those expenditures that were not deductible under the laws of either the branch or head office jurisdiction). This excess may be treated as a double deduction (subject to adjustment under Recommendation 4) to the extent it cannot be explained solely by reference to differences in timing or valuation. An example of this calculation, based on the figures in Table B.5.2 is set out below.

Table B.5.3. **Calculation of total deductions claimed in Branch and Head Office**

Deductions for actual expenditure under Country A law		
Employment	(10)	
Administrative costs	(20)	
Third party services	(50)	
Total actual deductible expenditures (Country A)		(80)
Deductions for actual expenditure under Country B law		
Employment	(30)	
Administrative costs	(20)	
Software license and IT support	(10)	
Other third party services	(30)	
Research and development costs*	(10)	
Total actual deductible expenditures (Country B)		(100)
Total tax deductions under both jurisdictions in relevant period		(180)

* Note that when taking into account aggregate deductions for expenditure in the Country B Branch, the branch should take into account any reduction in the adjustment made under Recommendation 3 due to an allocation of equivalent expenditure by the head office.

21. The total tax deductions claimed on the branch and head office return for the relevant period exceed the actual (tax adjusted) expenditure in the accounts. The difference of 20 (which is not attributable to differences in the timing in the recognition of expenditure) should be treated as giving rise to a double deduction. Table B.5.4 sets out the adjustment required under both Country A and Country B law.

Table B.5.4. **Adjustments under Recommendations 3 and 4**

Country A			Country B		
Income	**Tax**	**Book**	**Income**	**Tax**	**Book**
Country A Customers	200	200	Country B Customers	200	200
Expenses			**Expenses**		
Employment	(10)	(10)	Employment	(30)	(30)
Administration costs	(20)	(20)	Administration costs	(20)	(20)
Research and development	-	(10)			
Third party services	(50)	(70)			
			Deemed Royalty	(40)	-
			Software license and IT support	(10)	-
			Other third party services	(30)	-
Rec. 4 Adjustment	20		Rec. 3 Adjustment	40	
			Research and development costs (allocated by head office)	(10)	
Net return before tax		90	Net return before tax		150
Taxable income	140		Taxable income	100	

22. Therefore the overall impact of the recommendations in this report on the facts of this example is that:

a. The branch jurisdiction should not allow a deduction for a notional payment to the extent that the income or expenses associated with that payment are not taken into account under the laws of the residence jurisdiction.

b. Any deductions for actual expenditure that are taken into account in both the head office and the branch are denied at the level of the head office to the extent the branch has already set those deductions off against (exempt) branch income.

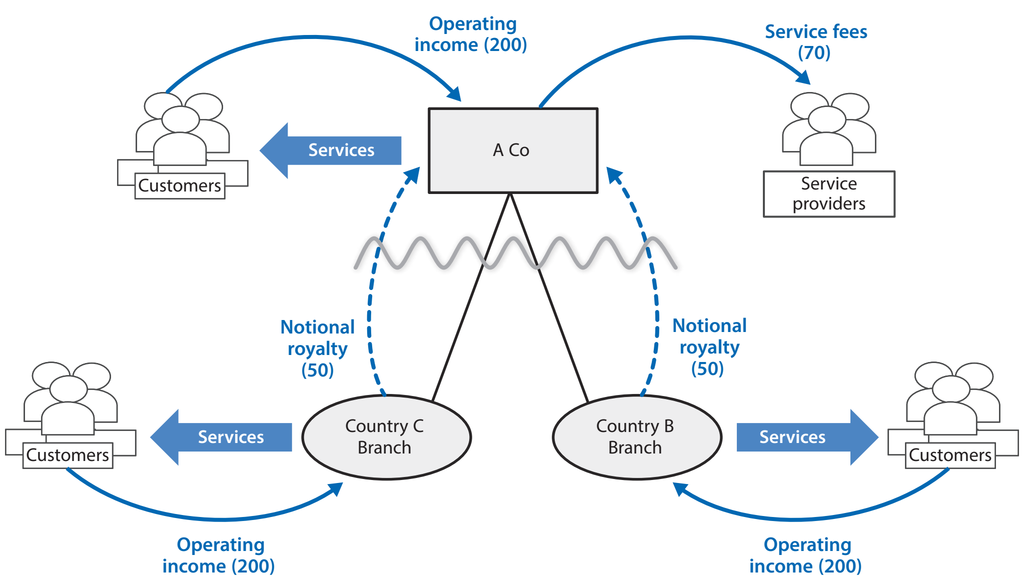
23. The net effect of these rules is to ensure that the branch only grants a deduction for a deemed payment when (and to the extent) that the taxpayer has taken the effect of that payment into account in the counter-party jurisdiction and that the total of the tax deductions claimed by the taxpayer in the branch and head office do not exceed the taxpayer's actual deductible expenditure. Adjustments under the branch mismatch rules ensure that the full amount of the taxpayer's net income is brought into charge under the laws of either the branch or the residence jurisdiction while ensuring that the adjustments do not result in double taxation.

Example 6

Application of primary rule in Recommendation 4 to taxpayer with multiple branches

Facts

1. The facts of this example are the same as in Example 5 except that A Co also has an identical branch in Country C. Country A exempts the income of both branches from taxation. As in the previous example, A Co contracts for various services from third party service providers. Both Country B and Country C Branches recognise a notional payment (or payments) to the head office to compensate the head office for the performance of services or the assumption of risks or ownership of assets held by the head office. A Co's operations in Country B and Country C (including the service fees paid to third party service providers) are illustrated in the figure below.



2. In this case it is assumed that Country B has applied the deemed branch payment rule to neutralise the mismatch arising in respect of the notional payment between Country B Branch and the head office. Table B.6.1 provides an illustration of the net position of the head office and the branches for tax purposes.

3. The figures for Countries A and B set out in Table B.6.1 are the same as those shown in B.5.2 except that A Co is only permitted to deduct 30 out of its total expenditure on third party services of 70 (the balance of the expenditure being treated as allocated evenly between the two branches). While A Co is ordinarily entitled to deduct research and development (R&D) costs, this deduction is denied owing to the fact that the intellectual property (IP) in question is used in Country B branch (see the analysis in Example 4 above).

4. The branch operations in Country B are the same as those described in Example 5 (and the adjustment made under the deemed branch payment rule is therefore the same as

set out in that example). While the branch operations in Country C are the same as those in Country B, Country C has not implemented the branch mismatch rules and therefore does not make any adjustment under Recommendation 3 in respect to the deemed branch payment. The net effect of these allocations (after the application of the deemed payment rule in Country B) is that A Co is required to include an aggregate of 310 of taxable income against a net return (before tax) of 390 (i.e. there is a mismatch of 80).

Table B.6.1. **Mismatch arising in respect of deemed and actual payments**

Country A			Country B			Country C		
Income	**Tax**	**Book**		**Tax**	**Book**	**Income**	**Tax**	**Book**
Country A Customers	200	200	Country B Customers	200	200	Country C Customers	200	200
Expenses			**Expenses**			**Expenses**		
Employment	(10)	(10)	Employment	(30)	(30)	Employment	(30)	(30)
Administration costs	(20)	(20)	Administration costs	(20)	(20)	Administration costs	(20)	(20)
Research and development	-	(10)	Deemed Royalty	(40)	-	Deemed Royalty	(40)	-
Third party services	(30)	(70)	Software license and IT support	(10)	-	Software license and IT support	(10)	-
			Other third party services	(30)	-	Other third party services	(30)	-
			Rec. 3 Adjustment	40				
			Research and development costs (allocated by head office)	(10)				
Net return before tax		90	Net return before tax		150	Net return before tax		150
Taxable income	140		Taxable income	100		Taxable income	70	

Question

5. How would Country A apply the primary rule in Recommendation 4 to neutralise the mismatch in tax outcomes arising from the arrangement described above?

Answer

6. To the extent the mismatch is attributable to double deduction outcomes it will be subject to adjustment in Country A under the primary rule in Recommendation 4. Recommendation 4 will not, however, operate to neutralise the mismatch associated with the deemed royalty payment made by the Country C Branch.

Analysis

Adjustment under primary rule in Recommendation 4

7. Under the primary rule in Recommendation 4 the investor jurisdiction (Country A) should restrict the deductibility of any payment, expense or loss that is also deductible under the laws of the payer jurisdictions (Countries B and C) so that such amount can only be set off against income that is dual inclusion income. In this case, where Country A provides a general exemption in respect of branch income then any deduction in the branch jurisdiction that is also deductible in the residence jurisdiction is likely to end up being set off against income that is not subject to tax in the residence jurisdiction.

8. As in Example 5, it will generally be impractical to expect A Co to undertake a line-by-line (or even category-by-category) investigation into whether the amount of deductible expenditure claimed in the branch jurisdiction exceeds the amount that has been allocated to the branch by the head office and A Co should be permitted, under the laws of Country A, to use an implementation solution that is simple, robust and based, as much as possible, on existing domestic rules, administrative guidance, presumptions and tax calculations while still meeting the basic policy objectives of Recommendation 4.

9. For example, A Co could determine the total amount of double deductions on an aggregate basis by comparing the deductions claimed for actual expenditure and loss in the branch and head office jurisdictions against the taxpayer's total expenditures (excluding those expenditures that were not deductible under the laws of either the branch or head office jurisdiction). This excess may be treated as a double deduction (subject to adjustment under Recommendation 4) to the extent it cannot be explained solely by reference to differences in timing or valuation. An example of this calculation, based on the figures in Table B.6.2, is set out below.

Table B.6.2. **Calculation of total deductions claimed in each jurisdiction**

Deductions for actual expenditure under Country A law		
Employment	(10)	
Administrative costs	(20)	
Third party services	(30)	
Total actual deductible expenditures (Country A)		(60)
Deductions for actual expenditure under Country B law		
Employment	(30)	
Administrative costs	(20)	
Software license and IT support	(10)	
Other third party services	(30)	
Research and development costs (allocated to B Branch)*	(10)	
Total actual deductible expenditures (Country B)		(100)
Deductions for actual expenditure under Country C law		
Employment	(30)	
Administrative costs	(20)	
Software license and IT support	(10)	
Other third party services	(30)	
Total actual deductible expenditures (Country C)		(90)

* Note that when taking into account aggregate deductions for expenditure in the Country B Branch, the branch should take into account any reduction in the adjustment made under Recommendation 3 due to an allocation of equivalent expenditure by the head office.

10. Table B.6.2 above shows that the total deductions claimed in the branch and head office tax returns for the relevant period is 250. This total should be compared with 210 of total expenditure recorded in the accounts for tax purposes resulting in an excess of 40. This excess may be treated as a double deduction (subject to adjustment under Recommendation 4) to the extent it cannot be explained solely by reference to differences in timing or valuation.

Table B.6.3. **Adjustments under Recommendations 3 and 4**

Country A			Country B			Country C		
Income	**Tax**	**Book**		**Tax**	**Book**	**Income**	**Tax**	**Book**
Country A Customers	200	200	Country B Customers	200	200	Country C Customers	200	200
Expenses			**Expenses**			**Expenses**		
Employment	(10)	(10)	Employment	(30)	(30)	Employment	(30)	(30)
Administration costs	(20)	(20)	Administration costs	(20)	(20)	Administration costs	(20)	(20)
Research and development	-	(10)	Deemed Royalty	(40)	-	Deemed Royalty	(40)	-
Third party services	(30)	(70)	Software license and IT support	(10)	-	Software license and IT support	(10)	-
			Other third party services	(30)	-	Other third party services	(30)	-
Rec. 4 Adjustment	40		Rec. 3 Adjustment	40				
			Research and development costs (allocated by head office)	(10)				
Net return before tax		90	Net return before tax		150	Net return before tax		150
Taxable income	180		Taxable income	100		Taxable income	70	

11. Table B.6.3 sets out the adjustment required under Country A law. Note that this adjustment does not entirely eliminate the mismatch in tax outcomes and the remaining mismatch is attributable to the recognition of the notional payment in Country C.

12. The overall impact of the recommendations in this report on this arrangement is that:

a. Country B does not allow a deduction for a notional payment to the extent that the income or expenses associated with that payment are not taken into account under the laws of the residence jurisdiction.

b. Any deductions for actual expenditure that are taken into account in both the head office and the branch are denied at the level of the head office to the extent the branch has already set those deductions off against (exempt) branch income.

c. No adjustment is required in respect of the branch mismatch that is attributable to the notional payment between the Country C Branch and the head office because Country C has not adopted the branch mismatch rules.

13. The net effect of these rules is to ensure that the branch jurisdiction (Country B) only grants a deduction for the deemed payment when (and to the extent) that the taxpayer has taken the effect of that payment into account in the counter-party jurisdiction. In addition, the application of Recommendation 4 in Country A ensures that the total of the tax deductions claimed by the taxpayer in the branch and head office do not exceed the taxpayer's actual deductible expenditure. In respect of the outstanding mismatch, this example illustrates that changes to the scope of the branch exemption under Recommendation 1 may, in certain cases, be a more effective mechanism for addressing branch mismatches than making adjustments at the level of the branch.

Example 7

Application of secondary rule in Recommendation 4 to taxpayer with multiple branches

Facts

1. The facts of this example are the same as in Example 6 except that only Countries B and C have implemented the branch mismatch rules.

Question

2. How does the deemed branch payment rule in Recommendation 3 and the secondary rule in Recommendation 4 apply to neutralise the mismatch in tax outcomes arising from this arrangement?

Answer

3. Countries B and C should deny a deduction for the amount of the deemed royalty payment, under the deemed branch payment rule in Recommendation 3 except to the extent that Country A has allocated an equivalent category of expenditure to the Country B Branch in the form of a denial of a deduction for research and development (R&D) costs. Each branch should also be denied a deduction under the double deduction rule in Recommendation 4 to the extent the aggregate tax deductions claimed in the branch and head office jurisdiction exceed the total amount of (tax adjusted) expenditure in the head office and each branch.

Analysis

Adjustments required under Country B law

4. Consistent with the analysis set out in Example 4, Country B should deny a deduction for the amount of the deemed royalty except to the extent that Country A has allocated an equivalent category of expenditure to the branch in the form of a denial of a deduction for R&D costs.

5. As in Example 6, it may be impractical for the Country B Branch to undertake a line by line comparison of each item of income and expenditure to determine whether a double deduction has arisen in the branch. Country B may allow the branch to aggregate the tax deductions claimed for actual expenditure and loss in the branch and head office and compare this amount against actual expenditures in order to determine the amount of double deductions that are claimed by the branch.

6. An example of the calculation of the expenditures for the head office and Country B Branch is set out in Table B.6.2. This total (160) can be compared with total expenditure recorded in the accounts for the branch and head office (i.e. the actual expenditures of the branch and head office adjusted to reflect any amounts that are treated by the head office as allocable to another branch). Table B.7.1 sets out the amount of actual expenditure incurred by the Country B Branch and head office.

Table B.7.1. **Calculation of expenditure in each jurisdiction**

Actual expenditure of head office		
Employment	(10)	
Administrative costs	(20)	
Research and development (allocated to Country B Branch)	(10)	
Third party services	(70)	
Adjustment for amount allocated to Country C Branch	20	
Total actual expenditures (Country A)		(90)
Actual expenditure of Country B Branch		
Employment	(30)	
Administrative costs	(20)	
Total actual expenditures (Country B)		(50)
Total expenditure in head office and Country B Branch		(140)

7. There are a number of methods that a taxpayer could use to calculate the amount of expenditure incurred in the head office and branch jurisdiction. The method that is used by the taxpayer should be based on the existing accounts as prepared in accordance with the relevant standards in the jurisdictions where the taxpayer operates. In the calculation set out in Table B.7.1 above, A Co has started with the expenditures recorded in the head office accounts, and then adjusted these amounts for expenditure that can properly be treated as attributable to the Country C branch, in order to determine the total expenditure in the head office and Country B Branch. In making this calculation the taxpayer will be expected to adopt a simple but reliable and consistent methodology for making such adjustments that would be capable of being used in each jurisdiction that applies rules consistent with Recommendation 4. In this case where there is already an allocation of third party expenses under the laws of Country A (and it is assumed that Country B and C Branches are identical), A Co has divided that allocation evenly between the two jurisdictions.

8. The excess of deductions claimed over actual expenditure in this case is (160 - 140 =) 20. This excess may be treated as a double deduction (subject to adjustment under Recommendation 4) to the extent it cannot be explained solely by reference to differences in timing or valuation.

Adjustments required under Country C law

9. A similar calculation can be made under Country C law. The required adjustment under Recommendation 3 is greater than in Country B, however, as the adjustment is not offset by an allocation of equivalent expenditure in the form of R&D costs. Under Recommendation 4, the total deductions claimed for actual expenditure in both jurisdictions is 150 and the total expenditure recorded in the accounts for the branch and head office (adjusted to reflect any amounts that are treated by the head office as allocable to the Country B Branch) is 130. The excess of deductions claimed over actual expenditure in this case is (150 - 130 =) 20. This excess of 20 may be treated as a double deduction (and subject to adjustment under Recommendation 4) to the extent it cannot be explained solely by reference to differences in timing or valuation. Table B.7.2 sets out the net amount of adjustment required under Country B and C law.

Table B.7.2. **Adjustments under Country B and C law**

Country A			Country B			Country C		
Income	**Tax**	**Book**		**Tax**	**Book**	**Income**	**Tax**	**Book**
Country A Customers	200	200	Country B Customers	200	200	Country C Customers	200	200
Expenses			**Expenses**			**Expenses**		
Employment	(10)	(10)	Employment	(30)	(30)	Employment	(30)	(30)
Administration costs	(20)	(20)	Administration costs	(20)	(20)	Administration costs	(20)	(20)
Research and development	-	(10)	Deemed Royalty	(40)	-	Deemed Royalty	(40)	-
Third party services	(30)	(70)	Software license and IT support	(10)	-	Software license and IT support	(10)	-
			Other third party services	(30)	-	Other third party services	(30)	-
			Rec. 3 adjustment	40		Rec 3 Adjustment	40	
			Research and development costs (allocated by head office)	(10)				
			Rec. 4 adjustment	20		Rec. 4 adjustment	20	
Net return before tax		90	Net return before tax		150	Net return before tax		150
Taxable income	140		Taxable income	120		Taxable income	130	

10. Table B.7.2 sets out the adjustments required under Country B and C law. Note that these adjustments eliminate the mismatch in tax outcomes owing to the fact that the deemed branch payment has been neutralised in Country C under Recommendation 3. The overall impact of the recommendations in this report on this arrangement is that:

a. Country B Branch and Country C Branch do not allow a deduction for a notional payment to the extent that the income or expenses associated with those payments are not taken into account under the laws of the residence jurisdiction; and

b. Any deductions for actual expenditure that are taken into account in both the head office and the branch are denied at the level of the branch to the extent the head office has set those deductions off against income that is not taxable in the branch.

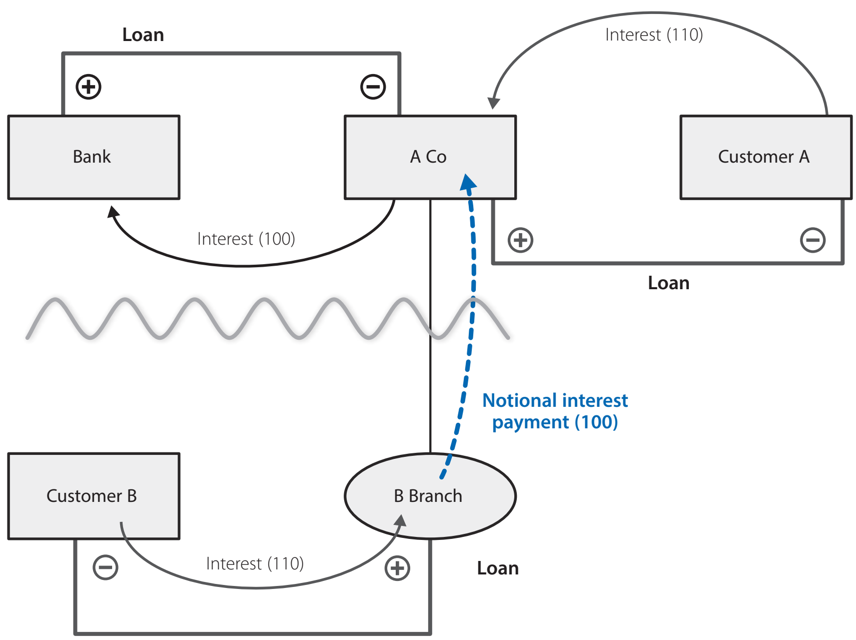
11. The net effect of these rules is to ensure that the branch only grants a deduction for a deemed payment when (and to the extent) that the taxpayer has taken the effect of that payment into account in the counter-party jurisdiction and that the total of the tax deductions claimed by the taxpayer in the branch and head office do not exceed the taxpayer's actual deductible expenditure. Adjustments under the branch mismatch rules ensure that the full amount of the taxpayer's net income is brought into charge under the laws of either the branch or the residence jurisdiction while ensuring that the adjustments do not result in double taxation.

Example 8

Allocation of third party expenses under Recommendation 3

Facts

1. A Co is a company established and resident in Country A. A Co uses its own equity and money borrowed from an unrelated bank to make a loan to a customer located in Country A (Customer A). A Co also lends funds to a customer located in Country B (Customer B) through a branch established in that country (Country B Branch).



2. The rules in Country A for allocating income and expenditure to the branch require the head office to treat a portion of the interest paid to the bank as attributable to the exempt branch (and that portion is therefore non-deductible under Country A law).

3. Country B law calculates the net income of Country B Branch as if it was a separate entity for tax purposes, however, in making this calculation, Country B treats the branch as making an interest payment to the head office. Table B.8.1 illustrates the mismatch in tax outcomes that arises under this structure.

4. As shown in Table B.8.1, A Co earns a total of 220 of interest income and has 100 of interest expenses. The net return (before tax) under the arrangement is therefore 120. Under Country B law, the branch is treated as taxable on the interest payment of 110 from Customer B and is entitled to a deduction for the notional interest expense of 100 on a hypothetical loan from the head office. The net income subject to tax in Country B is therefore 10.

5. Under Country A law, the head office of A Co is also treated as deriving 110 of taxable interest income. The interest paid by Customer B is eligible for the branch exemption and not subject to tax under Country A law. A Co is, however, required to allocate half the interest expense on the bank loan to the exempt branch for tax purposes so that the total amount of interest that is deductible under Country A law is only 50 leaving the head office with net taxable income under Country A law of 60.

6. The overall effect of this arrangement is that while A Co's net return under the arrangement is 120, A Co only has total taxable income of 70 under the laws of Country A and B.

Table B.8.1. **Mismatch arising from notional payment**

Country A			Country B		
	Tax	Book		Tax	Book
Income			**Income**		
Interest from Customer A	110	110			
			Interest from Customer B	110	110
Expenditure			**Expenditure**		
Interest paid to bank	(50)	(100)	Notional interest deduction	(100)	
Net return		10	Net return		110
Taxable income	60		Taxable income	10	

Question

7. How do the recommendations in this report apply to neutralise the mismatch in tax outcomes arising from this structure?

Answer

8. The notional interest payment treated as made by B Branch should be treated as an actual interest expense to the extent the payment represents or is calculated by reference to actual interest expenditure recognised in the accounts of the payee. The effect of treating the notional payment as an actual interest expense is that the mismatch will be subject to adjustment under Recommendation 4.

9. If the notional interest payment cannot be accurately and reliably traced through to an actual item of interest expenditure recognised in the taxpayer's accounts then Country B should deny a deduction for the amount of the deemed interest payment except to the extent that Country A has allocated an equivalent category of financing costs to the branch.

Analysis

Notional payment subject to adjustment under Recommendation 4 to the extent it represents an actual interest expense

10. While this payment is treated, under the laws of Country B, as a notional interest payment to the head office, if, in practice, the payment is calculated by reference to A Co's actual borrowing costs (or the interest expenditure or borrowing costs in the tax accounts of the payee that can be directly attributed to the notional interest payment) then the interest expense claimed under Country B law should not be treated as a deemed payment for the purposes of the deemed branch payments rule. This type of notional interest payment is (in reality) an allocation of third party interest costs to the branch under Country B law which should be treated as giving rise to a branch DD outcome subject to adjustment under Recommendation 4 (see the supporting analysis in Example 9).

11. The facts of this example involve only one loan and a single notional interest expense. In branch financing operations of any significant size a taxpayer may have some difficulty in tracing notional interest expenses to actual third party borrowing costs. In the context of significant financing operations, the taxpayer may have entered into a number of borrowing, security and hedging transactions that will make it difficult (if not impossible) to trace the notional interest charge to any identifiable third party expense. In these cases, where the notional payment is not expressly calculated by reference to actual expenditure of the payee, and there is no itemised expenditure of the same type in the tax accounts of the payee that can be directly attributed to that notional payment, then the taxpayer should treat the notional payment as a deemed payment subject to adjustment under Recommendation 3.

No adjustment required under Recommendation 3 to the extent head office allocates expenditure of an equivalent category

12. A deemed interest payment between the branch and the head office is not subject to adjustment under the deemed branch payment rule to the extent the payment is recognised through an actual allocation of third party interest expense by the head office under Country A law.

13. Unlike the tracing approach described above, which is used to determine whether a notional payment represents or is calculated by reference to actual expenditure of the taxpayer, the determination of whether a deemed payment belongs to an equivalent category as an item of expenditure or loss in the head office jurisdiction is a broader test that should be done on a like-kind basis. In this case, both the deemed payment recognised under Country B law and the expenditure required to be allocated under Country A law relate to the same general category of expenditure (i.e. financing costs) and accordingly the two items should be treated as being in an equivalent category for the purposes of the deemed branch payment rule.

14. The deemed payment does not need to be of the same type as the expenditure or loss allocated by the payee and does not need to be calculated on the same basis. Accordingly, if the financing costs in the payee jurisdiction that were allocated to the branch included swap, derivative or guarantee fees they should still be treated as expenditure of an equivalent category despite the fact that they are of a different type and calculated on a different basis.

15. In this case, therefore, a portion of the notional interest treated as paid by the branch to the head office under Country B law (50) is treated as recognised in the residence jurisdiction in the same period by virtue of the corresponding allocation made by the head office to the branch under the laws of Country A. No adjustment would be required under the deemed branch payment rule to the extent the notional payment (under Country B law) is treated as recognised by this allocation. The deemed branch payment rule will continue to apply, however, to the extent the notional interest paid to head office was not recognised through a corresponding allocation of third party interest. Accordingly, in this example, only a portion (50) of the notional interest expense would be caught by the deemed branch payment rule.

16. The overall impact of the recommendations in this report on this arrangement is that:

a. A notional payment that is, in reality, an allocation of third party interest costs to the branch should be treated as giving rise a double deduction outcome potentially subject to adjustment under Recommendation 4.

b. A notional payment that cannot be attributed to any third party expense (i.e. a deemed payment) is not deductible in the branch if that payment exceeds the amount of deductible expenditure of an equivalent category allocated to the payer jurisdiction by the branch.

17. The net effect of these rules is to ensure that the branch only grants a deduction for a deemed payment when (and to the extent) that the taxpayer has taken the effect of that payment into account in the counter-party jurisdiction. Adjustments under the branch mismatch rules ensure that the full amount of the taxpayer's net income is brought into charge under the laws of either the branch or the residence jurisdiction while ensuring that the adjustments do not result in double taxation.

Table B.8.2. **Adjustment under Recommendation 3**

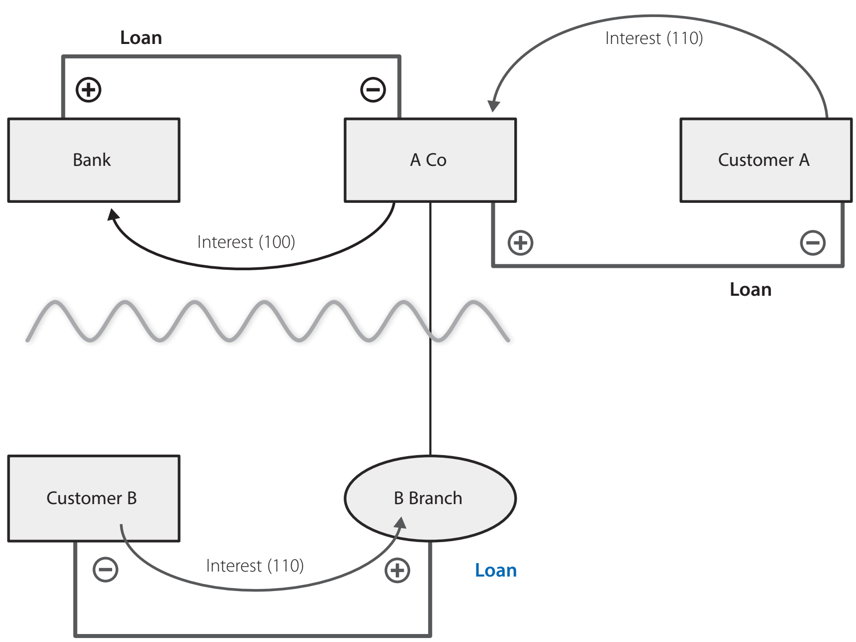
Country A			Country B		
	Tax	**Book**		**Tax**	**Book**
Income			**Income**		
Interest from Customer A	110	110			
			Interest from Customer B	110	110
Expenditure			**Expenditure**		
Interest paid to bank	(50)	(100)	Notional interest deduction	(100)	
			Recommendation 3 Adjustment	50	
Net return		10	Net return		110
Taxable income	60		Taxable income	60	

Example 9

Allocation of third party expenses under Recommendation 4

Facts

1. The facts are the same as those in Example 8 except that there is no notional interest payment between the branch and the head office. A Co uses its own equity and money borrowed from an unrelated bank to make a loan to a customer located in Country A (Customer A) and a customer located in Country B (Customer B). The loan to Customer B is made through a branch established in that country (Country B Branch). The structure of A Co's lending operations are illustrated in the figure below.



2. The rules in Country A for allocating income and expenditure to the branch require the head office to treat a portion of the interest paid to the bank as attributable to the exempt branch (and that portion is therefore non-deductible under Country A law). Country B law calculates the net income of Country B Branch as if it was a separate entity for tax purposes, however, in making this calculation, Country B applies a tracing approach to interest deductibility which treats all of the interest expenditure incurred by A Co as attributable to the branch. Table B.9.1 illustrates the mismatch in tax outcomes that arise under this structure.

3. As shown in Table B.9.1, A Co earns a total of 220 of interest income and has 100 of interest expenses. The net return (before tax) under the arrangement is therefore 120. Under Country B law, the branch is treated as taxable on the interest payment of 110 from Customer B and is entitled to a deduction for all the interest expense incurred on the loan from the bank (100). The net income subject to tax in Country B is therefore 10.

Table B.9.1. **Mismatch arising from double deduction**

Country A			Country B		
	Tax	Book		Tax	Book
Income			**Income**		
Interest from Customer A	110	110			
			Interest from Customer B	110	110
Expenditure			**Expenditure**		
Interest paid to bank	(50)	(100)	Interest paid to bank	(100)	
Net return		10	Net return		110
Taxable income	60		Taxable income	10	

4. Under Country A law, the head office of A Co is also treated as deriving 110 of taxable interest income. The interest paid by Customer B is eligible for the branch exemption and not subject to tax under Country A law. A Co is, however, required to allocate half the interest expense on the bank loan to the exempt branch for tax purposes so that the total amount of interest that is deductible under Country A law is only 50, leaving the head office with net taxable income under Country A law of 60.

5. As in Example 8, the overall effect of this arrangement is that while A Co's net return under the arrangement is 120, A Co only has total taxable income of 70 under the laws of Country A and B.

Question

6. How does Recommendation 4 of the branch mismatch report apply to neutralise the mismatch in tax outcomes arising from this structure?

Answer

7. Under the primary rule in Recommendation 4, Country A should restrict the deductibility of any interest expense that is also deductible under the laws of Country B. A similar adjustment should be made in Country B under the secondary rule where the deduction is not denied in the residence jurisdiction.

Analysis

8. A double deduction outcome arises where the same payment, expense or losses deductible in the jurisdiction where such payment is made, expenses are incurred or losses are suffered (the payer jurisdiction) and another jurisdiction (the investor jurisdiction). In this case where the actual interest expenditure is treated as incurred directly through the branch, it is the branch jurisdiction that should be treated as the payer jurisdiction and the residence jurisdiction as the investor jurisdiction.

9. Recommendation 4 applies to neutralise a double deduction outcome to the extent it gives rise to a branch mismatch. Recommendation 4.1 requires the adjustment to first be made in the investor jurisdiction (in this case, at the level of the head office). Recommendation 4.3 provides that no mismatch will arise to the extent that a deduction is set off against an amount that is included in income under the laws of both the investor

and the payer jurisdictions (i.e. dual inclusion income). In this case, however, because of the operation of the branch exemption in Country A, none of B Branch's income is subject to tax in Country A in the relevant period.

Application of the primary response

10. In this case it is the residence jurisdiction that should apply the primary response. Country A should deny A Co's duplicate deductions to the extent it gives rise to a mismatch in tax outcomes. Table B.9.2 sets out the required adjustment under the rule.

11. The head office would be entitled to carry the denied interest deduction forward in accordance with its ordinary domestic rules and this deduction would be available to be set off against future dual inclusion income. Such dual inclusion income could arise, for example, where the rules for allocating income and expense to the branch and head office resulted in the same item of income being treated as taxable under the laws of both jurisdictions.

Table B.9.2. **Adjustment under Recommendation 4.1 (a)**

Country A			Country B		
	Tax	Book		Tax	Book
Income			**Income**		
Interest from Customer A	110	110			
Interest from Customer B	-	110	Interest from Customer B	110	-
Expenditure			**Expenditure**		
Interest paid to bank	(50)	(100)	Interest paid to bank	(100)	-
Adjustment	50				
Net return		120	Net return		-
Taxable income	110		Taxable income	10	

Application of the defensive rule

12. In the event Country A does not apply the primary response, Country B should deny a deduction for the payment to the extent necessary to prevent that deduction from being set off against income that is not dual inclusion income. The total amount of adjustment required under Country B law would be calculated as set out in Table B.9.3.

Table B.9.3. **Adjustment under Recommendation 4.1 (b)**

Country A			Country B		
	Tax	Book		Tax	Book
Income			**Income**		
Interest from Customer A	110	110			
Interest from Customer B	-	110	Interest from Customer B	110	-
Expenditure			**Expenditure**		
Interest paid to bank	(50)	(100)	Interest paid to bank	(100)	-
			Adjustment	50	
Net return		120	Net return		-
Taxable income	60		Taxable income	60	

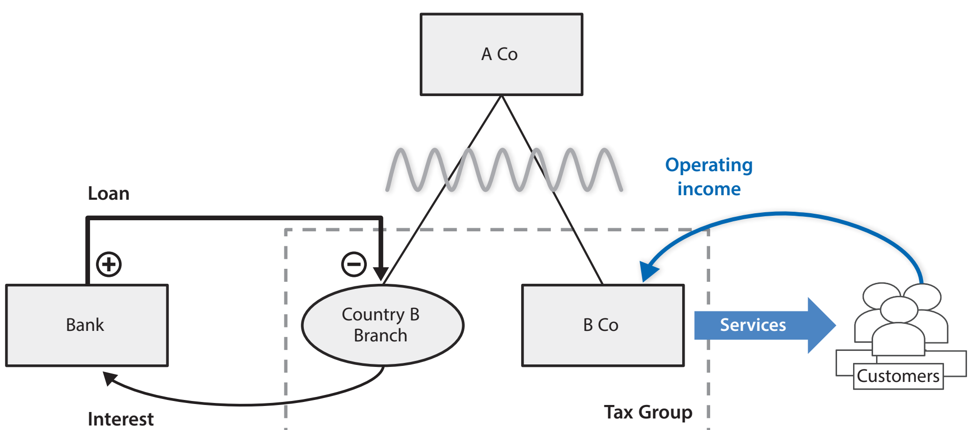
13. The overall impact of the recommendations in this report on this arrangement is that any deductions for actual expenditure that are taken into account in both the head office and the branch are denied at the level of the head office (or the branch) to the extent the counterparty jurisdiction allows the deduction to be set off against non-dual inclusion income. The structure and ordering of the rules in Recommendations 3 and 4 ensures that the mismatch is neutralised without giving rise to the risk of double taxation.

Example 10

DD outcomes and treating mismatch as arising at the time of offset

Facts

1. The facts of this example are the same as that illustrated in Figure 4 of this report. A Co has established both a branch operation and a subsidiary in Country B. Country B law permits the subsidiary (B Co) and the Country B Branch to form a group for tax purposes, which allows the expenditure incurred by the Country B Branch to be offset against the income of the subsidiary.



2. The net income (and loss) positions of A Co, Country B Branch and B Co over a 3 year period are as follows:

Table B.10.1. **Net income (and loss) positions**

	Year 1	Year 2	Year 3	Total
A Co (excluding branch)	800	800	800	2 400
B Branch	(400)	(200)	300	(300)
B Co	200	300	400	900
Total	600	900	1 500	3 000

3. If Country B Branch is treated as taxable under the laws of Country A, then the interest expense incurred by the branch will give rise to separate deductions under the laws of Country A and Country B. A Co will claim the deduction directly on the head office tax return, while this interest expenditure can also be offset, under Country B law, against the operating income derived by the subsidiary (i.e. against non-dual inclusion income). This structure therefore permits the same interest expense to be set off simultaneously against different items of income in the residence and branch jurisdiction.

4. The expected tax outcome in Country A (assuming that both countries apply tax at a marginal rate of 30%) will be as set out in Table B.10.2.

Table B.10.2. **Expected tax outcomes in Country A**

	Year 1	Year 2	Year 3	Total
Net income under Country A law	400	600	1 100	2 400
Tax under Country A law	(120)	(180)	(330)	(630)
Direct foreign tax credit			60	60
Total tax paid				(570)

5. As set out in Table B.10.2, the net income of A Co includes the expense incurred by the branch in the first two years. In Year 3 the branch turns a profit (perhaps due to the fact that a portion of the outstanding loan is forgiven by the bank) resulting in net income in the branch of 300.

6. It is assumed, for these purposes, that A Co will be entitled to a direct foreign tax credit for tax paid on branch income (as calculated under the laws of Country A). Accordingly the net tax paid in Country A over the three year period (taking into account the foreign tax credit) will be 570.

7. The expected tax outcome in Country B will be as follows:

Table B.10.3. **Expected tax outcomes in Country B**

	Year 1	Year 2	Year 3	Total
Net income under Country B law	(200)	100	700	600
Apply loss carry-forward		(100)	(100)	
Income subject to tax	0	0	600	
Tax under Country B law			(180)	(180)
Total tax paid				(180)

8. As set out in Table B.10.3, the combined net income of Country B Branch and B Co includes a deduction for the interest expense incurred by the branch in the first two years. This results in no net income and carry-forward losses for the first two years in respect of Country B's operations. In Year 3, the branch and company both become profitable resulting in net income under Country B law of 700 and income subject to tax (after the application of carry-forward losses) of 600.

9. The net effect of this structure is, therefore, that the group has both a net return and taxable income from its global operations of 3000. However, the effect of taking into account the foreign tax credit under Country A law is that A Co only pays tax of 750 on this income (out of an expected tax burden of 900).

Question

10. How does Recommendation 4 of the branch mismatch report apply to neutralise the mismatch in tax outcomes arising from this structure?

Answer

11. Recommendation 4.3 provides that a double deduction will give rise to a branch mismatch only to the extent the payer jurisdiction allows the deduction to be set off against an amount that is not dual inclusion income. Jurisdictions should have the flexibility to make the adjustment under the double deduction rule either at the time the deduction arises or at the time the deduction is actually offset against dual inclusion income under the laws of the payer jurisdiction.

Analysis

12. Recommendation 4 provides that a double deduction will give rise to a branch mismatch only to the extent the payer jurisdiction allows the deduction to be set off against an amount that is not dual inclusion income. This ambiguity as to the timing of the disallowance gives the jurisdiction the flexibility to make the adjustment under the double deduction rule either:

a. at the time the deduction arises (following the treatment set out in Recommendation 6.3 of the Action 2 Report (OECD, 2015))

b. at the time the deduction is actually offset against dual inclusion income under the laws of the payer jurisdiction.

Adjustments provided for under Action 2 Report (OECD, 2015)

13. Table B.10.4 sets out the required adjustment under the primary rule in Recommendation 4 adopting the timing rules set out in Recommendation 6.3 of the Action 2 Report (OECD, 2015).

Table B.10.4. **Adjustment under Recommendation 4**

	Year 1	Year 2	Year 3	Total
Net income under Country A law	400	600	1 100	2 400
Adjustment under Rec. 4	400	200	(300)	
	800	800	800	
Tax under Country A law	(240)	(240)	(240)	(720)
Direct foreign tax credit	0	0	0	0
Total tax paid				(720)

14. The net income that would otherwise be included under Country A law is adjusted by the application of the primary rule in Recommendation 4. In the first two years there is a reduction in the amount of the deduction claimed through the branch (owing to the fact that in both these years the deduction may be set off against non-dual inclusion income). In year 3 the branch derives 300 of dual inclusion income and the branch loss that has been carried-forward is offset against the dual inclusion income in that year.

15. Although the branch income is subject to tax in Country B in year 3, Country A does not allow a foreign tax credit for this tax as the income of the branch for Country A purposes is zero (after application of carry-forward losses).

Adjustments made at time payment is set off against non-dual inclusion income

16. In order to defer the adjustment under Recommendation 4 until such time as the expenditure is actually set off against dual inclusion income, the taxpayer may need to maintain two memorandum accounts to keep track of:

a. The amount of the potential adjustment that could be made under Recommendation 4. This memorandum account is similar to that recorded on the second line of Table B.10.4 and reflects the extent to which double deductions have exceeded dual inclusion income in each period.

b. The change in the amount of unused loss in the branch jurisdiction. This memorandum account adjusts (up or down) the amount in the first account by reference to the change in the amount of the unused loss in the counterparty jurisdiction. This memorandum account measures the change in the carry-forward loss amount recorded in line 2 of Table B.10.3.

17. Table B.10.5 sets out the required adjustment under the primary rule where the adjustment is deferred until the double deduction is actually set off against non-dual inclusion income in Country B.

Table B.10.5. **Adjustment under Recommendation 4**

	Year 1	Year 2	Year 3	Total
Net income under Country A law	400	600	1 100	2 400
Adjustment under Rec. 4	400	200	(300)	
Change in loss carry forward under Country B law	(200)	100	100	
	600	900	900	
Tax under Country A law	(180)	(270)	(270)	(720)
Direct foreign tax credit	0	0	0	0
Total tax paid				(720)

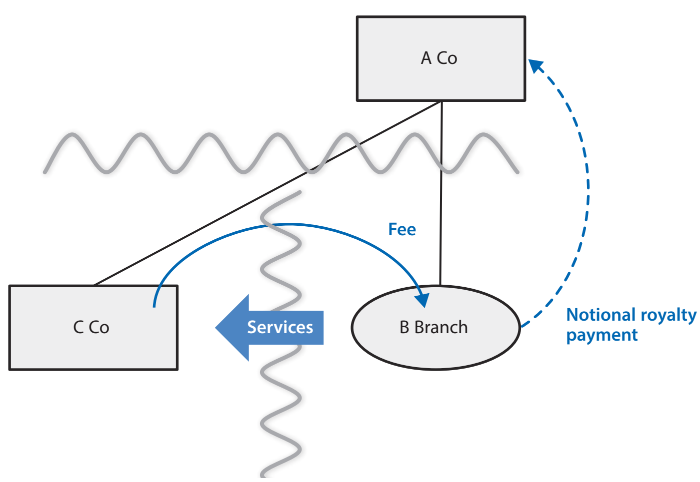
Example 11

Imported mismatch

Facts

1. This example is based on the one set out in Figure 5 of this report. In this example A Co supplies services to a related company (C Co) through a branch located in Country B. The services supplied by the branch exploit underlying intangibles owned by A Co. Country B attributes the ownership of those intangibles to the head office and treats the branch as making a corresponding arm's length payment to compensate A Co for the use of those intangibles.

2. This deemed payment is deductible under Country B law but is not recognised under Country A law (because Country A attributes the ownership of the intangibles to the branch). Meanwhile, the services income received by the branch is exempt from taxation under Country A law due to an exemption or exclusion for branch income in Country A. It is assumed that there is no rule in either Country A or B addressing the mismatch in tax outcomes arising from the notional payment.



3. As a consequence, the (deductible) service fee paid by C Co (which is treated as exempt under Country A law) is offset against a deduction under a branch mismatch arrangement resulting in an indirect D/NI outcome.

Question

4. How does the imported mismatch rule in Recommendation 5 apply to neutralise the mismatch in tax outcomes arising from this structure?

Answer

5. The services fee paid by C Co will be subject to adjustment under Recommendation 5 to the extent the income from the payment is set off against a deduction under a branch mismatch arrangement. Recommendation 5 will not apply, however, if the income of Country B Branch was taxable under Country A law so that the service fee paid to Country B Branch was treated as dual inclusion income by Country B. In such a case, the offset of the service fee against the deemed branch payment would not give rise to a branch mismatch, and there would therefore be no adjustment required under the imported branch mismatch rule.

Analysis

Services fee is subject to adjustment under Recommendation 5

6. An imported branch mismatch is a transaction or series of transactions that is entered into between members of a controlled group that directly or indirectly funds deductible expenditure under a branch mismatch arrangement.

7. In this case, the deemed royalty payment made by the Country B Branch to its head office is a branch mismatch payment under Recommendation 3 and the services fee paid by C Co to B Co is a deductible payment that directly funds that deductible expenditure under that branch mismatch arrangement. The arrangement (including the branch mismatch and the payment by C Co) has been entered into between members of the same control group and accordingly the payment of the services fee will be subject to adjustment under Recommendation 5.1.

No imported mismatch if income of the branch is taxable under the laws of the residence jurisdiction

8. A payment that is set off against a deduction under a deemed branch payment should not be treated as having funded expenditure under an imported mismatch arrangement if that payment gives rise to dual inclusion income. Accordingly, if the Country B Branch was a taxable branch (so that the service fee paid to Country B Branch was included in income in both Countries A and B) then the payment would not be treated as funding expenditure under an imported branch mismatch and there would no adjustment required under Recommendation 5.

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OECD PUBLISHING, 2, rue André-Pascal, 75775 PARIS CEDEX 16
(23 2017 07 1 P) ISBN 978-92-64-27795-3 – 2017

OECD/G20 Base Erosion and Profit Shifting Project

Neutralising the Effects of Branch Mismatch Arrangements

ACTION 2: INCLUSIVE FRAMEWORK ON BEPS

Addressing base erosion and profit shifting is a key priority of governments around the globe. In 2013, OECD and G20 countries, working together on an equal footing, adopted a 15-point Action Plan to address BEPS. Beyond securing revenues by realigning taxation with economic activities and value creation, the OECD/G20 BEPS Project aims to create a single set of consensus-based international tax rules to address BEPS, and hence to protect tax bases while offering increased certainty and predictability to taxpayers. A key focus of this work is to eliminate double non-taxation. However in doing so, new rules should not result in double taxation, unwarranted compliance burdens or restrictions to legitimate cross-border activity.

This 2017 report sets out recommendations for branch mismatch rules that would bring the treatment of these structures into line with the treatment of hybrid mismatch arrangements as set out in the 2015 Report on Neutralising the Effects of Hybrids Mismatch Arrangements (Action 2 Report). Branch mismatches arise where the ordinary rules for allocating income and expenditure between the branch and head office result in a portion of the net income of the taxpayer escaping the charge to taxation in both the branch and residence jurisdiction. Unlike hybrid mismatches, which result from conflicts in the legal treatment of entities or instruments, branch mismatches are the result of differences in the way the branch and head office account for a payment made by or to the branch. The 2017 report identifies five basic types of branch mismatch arrangements that give rise to one of three types of mismatches: deduction / no inclusion (D/NI) outcomes, double deduction (DD) outcomes, and indirect deduction / no inclusion (indirect D/NI) outcomes. This report includes specific recommendations for improvements to domestic law intended to reduce the frequency of branch mismatches as well as targeted branch mismatch rules which adjust the tax consequences in either the residence or branch jurisdiction in order to neutralise the hybrid mismatch without disturbing any of the other tax, commercial or regulatory outcomes. The annexes of the report summarise the recommendations and set out a number of examples illustrating the intended operation of the recommended rules.

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ISBN 978-92-64-27795-3
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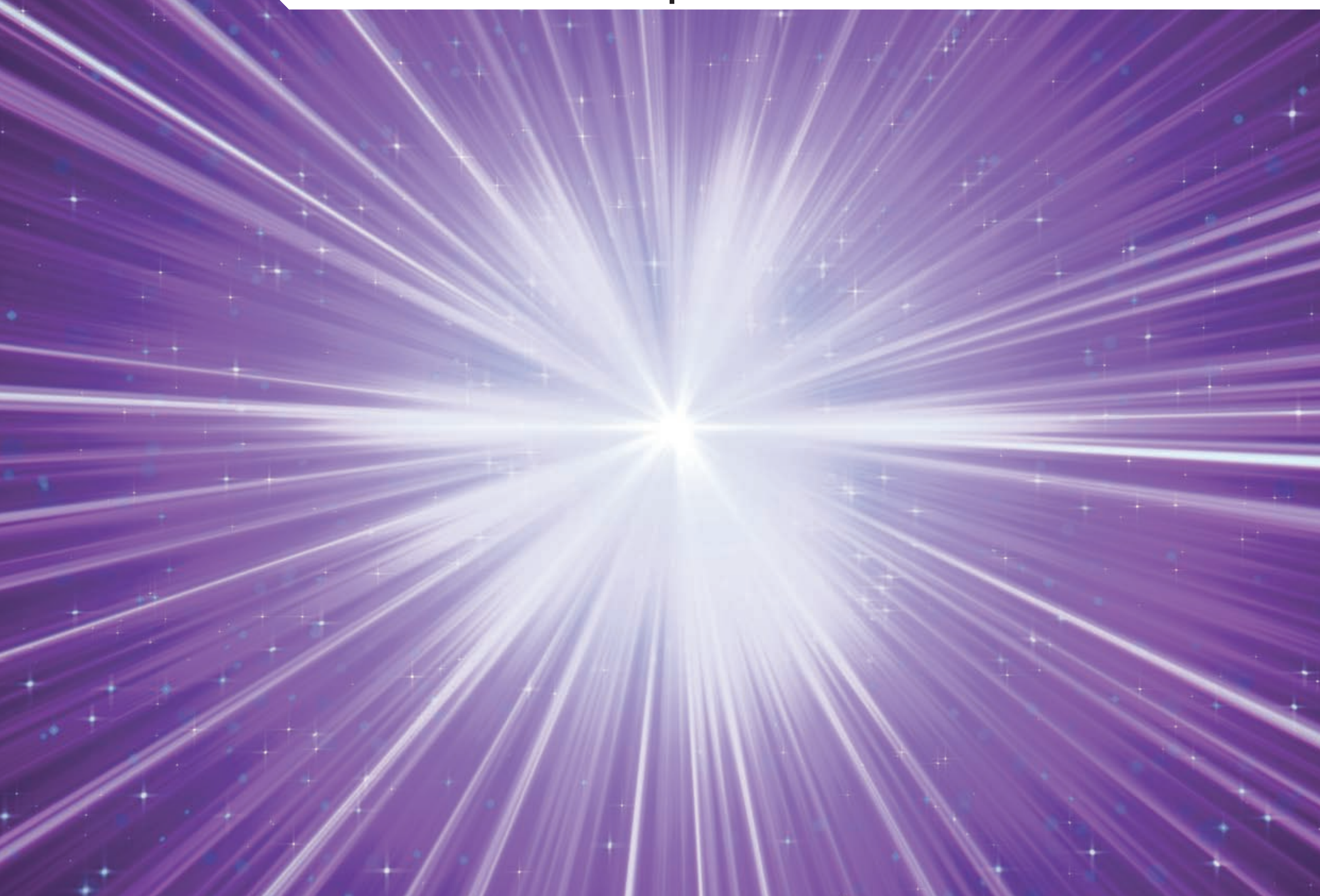
Neutralising the Effects of Hybrid Mismatch Arrangements

ACTION 2: 2015 Final Report



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Please cite this publication as:
OECD (2015), *Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2 - 2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris.
http://dx.doi.org/10.1787/9789264241138-en

ISBN 978-92-64-24108-4 (print)
ISBN 978-92-64-24113-8 (PDF)

Series: OECD/G20 Base Erosion and Profit Shifting Project
ISSN 2313-2604 (print)
ISSN 2313-2612 (online)

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Foreword

International tax issues have never been as high on the political agenda as they are today. The integration of national economies and markets has increased substantially in recent years, putting a strain on the international tax rules, which were designed more than a century ago. Weaknesses in the current rules create opportunities for base erosion and profit shifting (BEPS), requiring bold moves by policy makers to restore confidence in the system and ensure that profits are taxed where economic activities take place and value is created.

Following the release of the report *Addressing Base Erosion and Profit Shifting* in February 2013, OECD and G20 countries adopted a 15-point Action Plan to address BEPS in September 2013. The Action Plan identified 15 actions along three key pillars: introducing coherence in the domestic rules that affect cross-border activities, reinforcing substance requirements in the existing international standards, and improving transparency as well as certainty.

Since then, all G20 and OECD countries have worked on an equal footing and the European Commission also provided its views throughout the BEPS project. Developing countries have been engaged extensively via a number of different mechanisms, including direct participation in the Committee on Fiscal Affairs. In addition, regional tax organisations such as the African Tax Administration Forum, the *Centre de rencontre des administrations fiscales* and the *Centro Interamericano de Administraciones Tributarias*, joined international organisations such as the International Monetary Fund, the World Bank and the United Nations, in contributing to the work. Stakeholders have been consulted at length: in total, the BEPS project received more than 1 400 submissions from industry, advisers, NGOs and academics. Fourteen public consultations were held, streamed live on line, as were webcasts where the OECD Secretariat periodically updated the public and answered questions.

After two years of work, the 15 actions have now been completed. All the different outputs, including those delivered in an interim form in 2014, have been consolidated into a comprehensive package. The BEPS package of measures represents the first substantial renovation of the international tax rules in almost a century. Once the new measures become applicable, it is expected that profits will be reported where the economic activities that generate them are carried out and where value is created. BEPS planning strategies that rely on outdated rules or on poorly co-ordinated domestic measures will be rendered ineffective.

Implementation therefore becomes key at this stage. The BEPS package is designed to be implemented via changes in domestic law and practices, and via treaty provisions, with negotiations for a multilateral instrument under way and expected to be finalised in 2016. OECD and G20 countries have also agreed to continue to work together to ensure a consistent and co-ordinated implementation of the BEPS recommendations. Globalisation requires that global solutions and a global dialogue be established which go beyond OECD and G20 countries. To further this objective, in 2016 OECD and G20 countries will conceive an inclusive framework for monitoring, with all interested countries participating on an equal footing.

A better understanding of how the BEPS recommendations are implemented in practice could reduce misunderstandings and disputes between governments. Greater focus on implementation and tax administration should therefore be mutually beneficial to governments and business. Proposed improvements to data and analysis will help support ongoing evaluation of the quantitative impact of BEPS, as well as evaluating the impact of the countermeasures developed under the BEPS Project.

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Table

Abbreviations and acronyms

BEPS	Base Erosion and Profit Shifting
CFA	Committee on Fiscal Affairs
CFC	Controlled Foreign Company
CIV	Collective Investment Vehicle
CRS	Common Reporting Standard (Standard for Automatic Exchange of Financial Account Information in Tax Matters)
DD	Double deduction
D/NI	Deduction / no inclusion
FIF	Foreign Investment Fund
FTA	Forum on Tax Administration
GAAP	Generally Accepted Accounting Practice
IFRS	International Financial Reporting Standards
JITSIC	Joint International Tax Shelter Information and Collaboration
OECD	Organisation for Economic Co-operation and Development
PE	Permanent Establishment
REIT	Real Estate Investment Trust
TRACE	Treaty Relief and Compliance Enhancement
WP1	Working Party No.1 on Tax Conventions and Related Questions
WP11	Working Party No.11 on Aggressive Tax Planning

Executive summary

Hybrid mismatch arrangements exploit differences in the tax treatment of an entity or instrument under the laws of two or more tax jurisdictions to achieve double non-taxation, including long-term deferral. These types of arrangements are widespread and result in a substantial erosion of the taxable bases of the countries concerned. They have an overall negative impact on competition, efficiency, transparency and fairness.

With a view to increasing the coherence of corporate income taxation at the international level, the OECD/G20 BEPS Project called for recommendations regarding the design of domestic rules and the development of model treaty provisions that would neutralise the tax effects of hybrid mismatch arrangements. This report sets out those recommendations: Part I contains recommendations for changes to domestic law and Part II sets out recommended changes to the OECD Model Tax Convention. Once translated into domestic and treaty law, these recommendations will neutralise hybrid mismatches, by putting an end to multiple deductions for a single expense, deductions without corresponding taxation or the generation of multiple foreign tax credits for one amount of foreign tax paid. By neutralising the mismatch in tax outcomes, the rules will prevent these arrangements from being used as a tool for BEPS without adversely impacting cross-border trade and investment.

This report supersedes the interim report *Neutralising the Effect of Hybrid Mismatch Arrangements* (OECD, 2014) that was released as part of the first set of BEPS deliverables in September 2014. Compared to that report, the recommendations in Part I have been supplemented with further guidance and practical examples to explain the operation of the rules in further detail. Further work has also been undertaken on asset transfer transactions (such as stock-lending and repo transactions), imported hybrid mismatches, and the treatment of a payment that is included as income under a controlled foreign company (CFC) regime. The consensus achieved on these issues is reflected in the report. As indicated in the September 2014 report, countries remain free in their policy choices as to whether the hybrid mismatch rules should be applied to mismatches that arise under intra-group hybrid regulatory capital. Where one country chooses not to apply the rules to neutralise a hybrid mismatch in respect of a particular hybrid regulatory capital instrument, this does not affect another country's policy choice of whether to apply the rules in respect of the particular instrument.

Part I

Part I of the report sets out recommendations for rules to address mismatches in tax outcomes where they arise in respect of payments made under a hybrid financial instrument or payments made to or by a hybrid entity. It also recommends rules to address indirect mismatches that arise when the effects of a hybrid mismatch arrangement are imported into a third jurisdiction. The recommendations take the form of linking rules that align the tax treatment of an instrument or entity with the tax treatment in the counterparty jurisdiction but otherwise do not disturb the commercial outcomes. The rules apply automatically and there is a rule order in the form of a primary rule and a secondary or defensive rule. This prevents more than one country applying the rule to the same arrangement and also avoids double taxation.

The recommended primary rule is that countries deny the taxpayer's deduction for a payment to the extent that it is not included in the taxable income of the recipient in the counterparty jurisdiction or it is also deductible in the counterparty jurisdiction. If the primary rule is not applied, then the counterparty jurisdiction can generally apply a defensive rule, requiring the deductible payment to be included in income or denying the duplicate deduction depending on the nature of the mismatch.

The report recognises the importance of co-ordination in the implementation and application of the hybrid mismatch rules to ensure that the rules are effective and to minimise compliance and administration costs for taxpayers and tax administrations. To this end, it sets out a common set of design principles and defined terms intended to ensure consistency in the application of the rules.

Part II

Part II addresses the part of Action 2 aimed at ensuring that hybrid instruments and entities, as well as dual resident entities, are not used to obtain unduly the benefits of tax treaties and that tax treaties do not prevent the application of the changes to domestic law recommended in Part I.

Part II first examines the issue of dual resident entities, i.e. entities that are residents of two States for tax purposes. It notes that the work on Action 6 will address some of the BEPS concerns related to the issue of dual resident entities by providing that cases of dual residence under a tax treaty would be solved on a case-by-case basis rather than on the basis of the current rule based on the place of effective management of entities. This change, however, will not address all BEPS concerns related to dual resident entities, domestic law changes being needed to address other avoidance strategies involving dual residence.

Part II also deals with the application of tax treaties to hybrid entities, i.e. entities that are not treated as taxpayers by either or both States that have entered into a tax treaty (such as partnerships in many countries). The report proposes to include in the *OECD Model Tax Convention* (OECD, 2010) a new provision and detailed Commentary that will ensure that benefits of tax treaties are granted in appropriate cases to the income of these entities but also that these benefits are not granted where neither State treats, under its domestic law, the income of such an entity as the income of one of its residents.

Finally, Part II addresses potential treaty issues that could arise from the recommendations in Part I. It first examines treaty issues related to rules that would result in the denial of a deduction or would require the inclusion of a payment in ordinary income and concludes that tax treaties would generally not prevent the application of these rules. It then examines the impact of the recommendations of Part I with respect to tax treaty rules related to the elimination of double taxation and notes that problems could arise in the case of bilateral tax treaties that provide for the application of the exemption method with respect to dividends received from foreign companies. The report describes possible treaty changes that would address these problems. The last issue dealt with in Part II is the possible impact of tax treaty rules concerning non-discrimination on the recommendations of Part I; the report concludes that, as long as the domestic rules that will be drafted to implement these recommendations are properly worded, there should be no conflict with these non-discrimination provisions.

Part I

Recommendations for domestic law

Introduction to Part I

Background

1. The role played by hybrid mismatch arrangements in aggressive tax planning has been discussed in a number of OECD reports. For example, an OECD report on *Addressing Tax Risks Involving Bank Losses* (OECD, 2010) highlighted their use in the context of international banking and recommended that revenue bodies "bring to the attention of their government tax policy officials those situations which may potentially raise policy issues, and, in particular, those where the same tax loss is relieved in more than one country as a result of differences in tax treatment between jurisdictions, in order to determine whether steps should be taken to eliminate that arbitrage/mismatch opportunity." Similarly the OECD report on *Corporate Loss Utilisation through Aggressive Tax Planning* (OECD, 2011) recommended countries "consider introducing restrictions on the multiple use of the same loss to the extent they are concerned with these results."

2. As a result of concerns raised by a number of OECD member countries, the OECD undertook a review with interested member countries to identify examples of tax planning schemes involving hybrid mismatch arrangements and to assess the effectiveness of response strategies adopted by those countries. That review culminated in a report on *Hybrid Mismatch Arrangements: Tax Policy and Compliance Issues* (Hybrids Report, OECD, 2012). The Hybrids Report concludes that the collective tax base of countries is put at risk through the operation of hybrid mismatch arrangements even though it is often difficult to determine unequivocally which individual country has lost tax revenue under the arrangement. Apart from impacting on tax revenues, the Hybrids Report also concluded that hybrid mismatch arrangements have a negative impact on competition, efficiency, transparency and fairness. The Hybrids Report set out a number of policy options to address such hybrid mismatch arrangements and concluded that domestic law rules which link the tax treatment of an entity, instrument or transfer to the tax treatment in another country had significant potential as a tool to address hybrid mismatch arrangements. Although such "linking rules" make the application of domestic law more complicated, the Hybrids Report noted that such rules are not a novelty as, in principle, foreign tax credit rules, subject to tax clauses and controlled foreign company (CFC) rules often do exactly that.

Action 2 of the BEPS Action Plan

3. Action 2 calls for the development of "model treaty provisions and recommendations regarding the design of domestic rules to neutralise the effects of hybrid instruments and entities." The Action Item states that this may include:

(a) Changes to the OECD Model Tax Convention to ensure that hybrid instruments and entities (as well as dual resident entities) are not used to obtain the benefits of treaties unduly;

(b) Domestic law provisions that prevent exemption or non-recognition for payments that are deductible by the payer;

(c) Domestic law provisions that deny a deduction for a payment that is not includible in income by the recipient (and is not subject to taxation under CFC or similar rules);

(d) Domestic law provisions that deny a deduction for a payment that is also deductible in another jurisdiction; and

(e) Where necessary, guidance on co-ordination or tie-breaker rules if more than one country seeks to apply such rules to a transaction or structure.

Part I recommendations

4. Part I of this report sets out the recommendations for the design of the domestic law rules called for under Action 2. It recommends specific improvements to domestic law, designed to achieve a better alignment between those laws and their intended tax policy outcomes (specific recommendations) and the introduction of linking rules that neutralise the mismatch in tax outcomes under a hybrid mismatch arrangement without disturbing any of the other tax, commercial or regulatory consequences (hybrid mismatch rules).

5. In terms of specific changes to domestic law, Chapters 2 and 5 of this report recommend improvements to domestic law rules that:

(a) Deny a dividend exemption, or equivalent relief from economic double taxation, in respect of deductible payments made under financial instruments.

(b) Introduce measures to prevent hybrid transfers being used to duplicate credits for taxes withheld at source.

(c) Alter the effect of CFC and other offshore investment regimes to bring the income of hybrid entities within the charge to taxation under the laws of the investor jurisdiction.

(d) Encourage countries to adopt appropriate information reporting and filing requirements in respect of tax transparent entities established within their jurisdiction.

(e) Restrict the tax transparency of reverse hybrids that are members of a control group.

6. In addition to these specific recommendations, Part I also sets out recommendations for hybrid mismatch rules that adjust the tax outcomes under a hybrid mismatch arrangement in one jurisdiction in order to align them with the tax outcomes in the other jurisdiction. These recommendations target payments under a hybrid mismatch arrangement that give rise to one of the three following outcomes:

(a) *Payments that give rise to a deduction / no inclusion outcome* (D/NI outcome), i.e. payments that are deductible under the rules of the payer jurisdiction and are not included in the ordinary income of the payee.

(b) *Payments that give rise to a double deduction outcome* (DD outcome), i.e. payments that give rise to two deductions in respect of the same payment.

(c) *Payments that give rise to an indirect D/NI outcome*, i.e. payments that are deductible under the rules of the payer jurisdiction and that are set-off by the payee against a deduction under a hybrid mismatch arrangement.

D/NI outcomes

7. Both payments made under hybrid financial instruments and payments made by and to hybrid entities can give rise to D/NI outcomes. In respect of such hybrid mismatch arrangements this report recommends that the response should be to deny the deduction in the payer jurisdiction. In the event the payer jurisdiction does not neutralise the mismatch, this report recommends a defensive rule that would require the payment to be included as ordinary income in the payee jurisdiction. Specific recommendations and recommendations for hybrid mismatch rules that are designed to address D/NI outcomes are set out in Chapters 1 to 5.

DD outcomes

8. As well as producing D/NI outcomes, payments made by hybrid entities can, in certain circumstances, also give rise to DD outcomes. In respect of such payments this report recommends that the primary response should be to deny the duplicate deduction in the parent jurisdiction. A defensive rule, that would require the deduction to be denied in the payer jurisdiction, would only apply in the event the parent jurisdiction did not adopt the primary response. Specific recommendations and recommendations for hybrid mismatch rules designed to address DD outcomes are set out in Chapters 6 and 7.

Indirect D/NI outcomes

9. Once taxpayers have entered into a hybrid mismatch arrangement between two jurisdictions without effective hybrid mismatch rules, it is a relatively simple matter for the effect of that mismatch to be shifted into a third jurisdiction (through the use of an ordinary loan, for example). Therefore, in order to protect the integrity of the recommendations, this report further recommends that a payer jurisdiction deny a deduction for a payment where the payee sets the income from that payment off against expenditure under a separate hybrid mismatch arrangement. Recommendations for the design and application of an imported mismatch rule neutralising such indirect D/NI outcomes are set out in Chapter 8.

Mismatch

10. The extent of a mismatch is determined by comparing the tax treatment of the payment under the laws of each jurisdiction where the mismatch arises. A D/NI mismatch generally occurs when a payment or part of a payment that is treated as deductible under the laws of one jurisdiction is not included in ordinary income by any other jurisdiction. A DD mismatch arises to the extent that all or part of the payment that is deductible under the laws of another jurisdiction is set-off against non-dual inclusion income.

11. The hybrid mismatch rules focus on payments and whether the nature of that payment gives rise to a deduction for the payer and ordinary income for the payee. Rules that entitle taxpayers to a unilateral tax deduction for invested equity without requiring the taxpayer to make a payment, such as regimes that grant deemed interest deductions

for equity capital, are economically closer to a tax exemption or similar taxpayer specific concessions and do not produce a mismatch in tax outcomes in the sense contemplated by Action 2. Such rules, and rules having similar effect, will, however, be considered separately in the context of the implementation of these recommendations.

12. The hybrid mismatch rules are not generally intended to pick-up mismatches that are attributable to differences in the value ascribed to a payment. For example, gains and losses from foreign currency fluctuations on a loan can be said to give rise to mismatches in tax outcomes but these mismatches are attributable to differences in the measurement of the value of payment (rather than its character) and can generally be ignored for the purposes of the hybrid mismatch rules.

Hybrid element

13. While cross-border mismatches arise in other contexts (such as the payment of deductible interest to a tax exempt entity), the only types of mismatches targeted by this report are those that rely on a hybrid element to produce such outcomes. Some arrangements exploit differences between the transparency or opacity of an entity for tax purposes (hybrid entities) and others involve the use of hybrid instruments, which generally involve a conflict in the characterisation of the instrument (and hence the tax treatment of the payments made under it). Hybrid instruments and entities can also be embedded in a wider arrangement or group structure to produce indirect D/NI outcomes.

14. In most cases the causal connection between the hybrid element and the mismatch will be obvious. There are some challenges, however, in identifying the hybrid element in the context of hybrid financial instruments. Because of the wide variety of financial instruments and the different ways jurisdictions tax them, it has proven impossible, in practice, for this report to comprehensively identify and accurately define all those situations where cross-border conflicts in the characterisation of a payment under a financing instrument may lead to a mismatch in tax treatment. Rather than targeting these technical differences, the focus of this report is on aligning the treatment of cross-border payments under a financial instrument so that amounts that are treated as a financing expense by the issuer's jurisdiction are treated as ordinary income in the holder's jurisdiction. Accordingly this report recommends that a financial instrument should be treated as hybrid where a payment under the instrument gives rise to a mismatch in tax outcomes and the mismatch can be attributed to the terms of the instrument.

Rule order

15. In order to avoid the risk of double taxation, Action 2 also calls for "guidance on the co-ordination or tie-breaker rules where more than one country seeks to apply such rules to a transaction or structure." For this reason the rules recommended in this report are organised in a hierarchy so that a jurisdiction does not need to apply the hybrid mismatch rule where there is another rule operating in the counterparty jurisdiction that is sufficient to neutralise the mismatch. The report recommends that every jurisdiction introduce all the recommended rules so that the effects of hybrid mismatch arrangements are neutralised even if the counterparty jurisdiction does not have effective hybrid mismatch rules.

Scope

16. Overly broad hybrid mismatch rules may be difficult to apply and administer. Accordingly, each hybrid mismatch rule has its own defined scope, which is designed to

achieve an overall balance between a rule that is comprehensive, targeted and administrable.

17. Table 1.1 provides a general overview of the hybrid mismatch rules recommended in this report.

Table 1.1 General Overview of the Recommendations

Mismatch	Arrangement	Specific recommendations on improvements to domestic law	Recommended hybrid mismatch rule		
			Response	Defensive rule	Scope
D/NI	Hybrid financial instrument	No dividend exemption for deductible payments Proportionate limitation of withholding tax credits	Deny payer deduction	Include as ordinary income	Related parties and structured arrangements
	Disregarded payment made by a hybrid		Deny payer deduction	Include as ordinary income	Control group and structured arrangements
	Payment made to a reverse hybrid	Improvements to offshore investment regime Restricting tax transparency of intermediate entities where non-resident investors treat the entity as opaque	Deny payer deduction	-	Control group and structured arrangements
DD	Deductible payment made by a hybrid		Deny parent deduction	Deny payer deduction	No limitation on response, defensive rule applies to control group and structured arrangements
	Deductible payment made by dual resident		Deny resident deduction	-	No limitation on response
Indirect D/NI	Imported mismatch arrangements		Deny payer deduction	-	Members of control group and structured arrangements

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Chapter 1

Hybrid Financial Instrument Rule

Recommendation 1

1. Neutralise the mismatch to the extent the payment gives rise to a D/NI outcome

The following rule should apply to a payment under a financial instrument that results in a hybrid mismatch and to a substitute payment under an arrangement to transfer a financial instrument:

(a) The payer jurisdiction will deny a deduction for such payment to the extent it gives rise to a D/NI outcome.

(b) If the payer jurisdiction does not neutralise the mismatch then the payee jurisdiction will require such payment to be included in ordinary income to the extent the payment gives rise to a D/NI outcome.

(c) Differences in the timing of the recognition of payments will not be treated as giving rise to a D/NI outcome for a payment made under a financial instrument, provided the taxpayer can establish to the satisfaction of a tax authority that the payment will be included as ordinary income within a reasonable period of time.

2. Definition of financial instrument and substitute payment

For the purposes of this rule:

(a) A financial instrument means any arrangement that is taxed under the rules for taxing debt, equity or derivatives under the laws of both the payee and payer jurisdictions and includes a hybrid transfer.

(b) A hybrid transfer includes any arrangement to transfer a financial instrument entered into by a taxpayer with another person where:

(i) the taxpayer is the owner of the transferred asset and the rights of the counterparty in respect of that asset are treated as obligations of the taxpayer; and

(ii) under the laws of the counterparty jurisdiction, the counterparty is the owner of the transferred asset and the rights of the taxpayer in respect of that asset are treated as obligations of the counterparty.

Ownership of an asset for these purposes includes any rules that result in the taxpayer being taxed as the owner of the corresponding cash-flows from the asset.

(c) A jurisdiction should treat any arrangement where one person provides money to another in consideration for a financing or equity return as a financial instrument to the extent of such financing or equity return.

(d) Any payment under an arrangement that is not treated as a financial instrument under the laws of the counterparty jurisdiction shall be treated as giving rise to a mismatch only to the extent the payment constitutes a financing or equity return.

Recommendation 1 (*continued*)

(e) A substitute payment is any payment, made under an arrangement to transfer a financial instrument, to the extent it includes, or is payment of an amount representing, a financing or equity return on the underlying financial instrument where the payment or return would:

(i) not have been included in ordinary income of the payer;

(ii) have been included in ordinary income of the payee; or

(iii) have given rise to hybrid mismatch;

if it had been made directly under the financial instrument.

3. Rule only applies to a payment under a financial instrument that results in a hybrid mismatch

A payment under a financial instrument results in a hybrid mismatch where the mismatch can be attributed to the terms of the instrument. A payment cannot be attributed to the terms of the instrument where the mismatch is solely attributable to the status of the taxpayer or the circumstances in which the instrument is held.

4. Scope of the rule

This rule only applies to a payment made to a related person or where the payment is made under a structured arrangement and the taxpayer is party to that structured arrangement.

5. Exceptions to the rule

The primary response in Recommendation 1.1(a) should not apply to a payment by an investment vehicle that is subject to special regulation and tax treatment under the laws of the establishment jurisdiction in circumstances where:

(a) The tax policy of the establishment jurisdiction is to preserve the deduction for the payment under the financial instrument to ensure that:

(i) the taxpayer is subject to no or minimal taxation on its investment income; and

(ii) that holders of financial instruments issued by the taxpayer are subject to tax on that payment as ordinary income on a current basis.

(b) The regulatory and tax framework in the establishment jurisdiction has the effect that the financial instruments issued by the investment vehicle will result in all or substantially all of the taxpayer's investment income being paid and distributed to the holders of those financial instruments within a reasonable period of time after that income was derived or received by the taxpayer.

(c) The tax policy of the establishment jurisdiction is that the full amount of the payment is:

(i) included in the ordinary income of any person that is a payee in the establishment jurisdiction; and

(ii) not excluded from the ordinary income of any person that is a payee under the laws of the payee jurisdiction under a treaty between the establishment jurisdiction and the payee jurisdiction.

(d) The payment is not made under a structured arrangement.

The defensive rule in Recommendation 1.1(b) will continue to apply to any payment made by such an investment vehicle.

Overview

18. The policy behind Recommendation 1 is to prevent a taxpayer from entering into structured arrangements or arrangements with a related party that exploit differences in the tax treatment of a financial instrument to produce a D/NI outcome. The rule aligns the tax treatment of payments under a financial instrument by adjusting the amount of deductions allowed under the laws of the payer jurisdiction, or the amount of income to be included in the payee jurisdiction, as appropriate, in order to eliminate the mismatch in tax outcomes. Recommendation 1 applies to three different types of financing arrangement:

(a) Arrangements that are treated as debt, equity or derivative contracts under local law ("financial instruments").

(b) Arrangements involving the transfer of financial instruments where differences in the tax treatment of that arrangement result in the same financial instrument being treated as held by more than one taxpayer ("hybrid transfers").

(c) Arrangements involving the transfer of financial instruments where a payment is made in substitution for the financing or equity return on the transferred asset and differences between the tax treatment of that payment and the underlying return on the instrument have the net-effect of undermining the integrity of the hybrid financial instrument rule ("substitute payments").

Arrangements treated as financial instruments under local law

19. Recommendation 1 is primarily targeted at arrangements that are taxed as debt, equity or derivative contracts (i.e. financial instruments) under the laws of the payer and payee jurisdictions. While the Recommendation encourages jurisdictions to extend their existing rules for taxing financial instruments to cover any arrangement to the extent it produces an equity or financing return, it is recognised that the final determination of the type of arrangements falling within the definition of a financial instrument (and therefore potentially subject to adjustment under the hybrid financial instrument rule) must ultimately be left to each jurisdiction.

20. Although Recommendation 1 is described as applying to "hybrid financial instruments", it does not specify the particular features of a financial instrument that make it "hybrid". The wide variety of financial instruments and the different ways they can be characterised and treated for tax purposes make it impossible to comprehensively and accurately identify all the situations where a payment under the instrument can give rise to a hybrid mismatch. Rather the hybrid financial instrument rule focuses on whether the payment is expected to give rise to a mismatch in tax outcomes and whether that mismatch is attributable to differences in the way the instrument is taxed under the laws of the payer and payee jurisdictions.

21. If the conditions for the application of the hybrid financial instrument rule are satisfied then the response recommended in the report is to align the tax treatment of the payments made under the arrangement so that the payer is not entitled to claim a deduction for the financing or equity return paid under the arrangement unless the payment is treated as ordinary income of the payee. The mechanics and rule order for the adjustments are set out in Recommendation 1.1. The primary recommendation is for the payer jurisdiction to deny a deduction to the extent the payment gives rise to a D/NI outcome. If the payer jurisdiction does not apply the recommended response, then the

defensive rule calls on the payee jurisdiction to treat the deductible payment as ordinary income under a financial instrument.

22. The primary and defensive rules are limited to adjusting the tax consequences that flow from the difference in the tax treatment of the instrument and should not generally affect the underlying character of the payment (e.g. whether it is treated as interest or a dividend) or the quantification or tax treatment of a taxpayer's overall gain or loss on the acquisition or disposal of an asset acquired under a financial instrument.

Hybrid transfers

23. A hybrid transfer is any arrangement to transfer a financial instrument where, as a consequence of the economics of the transaction and the way it is structured, the laws of two jurisdictions take opposing views on who is the owner of the underlying return on the transferred asset. Payments under a hybrid transfer generally give rise to a D/NI outcome where one party to the transfer claims a deduction for the underlying financial or equity return on the transferred asset that is paid (or treated as paid) to the counterparty under the terms of the hybrid transfer, while the counterparty treats that same payment as a direct return on the underlying financial instrument itself (and therefore excluded or exempt from taxation). Recommendation 1 deems this type of asset transfer to be financial instrument so that the D/NI outcome arising under such an arrangement falls within the scope of the hybrid financial instrument rule, regardless of how the hybrid transfer is characterised under local law.

24. Because hybrid transfers are treated as a type of financial instrument, the same rules will apply for testing whether the mismatch in tax outcomes is a hybrid mismatch. A D/NI outcome under a hybrid transfer will only be subject to adjustment under the hybrid financial instrument rule where the mismatch can be attributed to differences in the tax treatment of the arrangement under the laws of the payer and payee jurisdictions and any adjustment required to be made under that rule will be limited to the tax consequences that flow from that difference in the tax treatment.

Substitute payments

25. The final category of arrangements that are brought within the scope of Recommendation 1 are transfers of financial instruments where the transferee receives a payment in substitution for the financing or equity return on the transferred asset (a substitute payment) and differences between the tax treatment of substitute payment and the underlying return on the instrument have the potential to undermine the integrity of the hybrid financial instrument rule. A substitute payment that gives rise to a D/NI outcome will be subject to adjustment under the hybrid financial instrument rule where the underlying financing or equity return on the transferred asset would otherwise have been taxable in the hands of the transferor or is treated as exempt or excluded from income in the hands of the transferee or where the transfer has the effect of taking financial instrument outside of the scope of the hybrid financial instrument rule.

26. Unlike the other rules in Recommendation 1, which only apply where and to the extent the mismatch is attributable to the terms of the instrument, the substitute payment rules apply to any type of D/NI outcome regardless of how it arises.

Recommendation 1.1 - Neutralise the mismatch to the extent the payment gives rise to a D/NI outcome

27. The hybrid financial instrument rule applies to substitute payments and payments under a financial instrument to the extent those payments give rise to a D/NI outcome.

Payment

28. The definition of "payment" is set out in further detail in Recommendation 12. A payment is any transfer of value and includes an amount that is *capable of being paid* such as a future or contingent obligation to make a payment. As illustrated in **Example 1.13**, the definition of payment includes the accrual of a future payment obligation even when that accrued amount does not correspond to any increase in the payment obligation during that period. The definition specifically excludes, however, payments that are only deemed to be made for tax purposes and that do not involve the creation of any new economic rights between the parties. Thus, as illustrated in **Example 1.14**, the hybrid financial instrument rule does not apply to an adjustment resulting from a deemed interest charge. Such adjustments are made purely for tax purposes and do not correspond to any present or future transfer of value.

D/NI outcome

29. A payment gives rise to a D/NI outcome to the extent it is deductible under the laws of the payer jurisdiction and not included in income under the laws of any jurisdiction where the payment is treated as being received (the payee jurisdiction). The hybrid financial instrument rule only looks to the expected tax treatment of the arrangement, based on the terms of the instrument and the character of the payments made under it, to determine whether the payment gives rise to a mismatch.

Deductible

30. A payment will be treated as "deductible" if, after a proper consideration of the character of the payment and its tax treatment under the laws of the payer jurisdiction, the payer is entitled to take the payment into account as a deduction in calculating its taxable income. A payment under a financial instrument will be treated as deductible to the extent that payment is treated as a separate deductible item under local law. Deductible payments made under a financial instrument will generally include interest, as well as: issue discount and redemption premiums; facilities and lending fees and payments under a derivative contract to the extent they are treated as separate items of deductible expenditure.

31. The concept of "deductible" also extends to payments that trigger other types of "equivalent tax relief". The meaning of this term is illustrated in **Example 1.11** where a dividend payment gives rise to a tax credit that can be set-off against a tax liability of the payer or refunded to the shareholder. While such credits are usually provided as a means of relieving economic double taxation on distributed income, in that example, the dividend that triggers the credit is not subject to a second layer of tax under the laws of the payer jurisdiction. The credit is therefore economically equivalent to a deduction in that, in the absence of any tax at the shareholder level, it will have the effect of reducing the amount of income under the arrangement that will be subject to the tax at the full rate in the payer jurisdiction.

Included in ordinary income

32. Ordinary income refers to those categories of income that are subject to tax at the taxpayer's full marginal rate and that do not benefit from any exemption, exclusion, credit or other tax relief applicable to particular types of payments (such as indirect credits for underlying tax on the income of the payer). A payment will be treated as included in ordinary income to the extent that, after a proper determination of the character and treatment of the payment under the laws of the payee jurisdiction, the payment is required to be incorporated as ordinary income into a calculation of the payee's taxable income. A payment of ordinary income under a financial instrument will generally include interest, dividends and other investment returns that are subject to tax at the payee's full marginal rate. Income is considered subject to tax at the taxpayer's full marginal rate, however, notwithstanding that the tax on the inclusion is reduced by a credit or other equivalent tax relief granted by the payee jurisdiction for withholding tax or other taxes imposed by the source jurisdiction on the payment itself.

D/NI outcomes in respect of payments under a financial instrument

33. Because the hybrid financial instrument rule looks only to the expected tax treatment of the payment under the laws of the counterparty jurisdiction, rather than its actual tax treatment in the hands of the counterparty, it is not necessary for the taxpayer or tax administration to know the counterparty's tax status or how that payment was actually treated for tax purposes in order to determine whether the payment has given rise to a mismatch. The application of this principle is illustrated in **Example 1.26** where a trader acquires shares under an asset transfer agreement. That example notes that, the trader's deduction for the acquisition cost of the shares will not be a product of the terms of the instrument and the character of the payments made under it but rather of the particular status of the payer. Therefore the fact that transfer agreement may constitute a hybrid transfer (so that the consideration paid for the shares is treated as payment under a financial instrument), will not result in the payment being treated as giving rise to a D/NI outcome in a hybrid financial instrument. The same principle is illustrated in **Example 1.29** where a share trader is entitled to interest in respect of the unpaid purchase price under a share sale agreement. The interest component of the purchase price is treated as giving rise to a separate deductible expense under the laws of the purchaser's jurisdiction while the share trader treats the entire amount payable under the share sale agreement as consideration for the sale of the shares. In this case the payment is treated as giving rise to a mismatch in tax outcomes, even though the payment is, in fact, included by the share trader in ordinary income as proceeds from the disposal of a trading asset.

D/NI outcomes in respect of substitute payments

34. The substitute payment rules apply to any actual mismatch in tax outcomes, regardless of the circumstances in which the deduction arises, including any amount taken into account in calculating the gain or loss on disposal of a trading asset. The application of the substitute payment rule is illustrated in **Example 1.34** where a trader acquires shares under a hybrid transfer. Although, in that case, the deduction claimed by the trader for the payment of the manufactured dividend is not attributable to the terms of the instrument (and therefore does not give rise to hybrid mismatch under a financial instrument), the example notes that the payment may still be a substitute payment that is subject to adjustment under the hybrid financial instrument rule.

Interaction between Recommendation 1.1(a) and Recommendation 2.1

35. The determination of whether a D/NI outcome has arisen requires a proper assessment of the legal character of the instrument and tax treatment of the payment in each jurisdiction. A payment under a hybrid financial instrument will not be treated as giving rise to a D/NI outcome if the mismatch will be neutralised in the counterparty jurisdiction by a specific rule designed to align the tax treatment of the payment with tax policy outcomes applicable to an instrument of that nature. Specific rules of this nature will include any rules in the payee jurisdiction, consistent with Recommendation 2.1, that limit the availability of a dividend exemption or equivalent tax relief to payments that are not deductible for tax purposes. This principle is illustrated in **Example 1.1** where a taxpayer borrows money under an interest bearing loan from a related taxpayer in another jurisdiction. The borrower is allowed a deduction for the interest paid on the loan while the holder treats the payment as a dividend. A proper consideration of the character of the payment and its tax treatment in both jurisdictions will take into account rules in the payee jurisdiction designed to limit double taxation relief on dividend payments made out of after-tax profits. Accordingly, if the payee jurisdiction does not extend its dividend exemption to a payment that is deductible under the laws of the payer jurisdiction, then no mismatch will arise for the purposes of the hybrid financial instrument rule. Similar outcomes are identified in **Example 1.2**, **Example 1.3** and **Example 1.4**.

Inclusion under a CFC regime

36. The hybrid financial instrument rule is only intended to operate where the payment gives rise to a mismatch in tax outcomes and is not intended to give rise to economic double taxation. In certain cases, a payment under a hybrid financial instrument that gives rise to a D/NI outcome, as between the payer and payee jurisdictions, may be included in income under a CFC regime. A country aiming to avoid economic double taxation in these cases should consider how to address the mismatch in tax outcomes under the hybrid financial instrument rule in light of the fact that the payment has been included in ordinary income by the shareholder under a CFC regime and determine whether the CFC inclusion is to be considered as included in ordinary income for the purposes of determining whether there is a D/NI outcome under the hybrid financial instrument rule.

37. Where a country takes into account a CFC inclusion in the parent jurisdiction, a taxpayer seeking to rely on that inclusion in order to avoid an adjustment under the hybrid financial instrument rule should only be able to do so in circumstances where it can satisfy the tax administration that the payment has been fully included under the laws of the relevant jurisdiction and is subject to tax at the full rate. This will include demonstrating that:

(a) The payment would ordinarily be required to be brought into account under the CFC rules in the parent jurisdiction.

(b) The CFC regime actually requires the payment to be attributed to the shareholder (i.e. the payment does not qualify for an active income exception).

(c) The quantification and timing rules of the CFC regime have actually brought that payment into account as ordinary income on the shareholder's return.

38. In addition, payments that are treated as exempt from the hybrid financial instrument rule on the grounds of a CFC inclusion should be eligible for such exemption only to the extent that the payment:

(a) Has not been treated as reduced or offset by any deduction or other relief other than in respect of expenditure incurred by the parent under the laws of the parent jurisdiction.

(b) Does not carry an entitlement to any credit or other relief.

(c) Does not give rise to an imported mismatch.

39. The application of this principle is illustrated in **Example 1.24** where a company makes an intra-group payment under a hybrid financial instrument. In that example, the CFC regime in the parent jurisdiction that treats certain items of passive income (e.g. rents, royalties and interest) derived by controlled foreign entities as "CFC income" attributable to shareholders in proportion to their shareholding in the CFC. In that example the taxpayer is not able to treat an item of CFC income as included in ordinary income under the laws of the jurisdiction of the parent to the extent that income was treated as reduced by expenditure incurred by the payee or to the extent that payment was sheltered by any credit or other relief in the parent jurisdiction. The example also notes that the taxpayer would further need to satisfy the tax administration that the payment has not been set-off against a hybrid deduction under an imported mismatch arrangement.

40. The rules that determine the type, amount and timing of attributed income under a CFC regime can make the determination of whether an amount has been included in ordinary income under a CFC regime difficult and fact intensive. Accordingly, when introducing the hybrid financial instrument rule into local law, countries may wish to balance the need to avoid double taxation outcomes and the burden of making such a determination in setting any materiality thresholds that a taxpayer must meet before a taxpayer can treat a CFC inclusion as reducing the amount of adjustment required under the rule.

Application of the rule in the case of exemption, reduced rate or credit

41. A deductible payment will be treated as giving rise to a mismatch whenever the payee jurisdiction subjects the payment to taxation at a rate that is less than the full marginal rate imposed on ordinary income, regardless of the form in which such tax relief is provided. The particular mechanism for securing tax relief in the payee jurisdiction, whether by exclusion or through exemption, rate reduction, credit or any other method, should not generally impact on the final outcome under the hybrid financial instrument rule.

42. Certain countries tax different types of income at different rates. For example, business or employment income may be taxed at a different rate from investment income. These differences should be taken into account in determining whether the payment has been subject to tax at the taxpayer's full marginal rate. In the context of the hybrid financial instrument rule, the payee's *full marginal rate* is the tax the payee would expect to pay on ordinary income derived under a financial instrument, so that a mismatch will not arise, for the purposes of the hybrid financial instrument rule, simply because the payee jurisdiction taxes income from financial instruments at a lower rate than other types of income. This is illustrated in **Example 1.3** where an interest payment is subject to tax at a reduced rate of taxation under the laws of the payee jurisdiction. **Example 1.3** notes that if the reduced tax rate is no less than the rate that applies to any other payment of ordinary income under a financial instrument (such as ordinary interest on a loan) then no mismatch will arise for the purposes of the hybrid financial instrument rule.

Partial exemption or reduced rate

43. In those cases where the payee jurisdiction only provides taxpayers with a partial exemption or reduced rate on a payment under a hybrid financial instrument, the amount of the deduction that is denied should generally be no more than is necessary to eliminate the mismatch in tax outcomes between the payer and payee jurisdictions and a deduction should continue to be allowed to the extent the payment is subject to tax in the payee jurisdiction at the full rate. The application of this principle is illustrated in **Example 1.2**, where the payee jurisdiction provides a partial tax exemption for a payment of interest under a subordinated loan, and in **Example 1.3**, where the payment under the hybrid financial instrument is subject to tax in the payee jurisdiction at 10% of the normal corporate rate.

44. Cases of partial tax relief usually arise in the context of debt/equity hybrids where the payee jurisdiction treats the payment as a dividend and provides for a credit, reduced rate or partial exemption which does not fully relieve the shareholder from tax on that dividend. In most cases, these types of payments will be covered by Recommendation 2.1, which deals with the granting of tax relief for deductible dividends, so that, in practice, the number of actual cases where the payer jurisdiction will be called upon to deny the deduction in respect of a payment that is subject to partial relief may, in fact, be limited.

45. In the cases of partial dividend relief, the limitation on tax relief in the payee jurisdiction may be intended to re-capture the benefit of a reduced rate or deferred taxation at the corporate level or to offset the benefit of other shareholder tax reliefs (such deductibility of interest expenses). In these cases, a full denial of the deduction will be more effective at preserving the intended tax policy outcomes in the payee jurisdiction and achieve a better equality of outcomes with payments under an ordinary equity instrument. This approach would need to be applied on a jurisdiction by jurisdiction basis, taking into account the tax policy outcomes in the counterparty jurisdiction, and may be unnecessary if the payee jurisdiction introduces comprehensive rules restricting taxation relief for deductible dividends in line with Recommendation 2.1.

Calculating the amount of the adjustment in the case of an underlying foreign tax credit

46. Unless the payee jurisdiction has adopted Recommendation 2.1 and denies the benefit of an underlying foreign tax credit for a deductible dividend, the primary response under the hybrid financial instrument rule will be to deny a deduction for such a payment to the extent it is sheltered from tax in the payee jurisdiction.

47. Unlike other methods of relieving double taxation, which either exempt the income in the payee jurisdiction or subject it to tax at a reduced rate, foreign tax credits are sensitive to changes in the calculation of the payer's taxable income and differences in tax rates between jurisdictions. The interaction between the hybrid financial instrument rule (which ensures a payment is not deductible to the extent it is sheltered from tax by an underlying foreign tax credit) and the foreign tax credit (which provides the shareholder with a credit for underlying taxes paid by the company) can also result in a circular calculation where the denial of a deduction in the payee jurisdiction under the hybrid financial instrument rule (due to the fact that payment is not included in ordinary income) increases the amount of tax payable in that jurisdiction, which, in turn, has the effect of increasing the foreign tax credit available in the payee jurisdiction and reducing the amount of the payment that is treated as included in ordinary income.

48. In practice the complexity of foreign tax credit calculations (including the potential for circularity) can make it difficult for taxpayers to calculate the required adjustment under the hybrid financial instrument rule. Accordingly, when determining the amount of the adjustment a taxpayer is required to make in respect of a payment that carries an entitlement to a foreign tax credit, countries should strike a balance between rules that are clear and easy to apply and that avoid the risk of double taxation. **Example 1.4** sets out an illustration of the type of adjustment that can be made under a hybrid financial instrument rule to a payment that is subject to an underlying foreign tax credit. In that case the payer country denies the deduction only to the extent the credit is sufficient to shelter the payment from taxation. In that example the potential for circularity can be avoided if the payee jurisdiction does not allow the crediting of any increased foreign taxes that arise due to the application of the hybrid financial instrument rule or if the incremental tax increase does not, in practice, have a material impact on the amount of the underlying foreign tax credit attributable to the payment.

Nature and extent of the adjustment required

49. The underlying principle of the hybrid financial instrument rule is to align the tax treatment of payments under a financial instrument so that a taxpayer cannot claim a deduction for a financing expense unless that payment is required to be included in ordinary income in the payee jurisdiction. The primary and secondary rules achieve this outcome by adjusting the amount of deductions allowed under the laws of the payer jurisdiction, or the amount of income to be included in the payee jurisdiction, as appropriate, in order to ensure that the aggregate tax treatment of the arrangement is the same regardless of the form of instrument used or whether the adjustment is made in the payee or payer jurisdictions. The adjustment should be no more than is necessary to neutralise the instrument's hybrid effect and should result in an outcome that is proportionate and that does not lead to double taxation.

No impact on other tax consequences

50. The adjustment in respect of a payment under a hybrid financial instrument does not affect the character of the payment made under it. Although the effect of the primary rule is to deny the payer a deduction, in order to bring the tax treatment of the payment in line with the tax treatment in the payee jurisdiction, the rule does not require a change to the character of the instrument or the payment made under the instrument for tax purposes. This is illustrated in **Example 1.1** where the hybrid financial instrument rule denies the payer a deduction for the interest payment made under a debt/equity hybrid but does not require the payer jurisdiction to treat the payment as a dividend for tax purposes.

Only adjust tax consequences that are attributable to the terms of the instrument

51. The adjustment to the tax consequences of a payment under a hybrid financial instrument should be confined to those that are attributable to the tax treatment of the instrument itself. The adjustment is not intended to impact on tax outcomes that are solely attributable to the status of the taxpayer or the context in which the instrument is held. **Example 1.5** and **Example 1.8** both describe cases where an adjustment under the defensive rule in the payee jurisdiction will not impact on the tax position of the taxpayer because that taxpayer is either not subject to tax on ordinary income or because it derives that income through an exempt branch. Although the payee may not be subject to any additional tax liability as a consequence of an adjustment under the secondary rule, the

primary rule can still apply to deny the deduction in the payer jurisdiction if the payment would be expected to give rise to a mismatch in tax outcomes.

52. This principle can further be illustrated by contrasting the outcomes described in **Example 1.27** and **Example 1.28**. In both these examples, the arrangement between the parties is an asset sale agreement that provides for the payment of the purchase price to be deferred for one year and for the purchase price to incorporate an adjustment equal to twelve months of interest on the unpaid purchase price. The purchaser's jurisdiction treats the interest portion of the purchase price as giving rise to a separate deductible payment for tax purposes while, under the laws of the seller's jurisdiction, the entire purchase price (including the interest component) is treated as consideration for the transfer of the asset. As described in **Example 1.27**, the asset sale agreement is treated as giving rise to a deductible financing expense for the purchaser and the purchaser's jurisdiction should therefore deny a deduction for that payment under the hybrid financial instrument rule. In **Example 1.28**, however, the purchaser acquires the asset as part of its activities as a trader and is able to include the purchase price as expenditure when calculating any taxable gain/loss on the asset. **Example 1.28** concludes that the hybrid financial instrument rule should not affect the ability of the trader to take the full amount payable under the asset transfer agreement into account when calculating the gain or loss on disposal of the asset. Taxpayers that buy and sell securities in the ordinary course of a business of dealing or trading in securities (such as securities dealers, banks and brokers) will treat the net profit or loss on each trade as included in taxable income, or deductible for tax purposes, as the case may be, regardless of the exact way in which the return on the transaction is accounted for or the manner in which the transaction is analysed for tax purposes. In **Example 1.34** a financial instrument is acquired by a trader under a hybrid transfer. Although the payment of the manufactured dividend under the share loan is deemed to be a payment under a financial instrument, the hybrid financial instrument rule will only operate to deny a deduction that is attributable to the terms of the instrument itself and will not prevent a trader from taking the expenditure incurred under the hybrid transfer into account in calculating the trader's overall (taxable) gain or loss on the asset.

Mismatch that is solely attributable to differences in the valuation of a payment

53. In order for a D/NI outcome to arise, there must be a difference in the way a payment is measured and characterised under the laws of the payer and payee jurisdictions. Differences in tax outcomes that are solely attributable to differences in the value ascribed to a payment (including through the application of transfer pricing) do not fall within the scope of the hybrid mismatch rule. If the amount of the payment is characterised and calculated in the same way under the laws of both jurisdictions, then differences in the value attributed to that amount under the laws of the payer and payee jurisdictions will not give rise to a D/NI outcome. In certain cases, however, particularly in the case of more complex financial instruments that incorporate both financing and equity returns, the way a payment is measured and characterised under local law may depend on the value attributed to each of its components and this difference in characterisation may give rise to a mismatch.

54. A mismatch does not arise simply because of differences resulting from converting foreign exchange into local or functional currency. This principle is illustrated in **Example 1.17**, where a fall in the value of the local currency results in foreign currency payments under a loan becoming more expensive in local currency terms. Under local law, the payer is entitled to a deduction for this increased cost. This deduction, however, is not reflected by a corresponding inclusion in the payee jurisdiction. The

difference in tax treatment does not give rise to a D/NI outcome, however, as the proportion of the interest and principal payable under the loan is the same under the laws of both jurisdictions. This principle is also illustrated in **Example 1.15**. That example considers the tax treatment of an equity premium that a noteholder receives on the maturity of a convertible note. The equity premium will not be treated as giving rise to a D/NI outcome simply because the payer and payee jurisdictions treat the shares received on conversion as having a different value for tax purposes. **Example 1.16** considers a situation where both the issuer and the holder treat a convertible note as being issued at a discount representing its equity value. The higher valuation given to the equity value of the note in the issuer's jurisdiction results in the issuer recognising a larger accrued discount, which results in greater portion of the payments being treated as deductible in the issuer's jurisdiction. The example concludes that, in this case, the way in which the component elements of the note are valued has a direct impact on the way a payment is measured and characterised for tax purposes and, accordingly, the difference in tax outcomes should be treated as giving rise to a mismatch in tax outcomes.

Timing differences

55. The hybrid financial instrument rule does not generally apply to differences in the timing of the recognition of payments under a financial instrument. The hybrid financial instrument rule should apply, however, where the taxpayer is not able to show that the mismatch in tax outcomes is merely one of timing. Recommendation 1.1(c) therefore clarifies that a payment will not be treated as giving rise to a D/NI outcome provided the tax administration can be satisfied that the payment under the instrument is expected to be included in income within a reasonable period of time.

Application of Recommendation 1.1(c)

56. A payment should not be treated as giving rise to a mismatch if it will be required to be included by the payee in ordinary income in an accounting period that commences within 12 months of the end of the payer's accounting period. If the payment does not meet the requirements of this safe harbour, the payer should still be entitled to a deduction for the payment if it can establish, to the satisfaction of the tax administration, that the payee can be expected to include the payment in ordinary income within a reasonable period of time.

Expected to be included in income

57. A payment can expected to be included in ordinary income where there was a reasonable expectation at the time the instrument was issued that the payment would be made and that such payment would be included in ordinary income by the payee at the time it was paid. If the terms of the instrument and other facts and circumstances indicate that the parties placed little commercial significance on whether payment would be made, or if the terms of the instrument are structured in such a way that such payment, when it is made, will not be treated as giving rise to ordinary income in the hands of the payee, then the payment cannot be said to be reasonably expected to be included in income.

Reasonable period of time

58. The determination of whether this payment will be made within a *reasonable period of time* should be based on the time period that might be expected to be agreed between unrelated parties acting at arm's length. This determination should take into

account such factors as the terms of the instrument, the circumstances in which it is held and the commercial objectives of the parties, taking into account the nature of the accrual and any contingencies or other commercial factors affecting payment. For example, a secured loan that is used to finance infrastructure investment may be expected to have longer payment terms than an unsecured loan that is used to fund working capital.

59. The application of these principles is illustrated in **Example 1.22** in respect of a subordinated loan where the interest is treated as deductible by the payer in the year it accrues but is only treated as income by the payee when it is actually paid. In that example, the lender is a minority shareholder in the borrower and there is a dividend blocker on the shares that prevents the borrower from making any distributions to its majority shareholder while there is accrued but unpaid interest on the loan. This type of contractual term incentivises the payer to make regular interest payments on the loan in order that it can continue to pay dividends to its majority shareholder and, accordingly, it can be concluded that the interest payments can be expected to be made within a reasonable period of time even in circumstances where the term of the loan is indefinite and interest payments are at the discretion of the borrower.

60. This outcome can be contrasted with the lending arrangement described in **Example 1.21** where the period over which interest accrues leads the tax administration to conclude that the parties have placed little commercial significance on whether payments under the loan will be made. Alternatively, in that example, interest may accrue over a shorter term but the lender has the power to waive its interest entitlement at any time before it is actually paid without adverse tax consequences. That example concludes that the taxpayer will be unable to establish, at the time the interest accrues, that the payment can reasonably be expected to be included in income within a reasonable period of time.

Recommendation 1.2 - Definition of financial instrument and substitute payment

61. Recommendation 1.2 defines when an arrangement should be treated as a financial instrument and when a payment should be treated as a substitute payment.

Definition of "financial instrument" to be determined under local law

62. The underlying policy of Recommendation 1 is to align the tax treatment of the payments made under a financing or equity instrument so that amounts that are not fully taxed in the payee jurisdiction are not treated as a deductible expense in the payer jurisdiction. Accordingly, Recommendation 1.2(c) encourages jurisdictions to treat any arrangement that produces a financing or equity return as a financial instrument and to tax those arrangements under the domestic rules for taxing debt, equity or derivatives.

63. The definitions of "equity return" and "financing return" set out in Recommendation 12.1 provide further detail on the types of payments that should be brought within the hybrid financial instrument rule under domestic implementing legislation. These terms are intended to be in line with those used in international and generally recognised accounting standards and to capture any instrument issued by a person that provides the holder with a return based on the time-value of money or enterprise risk.

64. The hybrid financial instrument rule should not, however, apply to: arrangements for the supply of services such as lease or licensing agreements; arrangements for the

assumption of non-financial risk (such as insurance) or to asset transfers that do not incorporate the payment of an equity or financing return.

65. Notwithstanding that countries should make reasonable endeavours to adopt similar definitions of financial instrument; there will continue to be cases where it is difficult to determine whether a contract should be treated as a financial instrument or some other type of agreement, such as sales contract or a contract for the assumption of risk. While Recommendation 1.2(c) encourages jurisdictions to ensure that the hybrid financial instrument rules apply to any arrangement to the extent it produces a financing or equity return, the rules are not intended to standardise the categories of financial instrument or to harmonise their tax treatment and, where the dividing line is unclear and the payment representing the financing or equity return is actually embedded into another transaction with a different character, it should be left to the laws of each country to determine whether and to what extent the payment is made under a financial instrument. Therefore, on the facts of any particular case, the question of whether an arrangement is a financial instrument (and therefore potentially subject to adjustment under the hybrid financial instrument rule) should be answered by reference to the domestic tax treatment of that arrangement.

Application of financial instrument definition to assets transfers

66. An arrangement that is treated as an asset transfer under local law will not generally be treated as a financial instrument under Recommendation 1, although, if such an arrangement is a hybrid transfer or incorporates a substitute payment, it may still be brought within the scope of the rule (see below). The application of the hybrid financial instrument rule to an ordinary asset transfer agreement is illustrated in **Example 1.26** where the purchase price paid by a trading entity to acquire shares gives rise to a D/NI outcome due to the fact that the trader is entitled to treat the purchase price as deductible, while the vendor does not include the payment in ordinary income. Although the payment gives rise to a D/NI outcome, the asset transfer agreement described in **Example 1.26** does not provide for an equity or financing return and therefore is outside both the language and intended scope of Recommendation 1.

67. **Example 1.27** provides an illustration of the type of transaction that could be treated as a financial instrument in one jurisdiction and an asset transfer in another. In this case the purchase price for the transfer of an asset includes an interest component which is intended to compensate the payee for the deferral in payment. The buyer treats the interest portion of the purchase price as giving rise to a separate deductible expense for tax purposes while the vendor treats the entire amount (including the interest component) as consideration for the transfer of the asset. In this case the example concludes that the payment is not subject to adjustment under the hybrid financial instrument rule in the jurisdiction of the vendor because the arrangement does not fall within the rules for taxing debt, equity or financial derivatives under local law. From the vendor's perspective, the transaction is indistinguishable from the transaction in **Example 1.26**. A further illustration is provided in **Example 1.30** where an agreement for the sale and purchase of shares in an operating subsidiary contains an earn-out arrangement that provides the vendor with a return based on enterprise risk. While some jurisdictions may treat this payment as deductible, other jurisdictions would treat this type of earn-out clause simply as a mechanic for calculating the purchase price for the sale of an asset and would not treat payments made under such a clause as an equity return under a financial instrument. It is therefore left to local law to determine whether the equity return is to be

characterised as a return under a financial instrument and brought within the scope of the hybrid financial instrument rule.

Application of the rule in cases where the counterparty does not treat the arrangement as a financial instrument

68. Taxpayers that enter into an arrangement that falls within the scope of the hybrid financial instrument rule should continue to apply the rule even when the counterparty does not treat the arrangement as a financial instrument and/or the counterparty jurisdiction has not implemented the report's recommendations. In such cases, however, the amount of the adjustment under the rule will be restricted to the amount of equity or financing return under the instrument. This principle is illustrated in **Example 1.25** where the lender provides finance to a related company under a finance lease. Although the lease is, in substance, a financing arrangement, the leasee treats the arrangement as an ordinary operating lease and the payments under the lease as deductible rental payments. The lessor is resident in a jurisdiction that has implemented the hybrid mismatch rules and, consistent with Recommendation 1.2, the lessor is required to treat the arrangement as a loan and the rental payments as periodic payments of interest and principal on that loan. The hybrid financial instrument rule is, however, only intended to capture mismatches that arise in respect of the equity or financing return and, accordingly, Recommendation 1.2(d) restricts the adjustment under the hybrid financial instrument rule to the extent of the financing return under the instrument.

Certain payments made to acquire a financial instrument treated as made under that financial instrument

69. A payment will be treated as made *under a financial instrument* if the payment is either required by the instrument or is in consideration for a release from a requirement under the instrument. The release from a requirement under a financial instrument does not, however, constitute a payment for the purposes of the hybrid financial iinstruemnt rule. This principle is illustrated in **Example 1.18** and **Example 1.20**. In **Example 1.18** a holder receives a one-off payment in consideration for agreeing to a change in the terms of a loan. The example concludes that the payment should be treated as a payment made under the instrument, as it is a payment in consideration for the release from an obligation under that instrument. In **Example 1.20** a parent company forgives a loan owed by one of its subsidiaries and claims a deduction for the unpaid principal and interest. Although the release of the debt does not trigger ordinary income for the subsidiary, the resulting D/NI outcome is not caught by the hybrid financial instrument rule because the release of rights under a financial instrument is not a payment under that financial instrument.

70. A payment made by a person in consideration for the transfer of an existing financial instrument is a payment for the disposal of the instrument rather than a payment made under it (although the payment to acquire that share or bond may include a substitute payment or be made under another separate financial instrument). This principle is illustrated in **Example 1.36** in respect of the transfer of a bond that carries the right to accrued but unpaid interest. The purchaser pays a premium for the bond that reflects this accrued interest component. The premium is deductible under the laws of the purchaser's jurisdiction and treated as giving rise to an exempt gain under the laws of the seller's jurisdiction. Although this payment gives rise to a mismatch in tax treatment the payment will not be treated as a "payment under a financial instrument" unless the

contract to acquire the bond is otherwise treated as a financial instrument under Recommendation 1.

71. A payment made to acquire an instrument should, however, be treated as a payment made under that instrument if the acquisition discharges, in whole or part, obligations owed under the instrument or neutralises the economic and tax consequences for the issuer. This is illustrated in **Example 1.19** where an issuer of a bond pays a premium to buy back a bond from the holder. While the cost of acquiring the bond from the holder is consideration for the transfer of the bond and not a payment required by the terms of the bond itself, the payment secures a release from the issuer's obligations under the instrument and will therefore be treated as a payment made under that financial instrument.

Hybrid transfers

72. The report recommends that jurisdictions treat certain transfers of financial instruments (*hybrid transfers*) as financial instruments within the scope of the hybrid financial instrument rule even when that jurisdiction would ordinarily treat payments made under that arrangement as made under an asset transfer agreement. A hybrid transfer is any arrangement to transfer a financial instrument where, as a consequence of the economics of the transaction and the way it is structured, the laws of two jurisdictions take opposing views on whether the transferor and transferee have ownership of the underlying asset. Ownership, in this context, means the owner of the payment flows on the underlying asset as opposed to legal ownership of the asset itself.

73. While a hybrid transfer can arise in the context of an ordinary sale and purchase agreement where there is a conflict in the determination of the timing of the asset transfer (see **Example 1.37**), the hybrid transfer rules are particularly targeted at sale and re-purchase (repo) and securities lending transactions where the rights and obligations of the parties are structured in such a way that the transferor remains exposed to the financing or equity return on the financial instrument transferred under the arrangement.

74. In the case of repo transaction that gives rise to a hybrid transfer, the transferor is taxed on the arrangement in accordance with its substance, so that the underlying transfer is ignored for tax purposes and the payments under the hybrid transfer are treated as payments under a financial instrument, while the transferee generally respects the legal arrangements entered into by the parties and treats the hybrid transfer as an asset sale. An illustration of a repo transaction that is treated as a hybrid transfer is set out in **Example 1.31**. In that example the parties enter into a collateralised loan that is structured as a repo over shares. The transferor's jurisdiction taxes the arrangement in accordance with its substance (treating the purchase price for the shares as a loan and the transferred shares as collateral for that loan) while the repo is taxed in the transferee's jurisdiction in accordance with its form (the sale and re-purchase of an asset). Both taxpayers therefore treat themselves as the owner of the subject matter of the repo (the transferred shares) and the arrangement therefore falls into the definition a hybrid transfer.

75. Examples of securities lending transactions that give rise to a hybrid transfer are set out in **Example 1.32**, **Example 1.33** and **Example 1.34** and also in **Example 2.2**. In these cases the transferee (the borrower under the arrangement) agrees to return the transferred securities (or their equivalent) plus any dividends or interest received on those securities during the term of the loan. The transferor's jurisdiction taxes the arrangement in accordance with its substance, disregarding the transfer and treating the transferor as if it continued to hold the underlying securities, while the transferee's jurisdiction treats the

transfer in accordance with its form and taxes the arrangement as the purchase and sale of securities.

76. Hybrid transfer's generally give rise to a D/NI outcome because one jurisdiction treats the equity or financing return on the transferred instrument as a deductible expense under that hybrid transfer, while the other jurisdiction treats that same amount as a return on the underlying asset (and, accordingly, as excluded or exempt from taxation or eligible for some other type of tax relief). Therefore, when applying the secondary rule, the payee may be required to make an adjustment to the tax treatment of the payment on the underlying instrument even though this payment is not treated by the payee jurisdiction as a payment under the hybrid transfer itself. Thus, in **Example 1.31** the transferee is required to apply the secondary rule to include a dividend payment on the transferred share in ordinary income despite the fact that, under local law, this payment would be regarded as a payment on the underlying shares and not a payment under the repo itself. In **Example 1.32** the transferee under a share-lending transaction makes a deductible payment of a manufactured dividend. Although the recipient of the manufactured dividend treats that dividend as having been paid on the underlying shares, the payment is treated as giving rise to a D/NI outcome under a hybrid financial instrument because of the deduction claimed by the counterparty to the share loan.

77. Hybrid transfers are treated as a type of hybrid financial instrument because they are, in substance, financial instruments rather than asset transfers and they give rise to a difference in tax treatment that allows them to be used as part of a structured arrangement to engineer a cross-border mismatch. As with other types of financial instrument, the hybrid transfer rules do not take into account whether the funds obtained under the transfer have been invested in assets that generate a taxable or exempt return. The adjustment that the transferor is required to make in respect of payment under a repo or stock loan will therefore not be affected by whether the transferor is taxable on the financing or equity return on the transferred asset. For example, the outcomes described in **Example 1.31** and **Example 1.33** are not affected by whether the transferor under the repo or the share lending arrangement, is taxable on the dividend it receives on the shares.

78. As hybrid transfers are a type of financial instrument, an adjustment is only required under the rule if the mismatch in outcomes can be attributed to the tax treatment of the hybrid transfer under the laws of the payer and payee jurisdictions. An adjustment to the tax treatment of payments under a hybrid transfer will not affect the ability of a trading entity to claim a genuine trading loss in respect of the disposal of an asset. This principle is explained further in **Example 1.34** and **Example 1.37**.

Substitute payments

79. The other category of asset transfers that are subject to adjustment under Recommendation 1 are transfers of financial instruments where the payment of a financing or equity return under that asset transfer gives rise to a D/NI outcome that has the effect of undermining the integrity of the hybrid financial instrument rules. The transfer will have this effect where:

(a) the transferor secures a better tax outcome on the payment under the asset transfer than it would have obtained if it had held onto the underlying instrument;

(b) the transferee treats the payment under the asset transfer as deductible while the return on the underlying instrument will be treated as exempt or excluded from income; or

(c) the transfer has the effect of taking instrument outside of the scope of the hybrid financial instrument rule.

80. The substitute payments rule neutralises any D/NI outcome in respect of the payment of a financing or equity return under asset transfer agreement when the transfer of the underlying financial instrument would give rise to one of the above outcomes. Under this rule a taxpayer that buys a financial instrument for a consideration that includes a financing or equity return, will be denied a deduction for the payment if: that return would have been included in ordinary income of the payee; would not have been included in ordinary income of the payer or would have given rise to hybrid mismatch if it had been made directly under the financial instrument.

81. The substitute payment rules apply to any type of D/NI outcome (regardless of whether such outcome is attributable to the terms of the instrument, the tax status of the parties or the context in which the asset is held). The rule is, however, confined to payments that give rise to a financing or equity return in respect of the underlying instrument. It would not ordinarily apply, for example, to a payment made to settle a claim for a breach of warranty under an asset sale agreement.

82. **Example 1.30**, **Example 1.35**, and **Example 1.36** explain the application of the hybrid financial instrument rule to substitute payments. In **Example 1.30** the hybrid financial instrument rule is applied to a purchase price adjustment under a share sale agreement where differences between the tax treatment of dividends and sale consideration in the payee/transferor jurisdiction allow the payee/transferor to substitute what would otherwise have been a taxable dividend for a non-taxable exchange gain. **Example 1.35** illustrates how the substitute payment definition prevents a payer/transferee manufacturing a deduction for a payment under an asset transfer agreement when the transferee has no economic loss. **Example 1.36** describes a situation where the transfer of a financial instrument takes the instrument outside the scope of the hybrid financial instrument rule. In that example the substitute payment definition will apply to adjust the tax consequences for the parties to the transfer to neutralise any mismatch in tax outcomes.

Recommendation 1.3 - Rule only applies to a payment under a financial instrument that results in a hybrid mismatch

83. Section 1.3 sets out the general rule for determining when a mismatch under a financial instrument is a hybrid mismatch.

Identifying the mismatch

84. A mismatch will arise in respect of a payment made under a financial instrument to the extent that the payment is deductible under the laws of one jurisdiction (the payer jurisdiction) and not included in ordinary income by a taxpayer under the laws of any other jurisdiction where the payment is treated as being received (the payee jurisdiction).

85. The identification of a mismatch as a hybrid mismatch under a financial instrument is primarily a legal question that requires an analysis of the general rules for determining the character, amount and timing of payments under a financial instrument in the payer and payee jurisdictions. In general it will not be necessary for the taxpayer or tax administration to know precisely how the payments under a financial instrument have actually been taken into account in the calculation of the counterparty's taxable income in order to apply the rule. It is expected that taxpayers will know their own tax position in

respect of a payment so that, in practice, a mismatch will be identified by comparing the actual tax treatment of an instrument in the taxpayer jurisdiction with its expected tax treatment in the counterparty jurisdiction.

86. In order to determine whether a payment has given rise to a mismatch, it is necessary to know the identity of the counterparty and the tax rules applying in the counterparty jurisdiction. In most cases the counterparty will be the person with the obligation (or right) to make (or receive) the payment and the counterparty jurisdiction will be the jurisdiction where that person is tax resident. In certain cases, however, where the counterparty is transparent or has a taxable presence in more than one jurisdiction, it may be necessary to look to the laws of more than one jurisdiction to determine whether the payment will give rise to a mismatch.

Deduction in any jurisdiction sufficient to trigger the application of the rule

87. A payment that is treated as paid under the laws of more than one jurisdiction only needs to be deductible under the laws of one jurisdiction in order to trigger a potential D/NI outcome. This principle is illustrated in **Example 1.23** where a hybrid entity borrows money from a related person in the same jurisdiction under an instrument that is treated as equity under local law. The hybrid entity is treated as making a non-deductible/exempt dividend payment for local law purposes but the payment under the instrument is treated as deductible under the laws of the parent jurisdiction. The arrangement therefore gives rise to a D/NI outcome even though, as between the direct payer and payee, there is no mismatch in tax treatment.

88. In those cases where the payer is transparent, the burden will be on the taxpayer claiming the benefit of the exemption or relief from taxation to establish, to the satisfaction of its own tax administration, that the payment has not given rise to a deduction under the laws of another jurisdiction.

Inclusion in any jurisdiction sufficient to discharge application of the rule

89. If the payment is brought into account as ordinary income in at least one jurisdiction, then there will be no mismatch for the rule to apply to. This principle is illustrated in **Example 1.8** which involves the payment of interest to a branch of a company that is resident in another jurisdiction. In this case it is necessary to also look to the laws of both the residence and the branch jurisdiction to definitively establish whether a mismatch has arisen.

90. It will be the taxpayer who has the burden of establishing, to the reasonable satisfaction of the tax administration, how the tax treatment of the payment in the other payee jurisdiction impacts on the amount of the adjustment required under the rule. The initial burden of proof may be discharged by the taxpayer demonstrating that the payment has actually been recorded as ordinary income on the tax return in the other jurisdiction.

Mismatch attributable to the terms of the instrument

91. The hybrid financing instrument rule only applies where the mismatch in tax treatment is attributable to the terms of the instrument rather than the status of the taxpayer or the context in which the instrument is held.

92. Differences in tax treatment that arise from applying different accounting policies to the same instrument will be treated as attributable to the terms of the instrument if the differences in accounting outcomes are based on the terms of the instrument itself. This is

illustrated in **Example 1.21** in respect of a payment under a bond that carries a contingent entitlement to interest. The loan is treated as debt under the laws of both the payee and payer jurisdictions. However, due to differences in the way the interest is accounted for tax purposes by the two countries, the interest is treated as deductible by the payer in the year it accrues but is only treated as income by the payee when (and if) such interest is actually paid. In this case the difference in accounting treatment gives rise to a hybrid mismatch unless the taxpayer can establish, to the satisfaction of the tax authority, that the payment will be included in income under the law of payee jurisdiction within a reasonable period of time.

93. It is not uncommon for the tax treatment of an instrument to depend on such factors as whether the issuer and holder are related or on the period an instrument has been held. Such factors directly affect the relationship between the holder and issuer and should be treated as part of the terms of the instrument. In **Example 1.1** the hybrid financial instrument rule is applied to a dividend payment, even though the exemption only applies where the payee has held more than 10% of the shares in the payer for at least one year prior to the payment date. **Example 1.13** provides an illustration of this principle in respect of a payer where the conditions for deductibility turn, in part, on whether the payment is made intra-group. The fact that the borrower and lender are members of the same group is an element of the relationship between the parties and should therefore be included within the terms of the loan instrument for the purposes of determining the application of the hybrid financial instrument rule notwithstanding that there may be no requirement for the loan to be held intra-group.

94. The *terms of the instrument* should also include any element directly affecting the relationship between the payer and the payee and the circumstances in which an instrument was issued or held if those circumstances are economically and commercially relevant to the relationship between the parties and affect the tax treatment of the instrument. This is illustrated in **Example 1.12** where all the shareholders subscribe for debt in proportion to their shareholding in the issuer. Under the laws of the holder's jurisdiction, debt that is issued in proportion to equity is re-characterised as a share and payments on such debt are treated as exempt dividends. The resulting difference in characterisation between the jurisdiction of the issuer and the holder gives rise to a mismatch in tax outcomes. The fact that the shareholder subscribes for debt in proportion to its shareholding is commercially significant to the relationship between the parties so that a mismatch in tax outcomes which is dependent on such facts should be treated as attributable to the terms of the instrument.

Mismatch that is solely attributable to the status of the taxpayer or the context in which the instrument is held

95. The test under Recommendation 1.3 for whether a payment under a financial instrument has given rise to a *hybrid* mismatch focuses on the ordinary or expected tax treatment of the instrument. A mismatch that is solely attributable to the status of the taxpayer or the context in which the financial instrument is held will not be a hybrid mismatch. One way of testing for whether a mismatch is attributable to the terms of the instrument is to pose a counterfactual test that asks whether the terms of the instrument were sufficient to bring about the mismatch in tax outcomes. This can be done by contrasting the parties' actual tax treatment with what it would have been if the instrument had been held directly and both the payer and payee were ordinary taxpayers that computed their income and expenditure in accordance with the ordinary rules applicable to taxpayers of the same type. If the same mismatch would have arisen had the

instrument been directly entered into by a taxpayer of ordinary status, then the mismatch will be attributable to the terms of the instrument itself rather than the status of the taxpayer or the context in which the instrument is held.

Tax status of the counterparty

96. The hybrid financial instrument rule does not apply to mismatches that are solely attributable to the status of the taxpayer. Where, however, the mismatch can also be attributed to the tax treatment of the instrument (i.e. the mismatch would have arisen even in respect of payment between taxpayers of ordinary status) the hybrid financial instrument rule will continue to apply although the adjustment may not, in practice have any impact on the tax position of the parties to the arrangement. An example illustrating the application of this principle is set out in **Example 1.5** where a deductible interest payment is made to a sovereign wealth fund that is a tax exempt entity under the laws of its own jurisdiction. The rule will not apply if the tax exempt status of the fund is the only reason for the D/NI outcome. If the hybrid financial instrument rule would ordinarily apply to such an instrument, however, then it will continue to apply and may result in a denial of a deduction for an amount paid under the arrangement.

Circumstances in which the instrument is held

97. The hybrid financial instrument rule does not apply to mismatches that are solely attributable to the circumstances under which an instrument is held. This principle is illustrated in **Example 1.8** where the payee holds the instrument through a foreign branch. The fact that the loan is held through a foreign branch is not a term of the instrument or part of the relationship between the parties. Therefore, if the mismatch arises solely due to the operation of the branch exemption in the residence country then the mismatch will not be a hybrid mismatch. The principle is also illustrated in **Example 1.9** where a taxpayer holds a bond issued by a company through a tax exempt savings account. In that case any mismatch in tax outcomes is not attributable to the terms of the instrument but the conditions under which the instrument is held.

Payments to a taxpayer in a pure territorial regime

98. A mismatch in tax treatment that arises in respect of a cross-border payment made to a taxpayer in a pure territorial tax regime (i.e. a jurisdiction that excludes or exempts all foreign source income) will not be caught by the hybrid financial instrument rule because the mismatch in tax outcomes will be attributable to the nature of the payer (i.e. to the fact that the payer is a non-resident making payments of foreign source income) rather than the terms of the instrument itself. This principle is illustrated in **Example 1.7** where the payee jurisdiction does not tax income from foreign sources. In the example, a related non-resident payer makes a payment of deductible interest that is treated as foreign source income. The resulting mismatch is not attributable to the terms of the instrument but to the fact that the payee is exempt on all foreign source income. The mismatch is therefore not caught by the hybrid financial instrument rule. This result should be contrasted with **Example 1.1** where the payee jurisdiction exempts only foreign dividend payments. In that case, the exemption on foreign source income applies only to a particular category of income (i.e. dividends) so that the tax exemption turns not only on the source of the payment but the character of the instrument under the laws of the payee jurisdiction and, accordingly, the terms of the instrument itself.

Recommendation 1.4 - Scope of the rule

99. In order to strike a balance between a rule that is clear and comprehensive and that is properly targeted and administrable, Recommendation 1.4 limits the scope of the hybrid financial instrument rule to payments made to related persons and under structured arrangements. See Recommendations 10 and 11 regarding the definition of structured arrangements and related persons.

Recommendation 1.5 - Exceptions to the rule

100. Recommendation 1.5 provides an exception for entities where the tax policy of the deduction under the laws of the payer jurisdiction is to preserve tax neutrality for the payer and payee.

Entities entitled to deduct dividends not within the scope of the hybrid financial instrument rule

101. In order to preserve its tax neutrality, a jurisdiction may grant an investment vehicle, such as a mutual fund or real estate investment trust (REIT), the right to deduct dividend payments. Although the payment of a deductible dividend is likely to give rise to a mismatch in tax outcomes, such a payment will not generally give rise to a hybrid mismatch under Recommendation 1 provided any resulting mismatch will be attributable to the payer's tax status rather than the ordinary tax treatment of dividends under the laws of that jurisdiction. As noted in **Example 1.10**, however, under Recommendation 2.1 of the report the payee jurisdiction should not permit a taxpayer to claim an exemption or equivalent relief from double taxation in respect of a deductible dividend paid by such an entity.

Application of the exception to securitisation vehicles and other investment funds

102. In certain cases, the tax neutrality of an investment vehicle depends not on the particular tax status of the vehicle but on assumptions as to the tax treatment of the instruments issued by the vehicle. One example of this is a securitisation vehicle or an infrastructure investment fund that is financed almost entirely by way of borrowing and where all, or substantially all, of the income is paid out to lenders in the form of deductible interest. The exception to the hybrid financial instrument rule set out in Recommendation 1.5 is intended to protect the tax neutrality of these vehicles while ensuring that they cannot be used to defer or avoid tax at the level of the payee. Accordingly, the exception applies where the regulatory and tax framework in the establishment jurisdiction has the effect that the financial instruments issued by the investment vehicle will result in all or substantially all of the income of the vehicle being paid and distributed to holders within a reasonable period of time and where the tax policy of the establishment jurisdiction is that such payments will be subject to tax in the hands of investors. Recommendation 1.5 specifically notes that the defensive rule in Recommendation 1.1(b) should continue to apply to such payments on receipt.

Chapter 2

Specific recommendations for the tax treatment of financial instruments

Recommendation 2

1. Denial of dividend exemption for deductible payments

In order to prevent D/NI outcomes from arising under a financial instrument, a dividend exemption that is provided for relief against economic double taxation should not be granted under domestic law to the extent the dividend payment is deductible by the payer. Equally, jurisdictions should consider adopting similar restrictions for other types of dividend relief granted to relieve economic double taxation on underlying profits.

2. Restriction of foreign tax credits under a hybrid transfer

In order to prevent duplication of tax credits under a hybrid transfer, any jurisdiction that grants relief for tax withheld at source on a payment made under a hybrid transfer should restrict the benefit of such relief in proportion to the net taxable income of the taxpayer under the arrangement.

3. Scope of the rule

There is no limitation as to the scope of these recommendations.

Overview

103. Recommendation 2 sets out two specific recommendations for changes to the tax treatment cross-border financial instruments.

(a) Under Recommendation 2.1 the report recommends that countries do not grant a dividend exemption or equivalent tax relief for payments that are treated as deductible by the payer.

(b) Under Recommendation 2.2 the report recommends limiting the ability of a taxpayer to claim relief from foreign withholding tax on instruments that are held subject to a hybrid transfer.

104. Rather than simply adjusting the tax treatment of a payment in order to align it with the tax consequences in another jurisdiction, the purpose of these recommendations goes further by seeking to bring the treatment of these instruments into line with the tax policy outcomes that will generally apply to the same instruments in the wholly-domestic context.

105. The domestic law changes required to implement Recommendation 2 will depend on the current state of a country's domestic law. There are a number of different ways of

restricting the benefit of double taxation relief and these recommendations only set out recommended outcomes rather than specifying how such changes ought to be implemented.

Recommendation 2.1 - Denial of dividend exemption for deductible payments

106. The purpose of a dividend exemption is generally to avoid imposing an additional layer of taxation at the shareholder level on income that has already been subject to tax at the entity level. Recommendation 2.1 recommends that jurisdictions that provide payees with an exemption for dividends, as a mechanism for relieving economic double taxation on corporate profits, do not extend that exemption to payments that have not borne tax at the entity level.

107. The operation of this Recommendation is set out in **Example 1.1**. In that example a taxpayer borrows money under an interest bearing loan from a related taxpayer in another jurisdiction. The issuer of the loan is allowed a deduction for the interest while the holder treats the payment as a dividend. Any mismatch in tax outcomes, however, is eliminated if the payee jurisdiction prevents the payee from taking advantage of a dividend exemption in respect of a payment that is deductible under the laws of the payer jurisdiction. Similar outcomes are identified in **Example 1.2**, **Example 1.3** and **Example 1.4**.

Recommendation extends to other types of dividend relief

108. Recommendation 2.1 also encourages countries to consider introducing restrictions on the availability of other types of double taxation relief for dividends. **Example 1.3** illustrates the potential application of the Recommendation to a deductible dividend subject to a reduced tax rate, **Example 1.4** illustrates the application of the Recommendation to a payment that is eligible for an underlying foreign tax credit and **Example 2.1** illustrates the possible application of the Recommendation to a payment that is eligible for a domestic tax credit.

Recommendation applies only to payments characterised as dividends

109. The Recommendation only affects payments that would otherwise qualify for a dividend exemption or equivalent tax relief and does not deal with other types of non-inclusion (such as a payment that is treated as a return of capital under a share). This principle is illustrated in **Example 1.13** where a taxpayer treats a loan from its parent as having been issued at a discount and accrues this discount as an expense over the life of the loan. The parent jurisdiction, however, does not adopt the same accounting treatment as its subsidiary and treats all the payments on the instrument as loan principal or a return of share capital. A rule limiting double taxation relief on deductible dividend payments will not apply to the facts of that example, because the payment is not treated as a dividend under the domestic laws of the payee jurisdiction.

Recommendation applies only to dividends that are deductible by the issuer

110. In determining whether a dividend is deductible for the purposes of Recommendation 2.1 a taxpayer will generally look to the instrument under which the payment was made and whether the issuer of that instrument was entitled to a deduction for such payment. The fact that a dividend triggers a deduction in another jurisdiction for separate taxpayer due to the existence of a hybrid entity structure or under a hybrid

transfer, will not generally trigger a denial of the dividend exemption in the payee jurisdiction.

111. This principle is illustrated in **Example 1.31** where the payment of a dividend on shares that have been subject to a repo triggers a deduction for the repo counterparty in a third jurisdiction. The payment, however, does not trigger a deduction for the issuer of the shares so that the recommended changes to domestic law in Recommendation 2.1 would not be expected to restrict the holder's entitlement to an exemption on the dividend. The principle is further illustrated in **Example 1.23** where a hybrid entity borrows money from a related person in the same jurisdiction under an instrument that is treated as equity under local law. The hybrid entity is treated as making a non-deductible payment for local law purposes but the payment under the instrument is treated as deductible under the laws of the parent jurisdiction. Recommendation 2.1 would not be expected to restrict the holder's entitlement to an exemption on the dividend as the payment under the hybrid financial instrument does not trigger a deduction for the issuer of the shares.

Recommendation 2.2 - Restriction of foreign tax credits under a hybrid transfer

112. A hybrid transfer exploits differences between two countries in their rules for attributing income from an asset with the effect that the same payment is treated as derived simultaneously by different taxpayers resident in different jurisdictions. Because there is only one underlying payment, however, the economic benefit of that payment will be shared between the parties under the terms of the hybrid transfer. Recommendation 2.2 sets out a rule that aligns the rules for granting of foreign withholding tax relief with the economic benefit of the payment as shared under the terms of the hybrid transfer. It does this by restricting the amount of the credit in proportion to the net taxable income of the taxpayer under the arrangement.

113. The operation of this Recommendation is set out in **Example 2.2**. In that example a taxpayer borrows securities under an arrangement that generally includes the requirement to make "manufactured payments" to the lender of any amounts paid on the underlying securities during the period of the loan. A hybrid transfer arises because the lender is treated as continuing to receive payments on the underlying securities. The borrower, however, also treats itself as receiving the same income on the underlying asset and is allowed a deduction for the manufactured payments made to the lender. The hybrid transfer therefore permits both parties to claim withholding tax credits on the payment which has the effect of lowering their effective tax burden under the instrument. By limiting the amount of the credit in proportion to the taxpayer's net income under the arrangement the tax treatment is brought into line with the tax treatment of a non-hybrid financing transaction.

Recommendation 2.3 - Scope

114. The report recommends that those countries applying Recommendations 2.1 and 2.2 should be able to deny the benefit of the exemption or tax credit without any qualification as to scope

Chapter 3

Disregarded hybrid payments rule

Recommendation 3

1. Neutralise the mismatch to the extent the payment gives rise to a D/NI outcome

The following rule should apply to a disregarded payment made by a hybrid payer that results in a hybrid mismatch:

(a) The payer jurisdiction will deny a deduction for such payment to the extent it gives rise to a D/NI outcome.

(b) If the payer jurisdiction does not neutralise the mismatch then the payee jurisdiction will require such payment to be included in ordinary income to the extent the payment gives rise to a D/NI outcome.

(c) No mismatch will arise to the extent that the deduction in the payer jurisdiction is set-off against income that is included in income under the laws of both the payee and the payer jurisdiction (i.e. dual inclusion income).

(d) Any deduction that exceeds the amount of dual inclusion income (the excess deduction) may be eligible to be set-off against dual inclusion income in another period.

2. Rule only applies to disregarded payments made by a hybrid payer

For the purpose of this rule:

(a) A disregarded payment is a payment that is deductible under the laws of the payer jurisdiction and is not recognised under the laws of the payee jurisdiction.

(b) A person will be a hybrid payer where the tax treatment of the payer under the laws of the payee jurisdiction causes the payment to be a disregarded payment.

3. Rule only applies to payments that result in a hybrid mismatch

A disregarded payment made by a hybrid payer results in a hybrid mismatch if, under the laws of the payer jurisdiction, the deduction may be set-off against income that is not dual inclusion income.

4. Scope of the rule

This rule only applies if the parties to the mismatch are in the same control group or where the payment is made under a structured arrangement and the taxpayer is a party to that structured arrangement.

Overview

115. A deductible payment can give rise to a D/NI outcome where the payment is made by a hybrid entity that is disregarded under the laws of the payee jurisdiction. Such disregarded payments can give rise to tax policy concerns where that deduction is available to be set-off against an amount that is not treated as income under the laws of the payee jurisdiction (i.e. against income that is not "dual inclusion income"). The purpose of the disregarded hybrid payments rule is to prevent a taxpayer from entering into structured arrangements, or arrangements with members of the same control group, that exploit differences in the tax treatment of payer to achieve such outcomes.

116. The primary recommendation under the deductible hybrid payments rule is that the payer jurisdiction should restrict the amount of the deduction that can be claimed for a disregarded payment to the total amount of dual inclusion income. The defensive rule requires the payee jurisdiction to include an equivalent amount in ordinary income.

117. An item of income should be treated as dual inclusion income if it is taken into account as income under the laws of both the payer and payee jurisdictions. It may be possible to undertake a line by line comparison of each item of income in straightforward cases where the hybrid payer is party to only a few transactions. In more complex cases however, countries may wish to adopt a simpler implementation solution for tracking deductions and items of dual inclusion income, which is based, as much as possible, on existing domestic rules, administrative guidance, presumptions and tax calculations while continuing to meet the basic policy objectives of the disregarded hybrid payments rule. Examples of possible implementation solutions are identified in Chapters 3, 6 and 7 and described in further detail in the examples.

118. Jurisdictions use different tax accounting periods and have different rules for recognising when items of income or expenditure have been derived or incurred. These timing and quantification differences should not be treated as giving rise to mismatches in tax outcomes under Recommendation 3. Excess deductions that are subject to restriction in the payer jurisdiction under the disregarded hybrid payments rule may be carried over to another period, in accordance with the ordinary rules for the treatment of net losses, and applied against dual inclusion income in that period.

Recommendation 3.1 - Neutralise the mismatch to the extent the payment gives rise to a D/NI outcome

119. The Recommendation for disregarded hybrid payments is to neutralise the effect of the mismatch through the adoption of a linking rule that aligns the tax outcomes for the payer and payee. This report recommends that the primary response should be to deny the payer a deduction for payments made under a disregarded payment with the payee jurisdiction applying a defensive rule that would require a disregarded payment to be included in ordinary income in the event the payer was located in a jurisdiction that did not apply the disregarded hybrid payments rule.

120. The hybrid mismatch rule does not apply, however, to the extent the deduction for the disregarded payment is set-off against "dual inclusion income", which is income that is taken into account as income under the laws of both the payer and payee jurisdictions. In order to address timing differences in the recognition of deductions for disregarded payments and dual inclusion income any excess deduction (i.e. net loss) from such disregarded payments that cannot be set-off against dual inclusion income in the current

period remains eligible to be set-off against dual inclusion income that arises in another period under the ordinary rules that allow for the carry-forward (or back) of losses to other taxable periods.

Deductible payments caught by the rule

121. In order to be a disregarded payment, the payment must be deductible under the laws of the payer jurisdiction. The meaning of deductible and deduction is the same as that used in the other recommendations in the report and generally covers items of current expenditure such as service payments, rents, royalties, interest and other amounts that may be set-off directly against ordinary income. The term does not cover the cost of acquiring a capital asset or an allowance for depreciation or amortisation.

122. Unlike the hybrid financial instrument rule, which focuses only on the tax treatment of the instrument, and not on the status of the counterparty or the context in which the instrument is held, the disregarded hybrid payments rule should only operate to the extent that the payer is actually entitled to a deduction for a payment under local law. Accordingly the rule will not apply to the extent the taxpayer is subject to transaction or entity specific rules that prevent the payment from being deducted (including the hybrid financial instrument rule).

123. The interaction between Recommendations 1 and 3 is explained in **Example 3.2** where a PE in the payer jurisdiction borrows money from the parent of the group. Both the loan and the interest payment are disregarded under the laws of the payee jurisdiction. In the example the payer jurisdiction first applies the hybrid financial instrument rule to determine whether interest on the loan is deductible before any adjustment is made under the disregarded hybrid payments rule.

No mismatch to the extent the deduction does not exceed dual inclusion income

124. A deductible payment will not be treated as giving rise to a mismatch in tax outcomes if the deduction does not exceed dual inclusion income. This is illustrated in **Example 3.1** where a hybrid entity (an entity that is treated as a separate taxpayer in its jurisdiction of establishment but as transparent under the laws of its parent) makes an interest payment to its non-resident parent that is disregarded under the laws of the parent jurisdiction. The adjustment under the disregarded hybrid payments rule only operates to the extent that the interest payment exceeds dual inclusion income for the hybrid entity in the payer jurisdiction.

Dual inclusion income

125. An item will be dual inclusion income if it is included in income under the laws of both the payer and payee jurisdictions. The identification of whether an item should be treated as dual inclusion income is primarily a legal question that requires an comparison of the treatment of the income under the laws of the payer and payee jurisdictions. An amount should be treated as dual inclusion income if it is included in income under the laws of both jurisdictions even if there are differences in the way those jurisdictions value that item or in the accounting period in which the income is derived. In **Example 6.1**, which considers the application of the deductible hybrid payments rule, the parent and subsidiary jurisdictions use different timing and valuation rules for recognising the income and expenses of a hybrid entity. In that case, both jurisdictions apply their own timing and valuation rules for calculating the amount of dual inclusion income and

duplicate deductions arising in each period and the resulting timing difference does not impact on the operation of the rule.

126. Double taxation relief, such as a domestic dividend exemption granted by the payer jurisdiction or a foreign tax credit granted by the payee jurisdiction should not prevent an item from being treated as dual inclusion income where the effect of such relief is simply to avoid subjecting the income to an additional layer of taxation in either jurisdiction. Thus, while a payment of dual inclusion income will generally be recognised as ordinary income under the laws of both jurisdictions, an equity return should still qualify as dual inclusion income if the payment is subject to an exemption, exclusion, credit of other type of double taxation relief in the payer or payee jurisdiction that relieves the payment from economic double taxation. An example of this type of dual inclusion income is given in **Example 6.3** in respect of a structure that produces DD outcomes and **Example 7.1** in respect of the dual resident payer rule. In **Example 6.3** the expenses of a hybrid entity are funded by an intra-group dividend that is exempt from taxation in the hands of jurisdiction where the dividend is received but included as income under the laws of its parent. Allowing the hybrid entity a deduction against this type of exempt or excluded equity return preserves the intended tax policy outcomes in both jurisdictions and, accordingly, the dividend should be treated as dual inclusion income for the purposes of disregarded hybrid payments rule even where such dividend carries an entitlement to an underlying foreign tax credit in the payee jurisdiction. Such double taxation relief may give rise to tax policy concerns, however, if it has the effect of generating surplus tax relief that can be used to reduce or offset the tax on non-dual inclusion income. In determining whether to treat an item of income, which benefits from such double-taxation relief, as dual-inclusion income, countries should seek to strike a balance between rules that minimise compliance costs, preserve the intended effect of such double taxation relief and prevent taxpayers from entering into structures that undermine the integrity of the rules.

127. A tax administration may treat the net income of a controlled foreign company that is attributed to a shareholder of that company under a CFC or other offshore inclusion regime as dual inclusion income if the taxpayer can satisfy the tax administration that the effect of the CFC regime is to bring such income into tax at the full rate under the laws of both jurisdictions. **Example 6.4** sets out a simplified calculation to illustrate how income attributed under a CFC regime can be taken into account in determining the amount of dual inclusion income under a hybrid structure.

Primary response and defensive rule

128. Where a payment gives rise to a D/NI outcome the payer jurisdiction should apply the recommended response and deny the deduction for the payment to the extent that the deduction exceeds dual inclusion income. The defensive rule is the mirror image of the primary recommendation in that the payee jurisdiction recognises the same amount as ordinary income. The operation of the primary and secondary rules are described in further detail in **Example 3.2**.

Carry-forward of deductions to another period

129. Because the hybrid mismatch rules are generally not intended to impact on, or be affected by, timing differences, the disregarded hybrid payment rules contain a mechanism that allows the payer jurisdiction to carry-forward (or back if permitted under local law) a hybrid deduction to a period where it can be set-off against surplus dual

inclusion income. The Recommendation contemplates that the ordinary domestic rules governing the utilisation of losses would apply to such deductions. **Example 6.1** sets out an example of the operation of the carry-forward of excess deductions.

Implementation solution based on existing domestic rules

130. The disregarded hybrid payments rule caps the aggregate amount of hybrid deductions that can be claimed to the aggregate amount of dual inclusion income. In principle Recommendation 3 requires the taxpayer to individually identify the items of income that arise under the laws of both jurisdictions and to determine which of them have given rise to dual inclusion income. In those cases where the taxpayer has entered into a large number of transactions this approach could result in a significant compliance burden for taxpayers. In order to facilitate implementation and minimise compliance costs, tax administrations will wish to consider simpler implementation solutions. These solutions should be designed to produce substantially similar results to those described in this Chapter while avoiding unnecessary complexity.

131. In the case of the kind of structures covered by Recommendation 3 it will generally be the case that accounts showing the income and expenditure of the taxpayer will have been prepared under the laws of both jurisdictions. These accounts will generally be prepared under local law using domestic tax concepts. Tax administrations should use these existing sources of information and tax calculations as a starting point for identifying dual inclusion income. For instance, **Example 3.2** contemplates that the payer jurisdiction might prohibit a hybrid entity from surrendering the benefit of any net loss to another group member to the extent the entity has made deductible payments that were disregarded under the laws of payee jurisdiction and introduce other transaction specific rules that prevent that entity entering into arrangements that stream non-dual inclusion income to the hybrid entity in order to soak-up unused losses. **Example 3.2** further suggests that the payee jurisdiction could use the accounts prepared by the hybrid payer as a starting point and (after making transaction specific adjustments to determine the amount of dual inclusion income derived by the hybrid payer) require the payee to recognise, as ordinary income in each accounting period, the amount of any deductible intra-group payments to the extent these payments generate a net loss under the laws of the payer jurisdiction.

Recommendation 3.2 - Rule only applies to disregarded payments made by a hybrid payer

132. The disregarded hybrid payments rule applies where the reason the deductible payment is not recognised by the payee is because of the way the payer is treated under the laws of the payee jurisdiction. Recommendation 3 restricts the scope of the rule to *disregarded payments* made by a *hybrid payer*.

Disregarded payment

133. A disregarded payment is a payment that is not treated as a payment under the laws of the payee jurisdiction or that is not otherwise taken into account as a receipt for tax purposes. **Example 3.1** and **Example 3.2** both provide examples of disregarded payments. In **Example 3.1** the payment is made by a hybrid entity that is disregarded under the laws of the payee jurisdiction so that a deductible payment made by the hybrid entity to its immediate owner is similarly disregarded for tax purposes and does not give rise to income in the hands of the payee. In **Example 3.2** the payment is made within the

confines of a tax consolidation regime that treats all transactions and payments between consolidated group members as disregarded for tax purposes.

Hybrid payer

134. A person making a payment will be treated as a hybrid payer in circumstances where the tax treatment of the payer, under the laws of the payee jurisdiction, results in the payment being disregarded for tax purposes in the hands of the payee. The kinds of arrangements that cause a person to be a hybrid payer under Recommendation 3 will also generally cause that person to be a hybrid payer under Recommendation 6, which applies to DD outcomes using hybrid entities.

Recommendation 3.3 - Rule only applies to payments that result in a hybrid mismatch

135. A deduction for a disregarded payment made by a hybrid payer will give rise to tax policy concerns where the laws of the payer jurisdiction permit that deduction to be set-off against an amount that is not dual inclusion income. Accordingly, Recommendation 3.3 restricts the application of the disregarded hybrid payments rule to those cases where the deduction may be set-off against dual inclusion income.

136. There are a number of different techniques that a taxpayer can use in the payer jurisdiction to set-off a double deduction against non-dual inclusion income. The most common mechanism used to offset a deduction against non-dual inclusion income will be the use of a tax consolidation or grouping regime that allows the payer to apply the benefit of a deduction against the income of another entity within the same group. An example of this technique is set out in **Example 3.2**. Other techniques include making an investment through a reverse hybrid (an entity that is only treated as transparent under the laws of the payer jurisdiction) so that the resulting income is only brought into account under the laws of the payer jurisdiction. An example of such a structure is set out in **Example 6.1**. Alternatively, as explained in further detail in **Example 3.1**, the taxpayer may enter into a financial instrument or other arrangement where payments are only included in income in the payer jurisdiction. Non-dual inclusion income can also be set-off via merger-type transactions.

137. Regardless of the mechanism used to achieve the offset, if the effect of the structure is to create the opportunity for a deduction under a disregarded payment to be set-off against income that will not be brought into account as ordinary income under the laws of the payee jurisdiction, this will be sufficient to bring the payment within the scope of the disregarded hybrid payments rule.

Recommendation 3.4 - Scope of the rule

138. Recommendation 3.4 limits the scope of the rule to structured arrangements and mismatches that arise within a control group. See Recommendations 10 and 11 regarding the definition of structured arrangements and control group.

Chapter 4

Reverse hybrid rule

Recommendation 4

1. Neutralise the mismatch to the extent the payment gives rise to D/NI outcome

In respect of a payment made to a reverse hybrid that results in a hybrid mismatch the payer jurisdiction should apply a rule that will deny a deduction for such payment to the extent it gives rise to a D/NI outcome.

2. Rule only applies to payment made to a reverse hybrid

A reverse hybrid is any person that is treated as a separate entity by an investor and as transparent under the laws of the establishment jurisdiction.

3. Rule only applies to hybrid mismatches

A payment results in a hybrid mismatch if a mismatch would not have arisen had the accrued income been paid directly to the investor.

4. Scope of the rule

The recommendation only applies where the investor, the reverse hybrid and the payer are members of the same control group or if the payment is made under a structured arrangement and the payer is party to that structured arrangement.

Overview

139. A deductible payment made to a reverse hybrid may give rise to a mismatch in tax outcomes where that payment is not included in ordinary income in the jurisdiction where the payee is established (the establishment jurisdiction) or in the jurisdiction of any investor in that payee (the investor jurisdiction). The recommended rule neutralises those mismatches that arise under a reverse hybrid structure where the mismatch is a result of both the establishment jurisdiction and the investor jurisdiction treating the payment to the reverse hybrid as owned by a taxpayer in the other jurisdiction. As for the other hybrid entity payments rules, the reverse hybrid rule can apply to a broad range of deductible payments (including interest, royalties, rents and payments for services). The rule only applies, however:

(a) to payments that are made to a reverse hybrid (as defined under Recommendation 4); and

(b) where the mismatch in tax outcomes would not have arisen had the payment been made directly to the investor.

140. A reverse hybrid is any person (including any unincorporated body of persons) that is treated as transparent under the laws of the jurisdiction where it is established but as a separate entity (i.e. opaque) under the laws of the jurisdiction of the investor. The transparency or opacity of an entity must be tested by reference to the payment that is subject to the reverse hybrid rule. A person will be treated as tax transparent in respect of a payment where the reverse hybrid attributes or allocates a payment that it has received to an investor and the effect of such attribution or allocation under the laws of the establishment jurisdiction is to treat the payment as it would have been treated had it been paid directly to that investor. The same person will be treated as opaque, from the perspective of the investor jurisdiction, if the effect of such attribution or allocation is ignored for tax purposes in the investor jurisdiction.

141. The mismatch in tax outcomes that arises in respect of a payment to a reverse hybrid will only be treated as a hybrid mismatch where that mismatch would not have arisen had the attributed payment been made directly to the investor. In order to prevent a reverse hybrid being inserted into a structure to circumvent the operation of the hybrid financial instrument rule, the reverse hybrid rule will also apply to the extent a direct payment would have been subject to adjustment under the primary rule in Recommendation 1.

142. The recommended response under the reverse hybrid rule is to deny the deduction on the payment to the extent of any hybrid mismatch.

143. The reverse hybrid rule will only apply where the payer, the reverse hybrid and the investor are part of the same control group or the payer is a party to a structured arrangement.

Recommendation 4.1 - Neutralise the mismatch to the extent the payment gives rise to a D/NI outcome

144. The response recommended in this report is to neutralise the effect of hybrid mismatches that arise under payments made to reverse hybrids through the adoption of a linking rule that denies a deduction for such payments to the extent they give rise to a D/NI outcome. This report only recommends the adoption of the primary response of denying the payer a deduction for payments made to a reverse hybrid. A defensive rule is unnecessary given the specific recommendations in Chapter 5 for changes CFC rules and other offshore investment regimes that would require payments to a reverse hybrid to be included in income in the investor jurisdiction.

Payment

145. The definition of payment is set out in further detail in Recommendation 12 and includes any amount that is capable of being paid including a distribution, credit or accrual. A payment will be treated as "deductible" if it is applied, or can be applied, to reduce a taxpayer's net income. Deductible payments generally include current expenditures such as rents, royalties, interest, payments for services and other payments that may be set-off against ordinary income under the laws of the payer jurisdiction in the period they are treated as made. The term would not typically cover the cost of acquiring a capital asset and would not extend to an allowance for a depreciation or amortisation.

146. A "payment" will give rise to a D/NI outcome under a reverse hybrid rule if it is deductible under the laws of the payer jurisdiction and if it is allocated or attributed by the reverse hybrid to the investor in circumstances that give rise to a mismatch in tax

outcomes. The payment does not incorporate any distribution or right to distribution from the reverse hybrid that occurs as a consequence of making a payment to a reverse hybrid. While the effect of allocating or attributing a payment to an investor may trigger an obligation on the part of the reverse hybrid to make a further payment to the investor (for example, in the form of a distribution), the tax treatment of that distribution will not generally be relevant to whether a D/NI outcome arises under the rule.

D/NI outcome in respect of a payment to a reverse hybrid

147. A D/NI outcome will arise in respect of a payment to a reverse hybrid to the extent that the payment is deductible under the laws of one jurisdiction (the payer jurisdiction) and not included in ordinary income by a taxpayer under the laws of any other jurisdiction where the payment is treated as being received (the payee jurisdiction).

Deduction in any jurisdiction sufficient to trigger application of the rule

148. In certain cases, where the payer is transparent or has a taxable presence in more than one jurisdiction, a payment may be treated as made from more than one jurisdiction. In these cases, however, the deduction of the payment in the other jurisdiction is not relevant to the question of whether the payment gives rise to a D/NI outcome under the laws of the jurisdiction applying the reverse hybrid rule. This principle is illustrated in **Example 4.4** where a payment to a reverse hybrid is made by a hybrid entity. In this case the example concludes that the hybrid mismatch rule in Recommendation 4 should be applied in both the parent and subsidiary jurisdictions to neutralise the effect of the mismatch and the application of the reverse hybrid rule in one jurisdiction does not impact on its application in the other.

Inclusion in any jurisdiction sufficient to discharge application of the rule

149. If the payment is brought into account as ordinary income in at least one jurisdiction then there will be no mismatch for the rule to apply to. A payment to a reverse hybrid will not be treated as giving rise to a D/NI outcome if the mismatch is neutralised by the investor or the establishment jurisdiction adopting a specific rule designed to bring into account items of ordinary income paid to a reverse hybrid. This will include any rules, consistent with Recommendation 5.1, that require a taxpayer in the investor jurisdiction to take into account, for tax purposes, any item of ordinary income allocated to that taxpayer by a reverse hybrid (including under a CFC regime) and any rules in the establishment jurisdiction, consistent with Recommendation 5.2, that deny the benefit of tax transparency to a non-resident investor or group of investors if they are not required to take into account, for tax purposes, an item of ordinary income that is allocated to them by the transparent entity.

CFC inclusion

150. A payment that has been fully attributed to the ultimate parent of the group under a CFC regime and has been subject to tax at the full rate should be treated as having been included in ordinary income for the purposes of the reverse hybrid rule. As for Recommendation 1 and Recommendation 3, the burden is on the taxpayer to establish, to the satisfaction of the tax administration, the extent to which the payment:

(a) Has been fully included under the laws of the investor jurisdiction and is subject to tax at the full rate.

(b) Has not been treated as reduced or offset by any deduction or other relief other than in respect of expenditure incurred by the investor under the laws of the investor jurisdiction.

(c) Does not carry an entitlement to any credit or other relief.

(d) Does not give rise to an imported mismatch.

151. In **Example 4.3** an intra-group services fee is paid to a reverse hybrid, but the ultimate parent of the group brings the full amount of that payment into account as ordinary income under its CFC rules. The example concludes that, provided the taxpayer can establish, to the satisfaction of the tax administration, that the full amount of the payment has been included in income under the CFC regime of the investor jurisdiction and is not subject to any deduction, credit or other relief, then the reverse hybrid rule does not apply because the payment has not given rise to a mismatch in tax outcomes.

Other types of inclusion

152. The same principle is illustrated in **Example 1.8** where interest is paid to a branch of a company that is resident in another jurisdiction. In determining whether the payment has given rise to a D/NI outcome, **Example 1.8** looks to the tax treatment of the payment under the laws of both the residence and the branch jurisdiction. While **Example 1.8** concerns the identification of D/NI outcomes under the hybrid financial instrument rule, the issues are the same in respect of a determination of D/NI outcomes under the reverse hybrid rule, and a similar interpretation would apply if the reverse hybrid maintained a branch in a third jurisdiction and the payment is brought into ordinary income in that jurisdiction.

Taxation in the establishment jurisdiction on the basis of source

153. Frequently, in the case of transparent intermediaries such as trusts and partnerships, the establishment jurisdiction will not treat the intermediary as a taxpayer in its own right. Rather, payments that are made to the intermediary will be treated as having been made directly by the underlying partners or beneficiaries in accordance with the allocation mechanics set out in the partnership agreement or trust deed. In these cases such payments may, nevertheless, be brought into account as ordinary income in the establishment jurisdiction because the payments are treated as being sourced in that jurisdiction, either because the payment is made by a person who is a taxpayer in the establishment jurisdiction or because the partnership or trust has a sufficient taxable presence in the establishment jurisdiction to give that income a domestic source. In such cases, provided the establishment jurisdiction taxes such payments on an ordinary basis, the payments should not generally give rise to a D/NI outcome under the reverse hybrid rules.

Demonstrating that a payment has not given rise to a D/NI outcome

154. It will be the taxpayer who has the burden of establishing, to the reasonable satisfaction of the tax administration, how the tax treatment of the payment in the payee jurisdiction impacts on the amount of the adjustment required under the rule. The initial burden of proof may be discharged by the taxpayer demonstrating that the payment has actually been recorded as ordinary income on the tax return in the other jurisdiction.

Deduction should only be denied to the extent of the mismatch

155. The adjustment should be no more than is necessary to neutralise the hybrid effect that results from inserting the reverse hybrid between the payer and the investor. If part of the payment remains subject to tax in the investor or establishment jurisdiction then that part of the payment should not be subject to adjustment under the hybrid financial instrument rule. This is illustrated in **Example 4.2** where a taxpayer makes a payment of interest to a reverse hybrid, only part of which is treated as exempt income under the laws of establishment jurisdiction. The example concludes that the payer jurisdiction should not deny a deduction for that part of the payment that remains subject to tax as ordinary income under the laws of the establishment jurisdiction.

Treatment of distributions from a reverse hybrid

156. The reverse hybrid rule will apply even if the investor is ultimately taxed on distributions made by the reverse hybrid. The mere fact that the accrued income of the reverse hybrid will be taxable as ordinary income when it is distributed to the investor will not be sufficient to show that the payment does not give rise to a mismatch. The reverse hybrid rule is intended to neutralise the D/NI outcome that arises at the time the payment is made to the reverse hybrid. The tax treatment of a separate payment that the reverse hybrid makes to the investor at some point in the future (and which may or may not be funded out of the payments caught by the reverse hybrid rule) will generally be too remote from the mismatch to be taken into account for the purposes of the rule.

Recommendation 4.2 - Rule only applies to payment made to a reverse hybrid

157. A reverse hybrid is any person (which includes an unincorporated body of persons such as a trust) that is treated as transparent under the laws of the jurisdiction where it is established but as a separate entity by an investor in that reverse hybrid.

158. An investor is not confined to persons that subscribe money for an interest in a reverse hybrid and includes any person to whom the reverse hybrid allocates or attributes a payment.

Establishment jurisdiction

159. The establishment jurisdiction will, in the case of entities that are formed by incorporation or registration, be the jurisdiction where that person is registered or established. For entities that can be formed without formal incorporation or registration requirements (such as partnerships and trusts) the establishment jurisdiction will be the jurisdiction under which the entity has been created and/or where the directors (or equivalent) perform their functions.

Transparent treatment in the establishment jurisdiction

160. A person will be treated as transparent under the laws of the establishment jurisdiction if the laws of that jurisdiction permit or require the person to allocate or attribute ordinary income to an investor and such allocation or attribution has the effect that the payment is not included in the income of any other taxpayer.

161. The most basic example of a transparent person is a trust or partnership, which is not treated as a taxpayer in its own right but where the income derived by that person is allocated or attributed to the partners or beneficiaries and those partners or beneficiaries

are liable to tax on that income as if they had received it directly. Other tax transparency regimes, however, may achieve the same effect without triggering a direct tax liability for the investor. For example, an establishment jurisdiction may permit or require an intermediary to allocate or attribute items of income to an investor but pay the tax on that allocated income on the investor's behalf and at the investor's marginal rate. Alternatively the regime in the establishment jurisdiction may exempt certain payments from tax on the grounds that the income is foreign source income allocated or attributed to a non-resident investor that would not have been subject to tax if the payment had been received by the investor directly.

162. The types of regimes described above should be treated as transparency regimes if the effect of allocating or attributing a payment of ordinary income to the investor results in the payment being taxed under the laws of the establishment jurisdiction as if it had been paid directly to that investor. **Example 4.2** provides an illustration of a transparency regime where the tax liability falls on the reverse hybrid rather than the investor. In that example the payee is entitled to claim an exemption for a payment of foreign source interest on the basis that the interest payment has accrued to the benefit of a non-resident. The example concludes that the payee is a reverse hybrid and the payment gives rise to a hybrid mismatch to the extent such payment would have been included in ordinary income if it had been paid directly to the investor.

Separate entity treatment in the investor jurisdiction

163. In most cases the allocation or attribution of ordinary income by the intermediary will not have any tax consequences for the investor under the laws of the investor jurisdiction. If this is the case then the intermediary should be considered opaque under the laws of the investor jurisdiction.

Recommendation 4.3 - Rule only applies to hybrid mismatches

164. A payment made to a reverse hybrid that gives rise to a D/NI outcome will only be subject to adjustment under the reverse hybrid rule if that D/NI outcome constitutes a hybrid mismatch under Recommendation 4.3

165. The identification of a mismatch as a hybrid mismatch under a reverse hybrid structure is primarily a legal question that requires the general rules in the investor jurisdiction to be applied to the payment that is made to the reverse hybrid to determine the character, amount and tax treatment of that payment and whether it would have been treated as ordinary income if it had been paid directly to the investor.

166. Unlike in the hybrid financial instrument rule, which applies whenever the terms of the instrument were sufficient to bring about a mismatch in tax outcomes, the reverse hybrid rule will not apply unless the payment attributed to the investor would have been included as ordinary income if it had been paid directly to the investor (i.e. the interposition of the reverse hybrid must have been necessary to bring about the mismatch in tax outcomes). This is illustrated in **Example 4.1** where income is allocated by a reverse hybrid to a tax exempt entity. In that case the payment would not have been taxable even if it had been made directly to the investor and the reverse hybrid rule will not apply to deny the deduction.

Reverse hybrids cannot be used to circumvent the application of Recommendation 1

167. In order to prevent a reverse hybrid being used to circumvent the operation of the hybrid financial instrument rule, the reverse hybrid rule will continue to apply to the extent a direct payment would have been subject to adjustment under the primary rule in Recommendation 1. An example where this principle might apply is set out in **Example 4.4** where the payment to a reverse hybrid is made under a financial instrument. In this case, the payer will continue to deny the deduction for the payment because the hybrid financial instrument rule would have applied *in the payer jurisdiction* to neutralise the mismatch in tax outcomes if the payment had been made directly to the investor. The mismatch in tax outcomes therefore still falls within the language and intent of the rule.

Recommendation 4.4 - Scope of the rule

168. Recommendation 4.4 limits the scope of the reverse hybrid rule to structured arrangements and mismatches that arise within a control group. See Recommendations 10 and 11 regarding the definition of structured arrangements and control group.

Chapter 5

Specific recommendations for the tax treatment of reverse hybrids

Recommendation 5

1. Improvements to CFC and other offshore investment regimes

Jurisdictions should introduce, or make changes to, their offshore investment regimes in order to prevent D/NI outcomes from arising in respect of payments to a reverse hybrid. Equally jurisdictions should consider introducing or making changes to their offshore investment regimes in relation to imported mismatch arrangements.

2. Limiting the tax transparency for non-resident investors

A reverse hybrid should be treated as a resident taxpayer in the establishment jurisdiction if the income of the reverse hybrid is not brought within the charge to taxation under the laws of the establishment jurisdiction and the accrued income of a non-resident investor in the same control group as the reverse hybrid is not brought within the charge to taxation under the laws of the investor jurisdiction.

3. Information reporting for intermediaries

Jurisdictions should introduce appropriate tax filing and information reporting requirements on persons established within their jurisdiction in order to assist both taxpayers and tax administrations to make a proper determination of the payments that have been attributed to that non-resident investor.

Overview

169. Recommendation 5 sets out three specific recommendations for the tax treatment of reverse hybrids. These recommendations cover the tax treatment of payments made to a reverse hybrid under the laws of the investor and establishment jurisdiction and recommendations on tax filing and information requirements in order to assist both taxpayers and tax administrations to make a proper determination of the payments that have been attributed to that non-resident investor.

170. These specific recommendations are not hybrid mismatch rules. That is, they do not adjust the tax consequences of a payment because of differences in its tax treatment in another jurisdiction. Rather, Recommendation 5 sets out improvements that jurisdictions could make to their domestic law that will reduce the frequency of hybrid mismatches by bringing the tax treatment of cross-border payments made to transparent entities into line with the tax policy outcomes that would generally be expected to apply to payments between domestic taxpayers.

Recommendation 5.1 - Improvements to CFC and other offshore investment regimes

171. Payments made through a reverse hybrid structure will not result in D/NI outcomes if the income is fully taxed under a CFC, foreign investment fund (FIF) or a similar anti-deferral rule in the investor jurisdiction that requires the investor to include its allocated share of any payment of ordinary income made to the intermediary on a current basis. Recommendation 5.1 therefore recommends that jurisdictions introduce or extend their offshore investment regimes to require a taxpayer to take into account, for tax purposes, any item of ordinary income allocated to that taxpayer by a reverse hybrid.

172. There are a number of ways a jurisdiction could go about aligning the tax treatment of the payment in the investor jurisdiction with its treatment in the establishment jurisdiction. A jurisdiction may use one or a combination of measures that could include changes to residency rules, CFC rules and rules that tax a resident investor on changes in the market value of the investment. When considering changes to their offshore investment regime, jurisdictions should also take into account the effect of existing exemptions, safe harbours and thresholds that may reduce the effectiveness of those regimes in bringing into account income of a reverse hybrid.

173. A reverse hybrid will be transparent under the laws of the establishment jurisdiction. Such transparency means that the laws of the establishment jurisdiction permit or require the reverse hybrid to allocate or attribute payments to an investor in such a way that the payment is not included in the income of any other taxpayer. An offshore investment regime in the investor jurisdiction could isolate this requirement and tax investors on the amount of income allocated to that investor. Treating income allocated by a reverse hybrid as taxable under the laws of the investor jurisdiction would have the effect of neutralising any hybrid mismatch under a payment to a transparent entity. Such a rule would ensure that the payer jurisdiction could suspend the application of the hybrid mismatch rule insofar as payments were allocated to investors in the investor jurisdiction.

Recommendation 5.2 - Limiting the tax transparency for non-resident investors

174. Tax transparency is an effective way for collective investment vehicles to ensure tax neutrality of outcomes for different investors that are subject to different marginal rates of taxation. Tax transparency proceeds on the assumption, however, that the income allocated to the investor will be taxable in the hands of the investor. In the cross-border context this is not always the case. Recommendation 5.2 is intended to prevent a non-resident taking advantage of a person’s tax transparency in order to achieve a mismatch in tax outcomes.

175. Recommendation 5.2 of the report applies where a tax transparent person is controlled or otherwise owned by a non-resident investor and that investor is not required to take into account payments of ordinary income allocated to them by that person. The rule effectively encourages jurisdictions to turn off their transparency rules when those rules are primarily used to achieve hybrid mismatches. The Recommendation only applies in circumstances where:

(a) the person is tax transparent under the laws of the establishment jurisdiction;

(b) the person derives foreign source income or income that is not otherwise subject to taxation in the establishment jurisdiction;

(c) all or part of that income is allocated under the laws of the establishment jurisdiction to a non-resident investor that is in the same control group as that person.

In these circumstances Recommendation 5.2 provides that the establishment jurisdiction should treat the reverse hybrid as if it were a resident taxpayer. By treating the entity as a resident taxpayer, this will eliminate the need to apply the reverse hybrid rule to such entities and the investor jurisdiction could continue to include such payments in income under Recommendation 5.1 but provide a credit for any taxes paid in the establishment jurisdiction on the income that is brought into account under such rules.

Recommendation 5.3 - Information reporting for intermediaries

176. Recommendation 5.3 is intended to encourage jurisdictions to maintain appropriate reporting and filing requirements for tax transparent entities that are established within that jurisdiction. This would involve the maintenance of accurate records of who their investors are, how much of an investment each investor holds in the entity and the amount of income and expenditure allocated to those investors. These records should be made available, on request, to both investors and to the tax administration in the establishment jurisdiction.

177. In Brisbane, the G20 Leaders endorsed the *Standard for Automatic Exchange of Financial Account Information in Tax Matters* (the AEOI Standard, OECD 2014a). As part of this standard, investment entities will be required to provide their local tax administration with certain information about their investors including the value of each investor's holding at the end of the relevant reporting period. This information will be automatically exchanged with the tax administration in the investor jurisdiction making it easier for tax authorities to identify (and identify the amount of) offshore investments held by resident investors.

178. The legal basis for information exchange between tax administrations is generally Article 26 of the *OECD Model Tax Convention on Income and on Capital* (OECD Model Tax Convention, OECD, 2014b) or *The Multilateral Convention on Mutual Administrative Assistance in Tax Matters, Amended by the 2010 Protocol* (Multilateral Convention, OECD, 2010). This Multilateral Convention provides for all possible forms of administrative co-operation between States and contains strict rules on confidentiality and proper use of the information.

179. Furthermore, tax authorities are encouraged to require intermediaries established in their jurisdiction to maintain records on the investors holding interests in those intermediaries and the amounts of income and expenditure allocated to those investors (including the categories of income and expenditure as determined under the relevant tax or accounting standard).

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Chapter 6

Deductible hybrid payments rule

Recommendation 6

1. Neutralise the mismatch to the extent the payment gives rise to a DD outcome

The following rule should apply to a hybrid payer that makes a payment that is deductible under the laws of the payer jurisdiction and that triggers a duplicate deduction in the parent jurisdiction that results in a hybrid mismatch:

(a) The parent jurisdiction will deny the duplicate deduction for such payment to the extent it gives rise to a DD outcome.

(b) If the parent jurisdiction does not neutralise the mismatch, the payer jurisdiction will deny the deduction for such payment to the extent it gives rise to a DD outcome.

(c) No mismatch will arise to the extent that a deduction is set-off against income that is included in income under the laws of both the parent and the payer jurisdictions (i.e. dual inclusion income).

(d) Any deduction that exceeds the amount of dual inclusion income (the excess deduction) may be eligible to be set-off against dual inclusion income in another period. In order to prevent stranded losses, the excess deduction may be allowed to the extent that the taxpayer can establish, to the satisfaction of the tax administration, that the excess deduction in the other jurisdiction cannot be set-off against any income of any person under the laws of the other jurisdiction that is not dual inclusion income.

2. Rule only applies to deductible payments made by a hybrid payer

A person will be treated as a hybrid payer in respect of a payment that is deductible under the laws of the payer jurisdiction where:

(a) the payer is not a resident of the payer jurisdiction and the payment triggers a duplicate deduction for that payer (or a related person) under the laws of the jurisdiction where the payer is resident (the parent jurisdiction); or

(b) the payer is resident in the payer jurisdiction and the payment triggers a duplicate deduction for an investor in that payer (or a related person) under the laws of the other jurisdiction (the parent jurisdiction).

3. Rule only applies to payments that result in a hybrid mismatch

A payment results in a hybrid mismatch where the deduction for the payment may be set-off, under the laws of the payer jurisdiction, against income that is not dual inclusion income.

4. Scope of the rule

The defensive rule only applies if the parties to the mismatch are in the same control group or where the mismatch arises under a structured arrangement and the taxpayer is party to that structured arrangement. There is no limitation on scope in respect of the recommended response.

Overview

180. Where a taxpayer makes a payment through a cross-border structure, such as a dual resident, a foreign branch or a hybrid person, that payment may trigger a DD outcome where:

(a) the expenditure is required to be taken into account in calculating the taxpayer's net income under the laws of two or more jurisdictions; or

(b) in the case of a payment made by a hybrid person that is treated as transparent by one of its investors, the payment is also treated as deductible in calculating the net income of that investor.

181. A DD outcome will give rise to tax policy concerns where the laws of both jurisdictions permit that deduction to be set-off against an amount that is not treated as income under the laws of the other jurisdiction (i.e. against income that is not "dual inclusion income"). The policy of the deductible hybrid payments rule is to limit a taxpayer's deduction to the amount of dual inclusion income in circumstances where the deduction that arises in the other jurisdiction is not subject to equivalent restrictions on deductibility.

182. Recommendation 6 applies to DD outcomes in respect of expenditure incurred through a foreign branch or hybrid person. The definition of "hybrid payer" means that the deductible hybrid payments rule only applies where a deductible payment in one jurisdiction (the payer jurisdiction) triggers a duplicate deduction in another jurisdiction (the parent jurisdiction) because:

(a) the payer is resident in the parent jurisdiction (i.e. the expenditure has been incurred through a branch); or

(b) an investor in the parent jurisdiction claims a deduction for the same payment (i.e. the expenditure has been incurred by a hybrid person that is treated as transparent under the laws of the parent jurisdiction).

183. The primary recommendation under the deductible hybrid payments rule is that the parent jurisdiction should restrict the amount of duplicate deductions to the total amount of dual inclusion income. There is no limitation on the scope of the primary response. The defensive rule, which imposes the same type of restriction in the payer jurisdiction, will only apply in the event that the effect of mismatch is not neutralised in the parent jurisdiction and is limited to those cases where the parties to the mismatch are in the same control group or the taxpayer is party to a structured arrangement.

184. Determining which payments have given rise to a double deduction and which items are dual inclusion income requires a comparison between the domestic tax treatment of these items and their treatment under the laws of the other jurisdiction. It may be possible to undertake a line by line comparison of each item of income or expense in straightforward cases where the hybrid payer is party to only a few transactions. In more complex cases, however, where the taxpayer has entered into a significant number of transactions which give rise to different types of income and expense, countries may wish to adopt a simpler implementation solution for tracking double deductions and dual inclusion income. The way in which DD outcomes will arise will differ from one jurisdiction to the next and countries should choose an implementation solution that is based, as much as possible, on existing domestic rules, administrative guidance, presumptions and tax calculations while still meeting the basic policy objectives of the

deductible hybrids payments rule. Examples of possible implementation solutions are identified in this guidance at **Example 6.1** to **Example 6.5**.

185. Jurisdictions use different tax accounting periods and have different rules for recognising when items of income or expenditure have been derived or incurred. These timing differences should not be treated as giving rise to mismatches in tax outcomes under Recommendation 6. Recommendation 6.1(d) therefore allows excess deductions that are subject to restriction under the deductible hybrid payments rule to be carried-forward to another period, in accordance with a jurisdiction's ordinary rules for the treatment of net losses, and applied against dual inclusion income in that period. In order to prevent stranded losses, jurisdictions may further permit excess deductions to be set-off against non-dual inclusion income if a taxpayer can show that such deductions cannot be offset against any income under the laws of the other jurisdiction that is not dual inclusion income.

Recommendation 6.1- Neutralise the mismatch to the extent the payment gives rise to a DD outcome

186. The response recommended in this report is to neutralise the effect of hybrid mismatches through the adoption of a linking rule that aligns the tax outcomes in the payer and parent jurisdictions. The hybrid mismatch rule isolates the hybrid element in the structure by identifying a deductible payment made by a hybrid payer in the payer jurisdiction and the corresponding "duplicate deduction" generated in the parent jurisdiction. The primary response is that the duplicate deduction cannot be claimed in the parent jurisdiction to the extent it exceeds the claimant's dual inclusion income (income brought into account for tax purposes under the laws of both jurisdictions). A defensive rule applies in the payer jurisdiction to prevent the hybrid payer claiming the benefit of a deductible payment against non-dual inclusion income if the primary rule does not apply.

187. In the case of both the primary and defensive rules, the excess deductions can be offset against dual inclusion income in another period. In order to prevent stranded losses, it is recommended that excess duplicate deductions should be allowed to the extent that the taxpayer can establish, to the satisfaction of the tax administration, that the deduction cannot be set-off against the income of any person under the laws of the other jurisdiction.

Deductible payments caught by the rule

188. The meaning of deductible payment is the same as that used in other recommendations in the report and generally covers a taxpayer's current expenditures such as service payments, rents, royalties, interest and other amounts that may be set-off against ordinary income under the laws of the payer jurisdiction in the period they are treated as made.

189. The determination of whether a payment is deductible requires a proper assessment of the character and treatment of the payment under the laws of both the payer and parent jurisdiction. The approach that should be taken to analysing the tax treatment of the payment is similar to that used for determining mismatches under a financial instrument, except that Recommendation 6 requires a comparison between the jurisdictions where the payment is made, rather than the jurisdictions where the payment is made and received.

190. Unlike the hybrid financial instrument rule, which focuses only on the tax treatment of the instrument, and not on the status of the counterparty or the context in which the instrument is held, the deductible hybrid payments rule should only operate to the extent a taxpayer is actually entitled to a deduction for a payment under local law. Accordingly the rule will not apply to the extent the taxpayer is subject to transaction or entity specific rules under the parent or payer jurisdiction that prevent the payment from being deducted. These restrictions on deductibility may include hybrid mismatch rules that deny the taxpayer a deduction in order to neutralise a direct or indirect D/NI outcome.

191. The interaction between Recommendation 6 and other rules that govern the deductibility of payments is illustrated in **Example 6.3** where the parent company establishes a hybrid subsidiary in another jurisdiction that incurs employment expenses. **Example 6.3** notes that, if the parent is tax exempt under the laws of its own jurisdiction and it is unable to claim deductions for any of its expenditure then no DD outcome will arise on these facts. In **Example 4.4** a hybrid person makes an interest payment to a reverse hybrid in the same group. In this case the example concludes that the reverse hybrid rule in Chapter 3 of the report will apply to the arrangement to deny the deduction so that there is no scope for the operation of the deductible hybrid payments rule.

Extending the principles of Recommendation 6 to other deductible items

192. As illustrated in **Example 6.1**, the kind of structures that give rise to DD outcomes in respect of payments can also be used to generate double deductions for non-cash items such as depreciation or amortisation. A DD outcome raises the same tax policy issues, regardless of how the deduction has been triggered, and distinguishing between deductible items on the basis of whether they are attributable to a payment would complicate rather than simplify the implementation of these recommendations. Accordingly when implementing the hybrid mismatch rules into domestic law countries may wish to apply the principles of Recommendations 6 and 7 to all deductible items regardless of whether they are attributable to a payment. **Example 6.1** provides an example of the application of the deductible hybrid payments rule to a depreciation deduction where both the payer and the parent jurisdiction provide for a depreciation allowance in respect of the same asset.

Determining the existence and amount of a DD outcome

193. The question of whether a payment has given rise to a "DD outcome" is primarily a legal question that should be determined by an analysis of the character and tax treatment of the payment under the laws of the payer and the parent jurisdiction. If the laws of both jurisdictions grant a deduction for the same payment (or an allowance in respect of the same asset) then that deduction can be said to give rise to a DD outcome.

194. This principle is applied in **Example 6.3** where a taxpayer claims a deduction for salary and other employment benefits paid to an employee. In order to determine whether these payments have given rise to a DD outcome, the taxpayer must make a proper assessment of the facts and circumstances that gave rise to the deduction under local law and determine whether a deduction has been granted on the same basis in the other jurisdiction. If, for example, one jurisdiction allows taxpayers a deduction for the value of share options granted under an employee incentive scheme, but the other jurisdiction does not, then this item of deductible expenditure will not give rise to a DD outcome. On the other hand, if one jurisdiction treats a travel subsidy as a deductible allowance, while the

other simply categorises the payment as part of the taxpayer's (deductible) salary or wages, then the payment will still be treated as giving rise to a DD outcome notwithstanding the different ways in which the payment is described under the laws of each jurisdiction.

Differences in valuation should not affect the amount treated as giving rise to a DD outcome

195. If a payment has triggered a deduction under the laws of two or more jurisdictions then differences between the payer and parent jurisdictions as to the value of that payment will not generally impact on the extent to which a payment has given rise to a mismatch in tax outcomes. This principle is illustrated in **Example 6.3** where a hybrid payer allocates share options to an employee. The example concludes that the grant of the share options should be treated as giving rise to a DD outcome if the laws of the payer and parent jurisdiction both allow a deduction for the grant of such options. The example notes that differences between the jurisdictions in the amount of value they ascribe to the share options will not generally prevent the deductible hybrid payments rule applying to the entire amount of the deduction under the laws of either jurisdiction.

Differences in timing should not affect the amount treated as giving rise to a DD outcome

196. The hybrid mismatch rules are not generally intended to impact on mismatches in the timing of income and expenditure. Equally the operation of the rules is not dependant on the timing of the deduction or receipt in the other jurisdiction. If a payment will be deductible under the laws of the other jurisdiction (or if an item of income will be included under the laws of another jurisdiction) it will be treated as a double deduction (or dual inclusion income) at the moment it is treated as incurred (or derived) under local law. This principle is illustrated in **Example 6.1** where both the hybrid person and its immediate parent are entitled to a deduction for the same interest payment. Differences in timing rules, however, mean that one jurisdiction requires the taxpayer to defer a deduction for part of the accrued interest expense to the next accounting period. The resulting difference in timing between the jurisdictions does not prevent the deductible hybrid payments rule from applying to the whole interest payment in both jurisdictions.

Dual inclusion income

197. An item of income will be dual inclusion income if the same item is included in income under the laws of the jurisdictions where the DD outcome arises. As for deductions, the identification of whether an item should be treated as dual inclusion income is primarily a legal question that requires a comparison of the treatment of that item under the laws of both jurisdictions. An amount should still be treated as dual inclusion income even if there are differences between jurisdictions in the way they value that item or in the accounting period in which that item is recognised for tax purposes. This principle is applied in **Example 6.1** and **Example 6.3** where the laws of the parent and the payer jurisdiction use different timing and valuation rules in the recognition of the income of a hybrid entity. In this case, both countries apply their own rules for calculating the amount of dual inclusion income arising in each period and the resulting difference in measurement does not impact on the operation of the rule.

198. Double taxation relief, such as a domestic dividend exemption granted by the payer jurisdiction or a foreign tax credit granted by the payee / parent jurisdiction should

not prevent an item from being treated as dual inclusion income where the effect of such relief is simply to avoid subjecting that item to an additional layer of taxation in either jurisdiction. Thus, while a payment must generally be recognised as ordinary income under the laws of both jurisdictions before it can be treated as dual inclusion income, an equity return should still qualify as dual inclusion income if the payment is subject to an exemption, exclusion, credit of other type of double taxation relief in the payer or parent jurisdiction that relieves the payment from economic double taxation. An example of this type of dual inclusion income is given in **Example 6.3** where the expenses of a hybrid entity are funded by an intra-group dividend that is exempt from taxation in the jurisdiction where the dividend is received but included as income under the laws of its parent. Allowing the hybrid entity a deduction against this type of exempt or excluded equity return preserves the intended tax policy outcomes in both jurisdictions. The dividend should be treated as dual inclusion income for the purposes of deductible hybrid payments rule even where such dividend carries an entitlement to an underlying foreign tax credit in the parent jurisdiction. Such double taxation relief may give rise to tax policy concerns, however, if it has the same net effect as allowing for a DD outcome. In determining whether to treat an item of income, which benefits from such double-taxation relief, as dual-inclusion income, countries should seek to strike a balance between rules that minimise compliance costs, preserve the intended effect of such double taxation relief and prevent taxpayers from entering into structures that undermine the integrity of the rules.

199. A tax administration may treat the net income of a CFC that is attributed to a shareholder of that company under a CFC or other offshore inclusion regime as dual inclusion income if the taxpayer can satisfy the tax administration that such income has been brought into account as income and subject to tax at the full rate under the laws of both jurisdictions. **Example 6.4** sets out a simplified calculation that illustrates how income attributed under a CFC regime can be taken into account in determining the amount of dual inclusion income under a hybrid structure.

To the extent of the mismatch

200. The adjustment should be no more than is necessary to neutralise the hybrid mismatch and should result in an outcome that is proportionate and that does not lead to double taxation. When applying the defensive rule, however, the amount of the deduction that must be denied in order to neutralise the mismatch may exceed the amount of the deduction that would have been disallowed by the parent jurisdiction in respect of the same payment. This will be the case, for example, where deductible interest accrued by a hybrid person is treated as allocated to a number of investors in accordance with their proportionate interest in the entity. As explained in **Example 6.5** a deduction must be denied for the full amount of the interest payment under the defensive rule in order to eliminate any mismatch in tax outcomes even though only a portion of the interest payment is treated as giving rise to a duplicate deduction under the laws of the investor's jurisdiction.

Excess deductions

Carry-forward of deductions to another period

201. Because the hybrid mismatch rules are generally not intended to impact on, or be affected by, timing differences, the deductible hybrids payment rules contain a mechanism that allows jurisdictions to carry-forward (or back if permitted under local

law) double deductions to a period where they can be set-off against surplus dual inclusion income. The Recommendation contemplates that the ordinary domestic rules governing the utilisation of losses would apply to such deductions. **Example 6.1** sets out an example of the operation of the carry-forward of excess deductions.

Stranded losses

202. In certain cases the rule may operate to restrict a deduction in the payer or parent jurisdiction even though the deduction that arises in the other jurisdiction cannot be used to offset income in that jurisdiction (because, for example, the business in that jurisdiction is in a net loss position). In this case it is possible for the rule to generate "stranded losses" that cannot be used in one jurisdiction for practical and commercial reasons and that cannot be used in the other jurisdiction due to the fact that they are caught by Recommendation 6. Recommendation 6.1(d) provides that a tax administration may permit those excess deductions to be set-off against non-dual inclusion income if the taxpayer can establish that the deduction in the other jurisdiction cannot be offset against any income that is not dual inclusion income. The treatment of stranded losses is discussed in **Example 6.2** where a taxpayer incurs losses in a foreign branch. In that example, the deductible hybrid payments rule has the potential to generate "stranded losses" if the taxpayer abandons its operations in the payer jurisdiction and winds up the branch at a time when it still has unused carry-forward losses from a prior period. The example notes that the tax administration may permit the taxpayer to set-off any excess against non-dual inclusion income provided the taxpayer can establish that the winding up of the branch will prevent the taxpayer from using those losses anywhere else. Stranded losses are discussed further in respect of dual resident entities at **Example 7.1**.

Implementation solution based on existing domestic rules

203. In principle, Recommendation 6 requires the taxpayer to identify the items of deductible expenditure under the laws of both jurisdictions and to determine which of those items have given rise to DD outcomes. The rule then caps the aggregate amount of duplicate deductions that can be claimed to the aggregate amount of dual inclusion income. Dual inclusion income should, in principle, be identified in the same way (i.e. by identifying each item of income in the domestic jurisdiction and determining whether and to what extent those items have been included in income in the other jurisdiction).

204. It may be possible to undertake such a line by line comparison in straightforward cases, where the hybrid payer or foreign branch is party to only a few transactions, but in more complex cases, where the taxpayer has entered into a large number transactions which could all potentially give rise to DD outcomes or dual inclusion income, this kind of approach could entail a significant compliance burden. In order to facilitate implementation and minimise compliance costs, tax administrations will wish to consider an implementation solution that preserves the policy objectives of the deductible hybrids payments rule and arrives at a substantially similar result but is based, as much as possible, on existing domestic rules, administrative guidance, presumptions and tax calculations.

205. In the case of the kind of structures covered by Recommendation 6, it will generally be the case that accounts have been prepared in both jurisdictions that will show the income and expenditure of the taxpayer. These accounts will generally be prepared under local law using domestic tax concepts. Tax administrations should use these

existing sources of information and tax calculations as a starting point for identifying duplicate deductions and dual inclusion income.

206. For example, a parent jurisdiction that requires the preparation of separate branch accounts could restrict the ability of the taxpayer to deduct any resulting branch loss from the income of the parent or parent affiliate. Alternatively the parent jurisdiction could require the branch to make adjustments to the accounts that have been prepared under the laws of the payer jurisdiction (eliminating items of income and expenditure that are not recognised under the law of the parent jurisdiction) to determine whether the activities of the branch have resulted in a net loss (as determined under parent jurisdiction's rules).

207. When applying the defensive rule, and subject to concerns about compliance and administration costs (especially when numerous items of income and expenditure are involved), a payer jurisdiction could adjust the income and expenditure of a hybrid person or branch to eliminate any material items of income or deduction that are not recognised under the laws of the parent jurisdiction. The payer jurisdiction could deny a deduction to the extent of any adjusted net loss and prevent the net loss being carried-forward to a subsequent period in the event of a change in control. Examples of implementation solutions to address DD outcomes are set out further in **Example 6.1** to **Example 6.5**.

Recommendation 6.2 - Rule only applies to deductible payments made by a hybrid payer

208. Recommendation 6.2 confines the operation of the deductible hybrid payments rule to DD outcomes that arise through the use of a foreign branch or hybrid entity.

209. Recommendation 6 does not presuppose that the person making the payment is regarded as transparent in one jurisdiction and opaque in the other. Paragraph (a) of the definition of "hybrid payer" applies in cases such as foreign branch structures where the payer is treated as transparent under the laws of both jurisdictions. The application of the deductible hybrid payments rule to a branch is set out in **Example 6.2**.

210. Paragraph (b) of Recommendation 6.2 covers those cases where the payer is a hybrid person, that is to say where the payer is treated as transparent by one of its investors so that a duplicate deduction arises for that investor in another jurisdiction. A transparent person in this case can include a disregarded person or one that is treated as if it were a partnership under the laws of the parent jurisdiction. **Example 6.3** sets out an instance where the rule applies to deductible payment made by a disregarded person and **Example 6.5** illustrates the application of the rule to entities that are treated as partnerships.

Recommendation 6.3 - Rule only applies to payments that result in a hybrid mismatch

211. A DD outcome will give rise to tax policy concerns where the laws of both jurisdictions permit a deduction for the same payment to be set-off against an amount that is not dual inclusion income (see **Example 6.2**). Recommendation 6.3 restricts the application of the deductible hybrid payments rule to those cases where the deduction may be set-off against dual inclusion income. It is not necessary for a tax administration to know whether the deduction has actually been applied against non-dual inclusion income in the other jurisdiction before it is subject to restriction under the rule.

212. In general, the deduction that arises in the parent jurisdiction will be available to be set-off against non-dual inclusion income (i.e. other income of the taxpayer) unless the parent jurisdiction has implemented the deductible hybrid payments rule.

213. The most common mechanism used to offset a double deduction that arises in the payer jurisdiction will be the use of a tax consolidation or grouping regime that allows a domestic taxpayer to apply the benefit of a deduction against the income of another person within the same group. There are a number of ways of achieving this offset. Some countries permit taxpayers to transfer losses, deductions, income and gains to other group members. Other jurisdictions simply treat all the group members as a single taxpayer. Some consolidation regimes permit taxpayers in the same group to make taxable intra-group payments in order to shift net income around the group. Regardless of the mechanism used to achieve tax grouping or consolidation, if its effect is to allow a double deduction to be set-off against income that will not be brought into account under the laws of the parent jurisdiction that will be sufficient to bring the double deduction within the scope of the hybrid deductible payments rule.

214. There are a number of other different techniques that a taxpayer can use in the payer jurisdiction to set-off a double deduction against non-dual inclusion income. These techniques include having the taxpayer:

(a) make an investment through a reverse hybrid so that the income of the reverse hybrid is only brought into account under the laws of the payer jurisdiction. An example of such a structure is set out in **Example 6.1**.

(b) enter into a financial instrument or other arrangement where payments are included in ordinary income in the payer jurisdiction but not included in income in the parent jurisdiction. An example of such a structure is set out in **Example 3.1** in respect of an adjustment under the disregarded hybrid payments rule.

(c) enter into a merger transaction or other corporate re-organisation that permits losses that have been carried-forward to be offset against the income of other entities.

Recommendation 6.4 - Scope of the rule

215. Recommendation 6.4 limits the scope of the defensive rule to structured arrangements and mismatches that arise within a control group. See Recommendations 10 and 11 regarding the definition of structured arrangements and control group.

Chapter 7

Dual-resident payer rule

Recommendation 7

1. Neutralise the mismatch to the extent the payment gives rise to a DD outcome

The following rule should apply to a dual resident that makes a payment that is deductible under the laws of both jurisdictions where the payer is resident and that DD outcome results in a hybrid mismatch:

(a) Each resident jurisdiction will deny a deduction for such payment to the extent it gives rise to a DD outcome.

(b) No mismatch will arise to the extent that the deduction is set-off against income that is included as income under the laws of both jurisdictions (i.e. dual inclusion income).

(c) Any deduction that exceeds the amount of dual inclusion income (the excess deduction) may be eligible to be set-off against dual inclusion income in another period. In order to prevent stranded losses, the excess deduction may be allowed to the extent that the taxpayer can establish, to the satisfaction of the tax administration, that the excess deduction cannot be set-off against any income under the laws of the other jurisdiction that is not dual inclusion income.

2. Rule only applies to deductible payments made by a dual resident

A taxpayer will be a dual resident if it is resident for tax purposes under the laws of two or more jurisdictions.

3. Rule only applies to payments that result in a hybrid mismatch

A deduction for a payment results in a hybrid mismatch where the deduction for the payment may be set-off, under the laws of the other jurisdiction, against income that is not dual inclusion income.

4. Scope of the rule

There is no limitation on the scope of the rule.

Overview

216. A payment made by a dual resident taxpayer will trigger a DD outcome where the payment is deductible under the laws of both jurisdictions where the taxpayer is resident. Such a DD outcome will give rise to tax policy concerns where one jurisdiction permits that deduction to be set-off against an amount that is not treated as income under the laws of the other jurisdiction (i.e. against income that is not "dual inclusion income").

217. Recommendation 6 applies to DD outcomes in respect of expenditure incurred through a foreign branch or hybrid person where it is possible to distinguish between the jurisdiction where the expenditure is actually incurred (the payer jurisdiction) and the jurisdiction where the duplicate deduction arises due to the resident status or the tax transparency of the payer (the parent jurisdiction). The distinction between the parent/payer jurisdictions is not possible in the context of dual resident taxpayers because it is not possible to reliably distinguish between where the payment is actually made and where the duplicate deduction has arisen. In this case, therefore, the dual resident payer rule provides that both jurisdictions should apply the primary rule to restrict the deduction to dual inclusion income. There is no limitation on the scope of the response under the dual resident payer rule as the deduction that arises in each jurisdiction is being claimed by the same taxpayer.

218. As for Recommendation 6, determining which payments have given rise to a double deduction and which items are dual inclusion income requires a comparison between the domestic tax treatments of these items in each jurisdiction where the payer is resident. As discussed in Recommendation 6, countries should choose an implementation solution that is based, as much as possible, on existing domestic rules, administrative guidance, presumptions and tax calculations while still meeting the basic policy objectives of the dual resident payer rule.

219. Jurisdictions use different tax accounting periods and have different rules for recognising when items of income or expenditure have been derived or incurred. These timing differences should not be treated as giving rise to mismatches in tax outcomes under Recommendation 7. Recommendation 7.1(c) allows excess deductions that are subject to restriction under the deductible hybrid payments rule to be carried over to another period and jurisdictions may further permit excess losses to be set-off against non-dual inclusion income if a taxpayer can show that such losses have become stranded.

Recommendation 7.1 - Neutralise the mismatch to the extent it gives rise to a DD outcome

220. Recommendation 7.1 identifies the hybrid element in the structure as a deductible payment made by a dual resident that gives rise to a corresponding "duplicate deduction" in the other jurisdiction where the payer is resident. The primary response is that the deduction cannot be claimed for such payment to the extent it exceeds the payer's dual inclusion income (income brought into account for tax purposes under the laws of both jurisdictions). As both jurisdictions will apply the primary response there is no need for a defensive rule.

221. As with other structures that generate DD outcomes, the excess deductions can be offset against dual inclusion income in another period. In order to prevent stranded losses, it is recommended that excess duplicate deductions should be allowed to the extent that the taxpayer can establish, to the satisfaction of the tax administration, that the deduction cannot be set-off against any income under the laws of the other jurisdiction that is not dual inclusion income.

Deductible payments caught by the rule

222. The meaning of deductible payment is the same as that used in other recommendations in the report and generally covers a taxpayer's current expenditures such as service payments, rents, royalties, interest and other amounts that may be set-off

against ordinary income under the laws of the payer jurisdiction in the period they are treated as made.

223. As for Recommendation 6, the determination of whether a payment is deductible requires a proper assessment of the character and treatment of the payment under the laws of each jurisdiction where the taxpayer is resident. The rule will not apply to the extent the taxpayer is subject to transaction or entity specific rules under the laws of either jurisdiction that prevent the payment from being deducted. These restrictions on deductibility may include hybrid mismatch rules in one jurisdiction that deny the taxpayer a deduction in order to neutralise a direct or indirect D/NI outcome.

Extending the principles of Recommendation 7 to other deductible items

224. Dual resident payers can also be used to generate double deductions for non-cash items such as depreciation or amortisation. As discussed in the guidance to Recommendation 6.1, DD outcomes raise the same tax policy issues regardless of how the deduction has been triggered. Distinguishing between deductible items on the basis of whether or not they are attributable to a payment may complicate rather than simplify the implementation of these recommendations. Accordingly, when implementing the hybrid mismatch rules into domestic law, countries may wish to apply the principles of Recommendation 7 to all deductible items regardless of whether the deduction that arises is attributable to a payment.

Determining the existence and amount of a DD outcome and dual inclusion income

225. As discussed in the guidance to Recommendation 6.1, the question of whether a payment has given rise to a "DD outcome" is primarily a legal question that should be determined by an analysis of the character and tax treatment of the payment under the laws of each residence jurisdiction. If both jurisdictions grant a deduction for the same payment (or an allowance respect of the same asset) then that deduction can be said to give rise to a DD outcome. Differences between jurisdictions as to the quantification and timing of a deduction will not generally impact on the extent to which a payment has given rise to a mismatch in tax outcomes. A payment should be treated as giving rise to a double deduction (or dual inclusion income) at the moment it is treated as incurred (or derived) under local law regardless of when such payment has been treated incurred (or derived) under the laws of the other jurisdiction.

226. While a payment must generally be recognised as ordinary income under the laws of both jurisdictions before it can be treated as dual inclusion income, an equity return should still qualify as dual inclusion income if the payment is subject to an exemption, exclusion, credit of other type of double taxation relief that relieves the payment from economic double taxation. An example of this type of dual inclusion income is given in **Example 7.1** in respect of the dual resident payer rule. Such double taxation relief may give rise to tax policy concerns, however, if it has the same net effect as allowing for a DD outcome. In determining whether to treat an item of income, which benefits from such double-taxation relief, as dual-inclusion income, countries should seek to strike a balance between rules that minimise compliance costs, preserve the intended effect of such double taxation relief and prevent taxpayers from entering into structures that undermine the integrity of the rules. As discussed in the guidance to Recommendation 6.1, a tax administration may also treat the net income of a CFC that is attributed to a shareholder of that company under a CFC or other offshore inclusion regime as dual

inclusion income if the taxpayer can satisfy the tax administration that the CFC regime brings that amount of income into account so that it is subject to tax at the full rate under the laws of both jurisdictions.

Recommended response

227. Where a payment by a dual resident payer gives rise to a DD outcome, the jurisdiction where the payer is resident should apply the recommended response to neutralise the effect of the mismatch by denying the deduction to the extent it gives rise to a mismatch in tax outcomes. A DD outcome will give rise to a mismatch in tax outcomes to the extent it is set-off against income that is not dual inclusion income. The adjustment should be no more than is necessary to neutralise the hybrid mismatch and should result in an outcome that is proportionate and that does not lead to double taxation. **Example 7.1** illustrates a situation where the simultaneous application of the dual resident payer rules in both residence jurisdictions has the potential to create double taxation. As noted in that example, however, structuring opportunities will usually be available to avoid the risk of double taxation.

Excess deductions

Carry-forward of deductions to another period

228. Because the hybrid mismatch rules are generally not intended to impact on, or be affected by, timing differences both Recommendations 6 and 7 allow jurisdictions to carry-forward (or -back if permitted under local law) double deductions to a period where they can be set-off against surplus dual inclusion income. The Recommendations contemplate that the ordinary domestic rules governing the utilisation of losses would apply to such deductions.

Stranded losses

229. In certain cases the rule may operate simultaneously to restrict a deduction in both jurisdictions. In this case it is possible for the rule to generate “stranded losses” that cannot be used in either jurisdiction. Recommendation 7.1(c) provides that a tax administration may permit those excess deductions to be set-off against non-dual inclusion income if the taxpayer can establish that the deduction that has arisen in the other jurisdiction cannot be offset against any income that is not dual inclusion income. **Example 7.1** discusses allowances for the use of stranded losses in respect of dual resident payers.

Recommendation 7.2 - Rule only applies to deductible payments made by a dual resident

230. Recommendation 7.2 confines the operation of the deductible hybrid payments rule to DD outcomes that arise through the use of dual resident structures.

231. A person should be treated as a resident of a jurisdiction for tax purposes if it qualifies as tax resident or is taxable in that jurisdiction on their worldwide net income. As discussed in **Example 7.1**, a person will be treated as a resident of a jurisdiction even if that person forms part of a tax consolidation group which treats that person as disregarded for local law purposes.

Recommendation 7.3 - Rule only applies to payments that result in a hybrid mismatch

232. As for Recommendation 6.3, the dual resident payer rule restricts the application of the deductible hybrid payments rule to those cases where the other jurisdiction permits the deduction to be set-off against income that is not dual inclusion income. It is not necessary for a tax administration to know whether the deduction has actually been applied against non-dual inclusion income in the other jurisdiction before it applies the rule in Recommendation 7.

233. The same techniques that a taxpayer can use to trigger a DD outcome that falls within the scope of Recommendation 6 can also be used to generate hybrid mismatches under Recommendation 7. These techniques include: the use of tax consolidation regimes, having the taxpayer make an investment through a reverse hybrid and entering into a financial instrument or other arrangement where payments are included in income in one jurisdiction but not the other. An example of the use of a consolidation regime and of the use of a reverse hybrid structure involving a dual resident entity is given in **Example 7.1**.

Chapter 8

Imported mismatch rule

Recommendation 8

1. Deny the deduction to the extent the payment gives rise to an indirect D/NI outcome

The payer jurisdiction should apply a rule that denies a deduction for any imported mismatch payment to the extent the payee treats that payment as set-off against a hybrid deduction in the payee jurisdiction.

2. Definition of hybrid deduction

Hybrid deduction means a deduction resulting from:

(a) a payment under a financial instrument that results in a hybrid mismatch;

(b) a disregarded payment made by a hybrid payer that results in a hybrid mismatch;

(c) a payment made to a reverse hybrid that results in a hybrid mismatch; or

(d) a payment made by a hybrid payer or dual resident that triggers a duplicate deduction resulting in a hybrid mismatch;

and includes a deduction resulting from a payment made to any other person to the extent that person treats the payment as set-off against another hybrid deduction.

3. Imported mismatch payment

An imported mismatch payment is a deductible payment made to a payee that is not subject to hybrid mismatch rules.

4. Scope of the rule

The rule applies if the taxpayer is in the same control group as the parties to the imported mismatch arrangement or where the payment is made under a structured arrangement and the taxpayer is party to that structured arrangement.

Overview

234. The policy behind the imported mismatch rule is to prevent taxpayers from entering into structured arrangements or arrangements with group members that shift the effect of an offshore hybrid mismatch into the domestic jurisdiction through the use of a non-hybrid instrument such as an ordinary loan. The imported mismatch rule disallows deductions for a broad range of payments (including interest, royalties, rents and payments for services) if the income from such payments is set-off, directly or indirectly, against a deduction that arises under a hybrid mismatch arrangement in an offshore jurisdiction (including arrangements that give rise to DD outcomes). The key objective of imported mismatch rule is to maintain the integrity of the other hybrid mismatch rules by

removing any incentive for multinational groups to enter into hybrid mismatch arrangements. While these rules involve an unavoidable degree of co-ordination and complexity, they only apply to the extent a multinational group generates an intra-group hybrid deduction and will not apply to any payment that is made to a taxpayer in a jurisdiction that has implemented the full set of recommendations set out in the report.

235. The imported mismatch rule applies to both structured and intra-group imported mismatch arrangements and can be applied to any payment that is directly or indirectly set-off against any type of hybrid deduction. This guidance sets out three tracing and priority rules to be used by taxpayers and administrations to determine the extent to which a payment should be treated as set-off against a deduction under an imported mismatch arrangement. These rules start by identifying the payment that gives rise to a hybrid mismatch under one of the other chapters in this report (a "direct hybrid deduction") and then determine the extent to which the deductible payment made under that hybrid mismatch arrangement has been funded (either directly or indirectly) out of payments made by taxpayers that are subject to the imported mismatch rule ("imported mismatch payments"). The tracing and priority rules are summarised below, in the order in which they should be applied.

Structured imported mismatches

236. If the hybrid deduction is attributable to a payment made under a *structured arrangement* it will be treated as giving rise to an imported mismatch to the extent that deduction is funded out of the *payments made under that structured arrangement*. This rule applies a tracing approach to determine to what extent an imported mismatch payment made under a structured arrangement has been set-off (directly or indirectly) against a hybrid deduction under the same arrangement.

Direct imported mismatches

237. If the structured imported mismatch rule does not fully neutralise the effect of the mismatch, the direct imported mismatch rule treats the hybrid deduction as giving rise to an imported mismatch to the extent that it is directly set-off against payments received from other members of the group that are subject to the imported mismatch rule. This rule applies an apportionment approach which prevents the same hybrid deduction giving rise to an imported mismatch under the laws of more than one jurisdiction.

Indirect imported mismatch rule

238. Finally, if the structured or direct imported mismatch rule does not fully neutralise the effect of the mismatch, the indirect imported mismatch rule treats any surplus hybrid deduction as being set-off against imported mismatch payments received indirectly from members of the same control group. This rule applies a *tracing methodology* to determine to what extent the expenditure that gave rise to a surplus hybrid deduction has been indirectly funded by imported mismatch payments from other group members and an *apportionment approach*, which prevents the same surplus hybrid deduction being treated as set-off against an imported mismatch payment under the laws of more than one jurisdiction.

239. These three rules are designed to co-ordinate the operation of the imported mismatch rule within and between jurisdictions so that they can be applied consistently by each jurisdiction to neutralise the effect of imported mismatch arrangements while avoiding double taxation and ensuring predictable and transparent outcomes for

taxpayers. The rules contemplate that each member of the group will calculate the amount of imported mismatch payments and hybrid deductions on the same basis, in order to prevent differences in the calculation, timing and quantification of payments giving rise to the risk of over- or under-taxation.

Recommendation 8.1 - Deny the deduction to the extent the payment gives rise to an indirect D/NI outcome

240. Imported mismatches rely on the absence of effective hybrid mismatch rules in offshore jurisdictions in order to generate the mismatch in tax outcomes which can then be imported into the payer jurisdiction. Therefore the most reliable protection against imported mismatches will be for all jurisdictions to introduce rules recommended in this report. Such rules will neutralise the effect of the hybrid mismatch arrangement in the jurisdiction where it arises and prevent its effect being imported into a third jurisdiction.

241. In order to protect the integrity of the recommendations, however, this report further recommends the adoption of linking rule that requires the payer jurisdiction to deny a deduction for a payment to the extent the income from such payment is offset against a hybrid deduction in the counterparty jurisdiction. The imported mismatch rule has three basic elements:

(a) a deductible payment, made by a taxpayer that is subject to the hybrid mismatch rules, and which is included in ordinary income under the laws of the payee jurisdiction (an "imported mismatch payment");

(b) a deductible payment made by a person that is not subject to the hybrid mismatch rules which directly gives rise to a hybrid mismatch (a "direct hybrid deduction");

(c) a nexus between the imported mismatch payment and the direct hybrid deduction that shows how the imported mismatch payment has been set-off (whether directly or indirectly) against that hybrid deduction.

Imported mismatch payment

242. The definition of payment used in the imported mismatch rule is the same as that used for the other recommendations. It is generally broad enough to capture any transfer of value from one person to another but it does not include payments that are only deemed to be made for tax purposes and that do not involve the change of any economic rights between the parties. A payment will only be treated as an imported mismatch payment if it is both deductible under the laws of the payer jurisdiction and gives rise to ordinary income under the laws of the payee jurisdiction. Imported mismatch payments will therefore include rents, royalties, interest and fees paid for services but will not generally include amounts that are treated as consideration for the disposal of an asset. A payment made to a person who is not a taxpayer in any jurisdiction 9such as in **Example 1.6**) will not be treated as an imported mismatch payment.

Hybrid deduction

243. A person's hybrid deduction can come from two sources:

(a) payments that directly give rise to a D/NI or DD outcome under one of the hybrid mismatch arrangements identified in the other chapters in this report. These types of hybrid deductions are referred to in this guidance as "direct hybrid deductions".

(b) hybrid deductions that are surrendered to a group member under a tax grouping regime or arise as a consequence of making taxable payments to a group member with surplus hybrid deductions. These types of hybrid deductions are referred to in this guidance as "indirect hybrid deductions".

A hybrid deduction does not arise, however, to the extent a disregarded or deductible hybrid payment is set-off against dual inclusion income (see **Example 8.11** and **Example 8.12**). The method for calculating a person's hybrid deductions is set out further below.

Nexus between hybrid deduction and imported mismatch payment

244. The third element of the imported mismatch rule is that there must be a nexus, or chain of transactions and payments, that connects the hybrid deduction of one person with the imported mismatch payment made by another. This will be relatively easy to establish in the case of direct imported mismatches where the imported mismatch payment is made to the person who has the direct hybrid deduction. The tracing exercise will become more complex, however, where the imported mismatch payment must be traced through a chain of taxable payments or offsets under a tax grouping regime in order to determine whether the imported mismatch payment has been set-off against an indirect hybrid deduction under the indirect imported mismatch rule.

245. A number of different approaches could be adopted for determining whether, and to what extent, the hybrid deduction has been used to shelter the income on an imported mismatch payment. Countries applying the imported mismatch rules should, however, adopt a uniform approach that is clear, easy to administer and apply and that avoids the risk of double taxation.

Tracing and priority rules

246. This guidance sets out three tracing and priority rules that a jurisdiction should apply to determine the extent of the adjustment required under the imported mismatch rule. The rules should be applied (in the following order) by each jurisdiction that has an imported mismatch rule:

(a) The first rule (the "structured imported mismatch rule") identifies whether a direct hybrid deduction is part of a structured arrangement and, if so, treats that hybrid deduction as being set-off against any imported mismatch payment that forms part of the same arrangement and that funds (directly or indirectly) the expenditure that gave rise to the hybrid deduction.

(b) To the extent the mismatch in tax outcomes has not been neutralised by a jurisdiction applying the structured imported mismatch rule, the second rule then looks to see whether the taxpayer's hybrid deduction can be directly set-off against an imported mismatch payment made by a taxpayer that is a member of the same control group (the direct imported mismatch rule).

(c) Finally the jurisdiction should determine the extent to which any surplus hybrid deductions can be treated as being indirectly set-off against imported mismatch payments from other group members under the indirect imported mismatch rule.

247. Each of these rules applies a different approach to determining the nexus between the imported mismatch payment and the hybrid deduction. The structured imported mismatch rule applies a tracing approach that starts with the imported mismatch payment in one jurisdiction and follows the path of payments under the structured arrangement,

through the interconnected entities and payments that make up the arrangement, to identify whether that imported mismatch payment has directly or indirectly funded expenditure that gives rise to the hybrid deduction. The direct imported mismatch rule applies an apportionment rule that looks to the aggregate amount of imported mismatch payments received by a group member and the aggregate amount of hybrid deductions incurred by that group member and treats the hybrid deduction as being set-off against the imported mismatch payment in the same proportion. The indirect imported mismatch rule applies a combination of tracing and apportionment approaches to determine whether, and to what extent, an imported mismatch payment made by a taxpayer in one part of the group can be said to be indirectly set-off against a hybrid deduction of a taxpayer in another part of the group.

Structured imported mismatch arrangements

248. Where a hybrid deduction has arisen under a structured arrangement it is necessary to identify all the steps and transactions that form part of the same arrangement and to identify whether the taxpayer has made a deductible payment under that arrangement that has been set-off (directly or indirectly) against that hybrid deduction. The structured imported mismatch rule is applied first because it has a wider scope and applies to all the payments made under a structured arrangement even if those payments are not intra-group. The structured imported mismatch arrangement should be applied, however, whenever a hybrid deduction forms part of a structured arrangement even where the mismatch in tax outcomes occurs within the confines of a wholly-owned group. For example, in **Example 8.1**, a multinational group puts in place a group financing structure where the first link in the chain of intra-group loans is designed to produce a hybrid mismatch. In that case, all the intra-group loans and imported mismatch payment flows under the financing arrangement are treated as part of the same structured arrangement.

249. The tracing approach under the structured imported mismatch rule requires taxpayers to follow the flow of payments under the structured arrangement through the tiers of entities and transactions that make up the arrangement to determine if the taxpayer's imported mismatch payment has been directly or indirectly offset against a hybrid deduction arising under the same arrangement. In general it is expected that a tax administration will respect both a taxpayer's decision to treat a transaction that gives rise to a hybrid mismatch as forming part of a structured arrangement and the taxpayer's definition of the scope of that structured arrangement provided that treatment and definition is applied consistently by all the parties to that structured arrangement.

250. **Example 8.1**, **Example 8.2** and **Example 10.5** illustrate the operation of the structured imported mismatch rule.

Intra-group mismatches

251. Although a hybrid mismatch arrangement that is entered into between two members of a wholly-owned group may not be designed to shelter income of any taxpayer other than the immediate parties to the arrangement, any such mismatch has the net effect of lowering the aggregate tax burden of the group and the combination of intra-group payment flows and the fungible nature of income and expenses for tax purposes can make it difficult, if not impossible, to determine, which taxpayer in the group has derived a tax advantage under a hybrid mismatch arrangement. In order to neutralise the effect of such intra-group mismatches, without giving rise to economic double taxation,

this guidance sets out a direct and indirect imported mismatch rule which should be applied (in that order) to neutralise the effect of such intra-group mismatches.

Direct imported mismatches

252. The direct imported mismatch rule applies an apportionment approach that compares the amount of the taxpayer's hybrid deductions (including any indirect hybrid deductions) to the total amount of imported mismatch payments made to that taxpayer by group entities (as calculated under the law of the taxpayer's jurisdiction) and treats each imported mismatch payment as being set-off against those hybrid deductions in accordance with that ratio. Calculating the limitation by reference to a ratio determined under the laws of the payee jurisdiction ensures that each jurisdiction applies the direct imported mismatch rule on the same basis. The direct imported mismatch rule provides countries with a simple and comprehensive solution for neutralising the effect of intra-group mismatches while avoiding the risk of economic double taxation. Any remaining hybrid deductions that are not treated as set-off against direct imported mismatch payments will be treated as "surplus hybrid deductions" and allocated in accordance with the indirect imported mismatch rule described in further detail below.

253. The mechanical steps in the application of the structured and direct imported mismatch rule are as follows:

(a) The tax manager of the group should determine whether any group entity has direct hybrid deductions.

(b) If the direct hybrid deduction arises under a transaction that forms part of a structured arrangement, then those hybrid deductions should be treated as directly or indirectly set-off against imported mismatch payments made under the same arrangement.

(c) Any remaining hybrid deductions, together with any indirect hybrid deductions allocated to that group member in accordance with the indirect imported mismatch rule (see below), should be treated as directly set-off (pro-rata) against imported mismatch payments made by a group member.

(d) Hybrid deductions that are not neutralised under the structured or direct imported mismatch rules are treated as surplus hybrid deductions.

254. **Example 8.2** to **Example 8.4**, and **Example 8.6**, **Example 8.7** and **Example 8.10**, illustrate the operation of the direct imported mismatch rule.

Indirect imported mismatches

255. If the effect of the hybrid deduction has not been fully neutralised through the operation of the direct imported mismatch rule, the final step is to determine whether the surplus hybrid deduction should be allocated to another group member under the indirect imported mismatch rule.

256. The indirect imported mismatch rule applies a waterfall approach (described below) to determine to what extent the surplus hybrid deduction has been indirectly funded from imported mismatch payments made by members of the same group. This approach incorporates an allocation and tracing methodology to match a taxpayer's surplus hybrid deductions with imported mismatch payments within the group while ensuring that the rule will not result in the same hybrid deduction being set-off against an imported mismatch payment under the laws of more than one jurisdiction.

257. The group member's surplus hybrid deductions are allocated proportionately around the group in accordance with taxable payment flows within the group and in a way that takes into account the extent to which such taxable payments have been funded, directly or indirectly, out of imported mismatch payments. The resulting offset gives rise to an indirect hybrid deduction for the group member making the taxable payment. That indirect hybrid deduction can, in turn, be treated as set-off against an imported mismatch payment under the direct imported mismatch rule or give rise to a further surplus hybrid deduction that can be allocated to another group member.

258. The approach starts with a group member's "surplus hybrid deductions", which are the total of that group member's direct and indirect hybrid deductions that have not been neutralised by a jurisdiction applying the structured or direct imported mismatch rule. The group member's surplus hybrid deductions are treated as set-off against any taxable payments received. Taxable payments received by a group member will include any intra-group payment that is included in ordinary income by that group member and that is deductible under the laws of the payer jurisdiction (other than an imported mismatch payment).

259. A taxable payment should be treated as fully set-off against a surplus hybrid deduction of each group member unless the amount of a payee's "funded taxable payments" exceeds the amount of the payee's surplus hybrid deductions. A funded taxable payment is any taxable payment that is directly funded out of imported mismatch payments made by other group entities. In a case where the amount of a payee's "funded taxable payments" exceeds the amount of the payee's surplus hybrid deductions, the payee's surplus hybrid deductions should be treated as set-off against such funded taxable payments on a pro-rata basis.

260. The mechanical steps in the application of the indirect imported mismatch rule are as follows:

(a) The tax manager of the group should determine whether any group member has surplus hybrid deductions.

(b) The surplus hybrid deductions of that group member should be treated as surrendered to another member of the same tax group or set-off against a taxable payment made by another group member in accordance with the allocation and tracing methodology of the waterfall approach. This means that:

- In the event the amount of funded taxable payments exceeds the amount of surplus hybrid deductions, the surplus hybrid deductions should only be treated as set-off pro rata to the amount of funded taxable payments.

- In all other cases the surplus hybrid deduction should be treated as fully surrendered under the tax grouping regime or fully set-off against each taxable payment;

(c) The group entity that made the taxable payment or received the benefit of the group surrender (the payer entity) should then apply the direct imported mismatch rule and treat those hybrid deductions as set-off against any imported mismatch payments received from other group members;

(d) Both group entities will have a surplus hybrid deduction to the extent the mismatch in tax outcomes is not addressed through the application of the direct imported mismatch rule as described in paragraph (c) above.

261. The calculation of a group entity's surplus hybrid deduction under paragraph (d) should be adjusted as necessary to ensure that the application of the indirect imported mismatch rule does not result in the same hybrid deduction being treated as indirectly set-off against more than one imported mismatch payment.

262. **Example 8.5** and **Example 8.7** to **Example 8.15** illustrate the operation of the indirect imported mismatch rules.

Losses

263. In order to account for timing differences between jurisdictions and to prevent groups manipulating that timing in order to avoid the effect of the imported mismatch rule, a hybrid deduction should be taken to include any net loss that has been carried-forward to a subsequent accounting period, to the extent that loss results from a hybrid deduction. An example showing the application of the imported mismatch rule to losses which have been carried-forward from a prior period is set out in **Example 8.11** and **Example 8.16**. In order to reduce the complexity associated with the need to identify hybrid deductions that arose prior to the publication of this report any carry-forward loss from periods ending on or before 31 December 2016, should be excluded from the operation of this rule.

Co-ordination of imported mismatch rule between jurisdictions

264. In order to limit compliance costs and the risk of double taxation each country that implements the recommendations set out in the report should make reasonable endeavours to implement an imported mismatch rule that adheres to the methodology set out in this guidance and to apply this methodology in the same way. This will allow the adjustments required under the imported mismatch rules in each jurisdiction to be calculated consistently for the whole group and in a way that avoids any unnecessary duplication of compliance obligations.

265. It will be the domestic taxpayer who has the burden of establishing, to the reasonable satisfaction of the tax administration, that the imported mismatch rule has been properly applied in that jurisdiction. This initial burden may be discharged by providing the tax administration with copies of the group calculations together with supporting evidence of the adjustments that have been made under the imported mismatch rules in other jurisdictions. Tax administrations will generally be relying on the taxpayer to provide them with these calculations and supporting evidence. In the absence of such information, a tax administration may consider issuing its own assessment of the extent to which income from an imported mismatch payment has been directly or indirectly set-off against a hybrid deduction of another group member.

Recommendation 8.2 - Rule only applies to payments that are set-off against a deduction under a hybrid mismatch arrangement

266. Recommendation 8.2 defines when a deduction will be treated as a hybrid deduction for the purposes of the imported mismatch rule.

267. The definition of hybrid deduction includes a payment by a hybrid payer or dual resident that triggers a duplicate deduction resulting in a hybrid mismatch (i.e. a deduction that arises under a DD structure). When applying the imported mismatch rule in the intra-group context the rule applies in such a way that ensures there is no

double-counting of the hybrid deductions that are generated under such a DD structure. An illustration of a hybrid deduction involving a DD structure is set out in **Example 8.12**.

Recommendation 8.3 – Definition of imported mismatch payment

268. As noted above, the most reliable protection against imported mismatches will be for jurisdictions to introduce hybrid mismatch rules recommended in this report. Such rules will address the effect of the hybrid mismatch arrangement in the jurisdiction where it arises, and therefore prevent the effect of such mismatch being imported into a third jurisdiction. The imported mismatch rule therefore will not apply to any payment that is made to a taxpayer in a jurisdiction that has implemented the full set of recommendations set out in the report.

Recommendation 8.4 – Scope of the rule

269. The imported mismatch rule targets both structured arrangements and imported mismatch arrangements that arise within a control group.

270. An imported mismatch should be treated as structured if the hybrid deduction and the imported mismatch payment arise under the same arrangement. The definition of arrangement is set out in Recommendation 12 and includes any agreement, plan or understanding and all the steps and transactions by which it is carried into effect. A structured imported mismatch arrangement therefore includes not only those payments and transactions that give rise to the mismatch but also all the other transactions and imported mismatch payments that are entered into as part of the same scheme plan or agreement.

271. An example of the application of the imported mismatch rule to a structured arrangement is set out in **Example 10.5**. In that example, a fund that is in the business of providing loans to medium-sized enterprises enters into negotiations to provide a company with an unsecured loan that will be used to meet the companies working capital requirements. The fund uses a subsidiary in a third jurisdiction to make the loan and finances that loan through the use of a hybrid financial instrument. Neither the fund nor the subsidiary is resident in a jurisdiction that has introduced the hybrid mismatch rules. In that example, the financing arrangement is conceived as a single plan that includes both the loan by the subsidiary to the taxpayer and the transaction between the subsidiary and the fund that gives rise to the hybrid deduction. The arrangement is therefore a structured arrangement and the taxpayer should be treated as a party to that structured arrangement if it is involved in the design or has sufficient information about the arrangement to understand its operation and effect.

Chapter 9

Design principles

Recommendation 9

1. Design principles

The hybrid mismatch rules have been designed to maximise the following outcomes:

(a) neutralise the mismatch rather than reverse the tax benefit that arises under the laws of the jurisdiction;

(b) be comprehensive;

(c) apply automatically;

(d) avoid double taxation through rule co-ordination;

(e) minimise the disruption to existing domestic law;

(f) be clear and transparent in their operation;

(g) provide sufficient flexibility for the rule to be incorporated into the laws of each jurisdiction;

(h) be workable for taxpayers and keep compliance costs to a minimum; and

(i) minimise the administrative burden on tax authorities.

Jurisdictions that implement these recommendations into domestic law should do so in a manner intended to preserve these design principles.

2. Implementation and co-ordination

Jurisdictions should co-operate on measures to ensure these recommendations are implemented and applied consistently and effectively. These measures should include:

(a) the development of agreed guidance on the recommendations;

(b) co-ordination of the implementation of the recommendations (including timing);

(c) development of transitional rules (without any presumption as to grandfathering of existing arrangements);

(d) review of the effective and consistent implementation of the recommendations;

(e) exchange of information on the jurisdiction treatment of hybrid financial instruments and hybrid entities;

(f) endeavouring to make relevant information available to taxpayers (including reasonable endeavours by the OECD); and

(g) consideration of the interaction of the recommendations with other Actions under the BEPS Action Plan including Actions 3 and 4.

Overview

272. The domestic law changes and hybrid mismatch rules recommended in Part I of the report are designed to be co-ordinated with those in other jurisdictions. Co-ordination of the rules is important because it ensures predictability of outcomes for taxpayers and avoids the risk of double taxation. Co-ordination can be achieved by ensuring that countries implement the recommendations set out in the report consistently and that tax administrations interpret and apply those rules in the same way.

273. In order to achieve that consistency, Recommendation 9 calls on countries to implement and apply the rules in a manner that preserves the underlying policy objectives of the report. The Recommendation further calls on countries to:

(a) agree guidance on how the rules ought to be applied;

(b) co-ordinate the implementation on the rules (primarily as to timing);

(c) agree how the rules should apply to existing instruments and entities that are caught by the rules when they are first introduced (i.e. transitional arrangements);

(d) undertake a review of the operation of the rules as necessary to determine whether they are operating as intended;

(e) agree procedures for exchanging information on the domestic tax treatment of instruments and entities in order to assist tax administrations in applying their rules to hybrid mismatch arrangements within their jurisdiction;

(f) endeavour to make such information available to taxpayers; and

(g) provide further commentary on the interaction between the recommendations in the report and the other Items in the *BEPS Action Plan* (OECD, 2013).

274. The guidance on Recommendation 9.1 sets out and explains the design principles in further detail and the guidance on Recommendation 9.2 sets out further detail on achieving co-ordination in the implementation and application of the rules summarised in the paragraph above.

Recommendation 9.1 - Design principles

275. Although the recommendations in the report are drafted in the form of rules, it is not intended that countries transcribe them directly into domestic law without adjustment. It is expected that the recommendations will be incorporated into domestic tax legislation using existing local law definitions and concepts in a manner that takes into account the existing legislative and tax policy framework. At the same time, countries should seek to ensure that these domestic rules, once implemented, will apply to the same arrangements and entities, and provide for the same tax outcomes, as those set out in the report.

276. The recommendations set out in this report are intended to operate as a comprehensive and coherent package of measures to neutralise mismatches that arise from the use of hybrid instruments and entities without imposing undue burdens on taxpayers and tax administrations.

277. In practice, many of these design principles are complementary. For example, hybrid mismatch rules that apply automatically will be more clear and transparent in their operation and reduce administration costs for tax authorities. Rules that minimise disruption to domestic law will be easier for countries to implement and reduce

compliance costs for taxpayers. Each of these design principles and their implications for the domestic implementation and application of the rules is discussed in further detail below.

Rules should target the mismatch rather than focusing on establishing in which jurisdiction the tax benefit arises

278. The Action Plan simply calls for the elimination of mismatches without requiring the jurisdiction applying the rule to establish that it has "lost" tax revenue under the arrangement. While neutralising the effect of hybrid mismatch arrangements will address the risks to a jurisdiction's tax base, this will not be achieved by capturing additional revenue under the hybrid mismatch rules themselves, rather the rules are intended to drive taxpayers towards less complicated and more transparent tax structuring that is easier for jurisdictions to address with more orthodox tax policy tools. Accordingly the hybrid mismatch rules apply automatically and without regard for whether the arrangement has eroded the tax base of the country applying the rule. This approach assures consistency in the application of the rules (and their outcomes) between jurisdictions and also avoids the practical and conceptual difficulties in distinguishing between acceptable and unacceptable mismatches or trying to allocate taxing rights based on the extent to which a country's tax base has been eroded through the hybrid mismatch arrangement.

Comprehensive

279. Hybrid mismatch rules that are not comprehensive will create further tax planning opportunities and additional compliance costs for taxpayers without achieving their intended policy outcomes. The rules should avoid leaving gaps that would allow a taxpayer to structure around them. This report recommends that every jurisdiction introduces a complete set of rules that are sufficient to neutralise the effect of the hybrid mismatch on a stand-alone basis, without the need to rely on hybrid mismatch rules in the counterparty jurisdiction.

280. Hybrid mismatch rules that are both comprehensive and widespread will be subject to some degree of jurisdictional overlap; while it is important to have rules that are comprehensive and effective, such overlap should not result in double taxation of the same economic income. For this reason the rules recommended in the report are organised in a hierarchy that switches-off the effect of one rule where there is another rule operating in the counterparty jurisdiction that will be sufficient to address the mismatch. Both primary recommendations and defensive rules are required, however, in order to comprehensively address the mismatch; the hierarchy simply addresses the risk of over-taxation in the event the same hybrid mismatch rules apply to the same arrangement in different jurisdictions.

281. The hybrid mismatch rules apply automatically to a hybrid mismatch arrangement if it gives rise to a mismatch in tax outcomes that can be attributed to the hybrid element in the arrangement. Automatic rules are more effective than those that only apply subject to the exercise of administrative discretion and avoid the need for co-ordination of responses between tax authorities, which would increase complexity and make the rules less efficient and consistent in their operation.

Co-ordination of rules to avoid double taxation

282. Rules that are comprehensive and apply automatically need:

(a) an agreed ordering rule to ensure that they apply consistently and proportionately in situations where the counterparty jurisdiction does, or does not, have a similar set of hybrid mismatch rules;

(b) to apply consistently with other rules of the domestic tax system so that the interaction does not result in double taxation of the same economic income;

(c) to co-ordinate with the rules in a third jurisdiction (such as CFC rules) which subject payments to taxation in the residence state of the investor.

283. In order to achieve the first of these design outcomes, these recommendations contain an ordering rule so that one rule is turned-off when the counterparty jurisdiction with the same set of rules can neutralise the effect of the hybrid mismatch arrangement in a more efficient and practical way. This ordering rule avoids the need for an express tie-breaker and achieves the necessary degree of co-ordination without resorting to the competent authority procedure.

284. Just as the hybrid mismatch rules require co-ordination with hybrid mismatch rules in other jurisdictions they also must be co-ordinated as between themselves and with other specific anti-abuse and re-characterisation rules.

Co-ordination between specific recommendations and hybrid mismatch rules

285. The hybrid financial instrument rule and the reverse hybrid rule only operate to the extent the arrangement gives rise to a D/NI outcome. Such an outcome will not arise if, after a proper determination of the character and treatment of the payment under the laws of the payer and payee jurisdictions, a mismatch in tax outcomes has not arisen. This consideration of the tax consequences in each jurisdiction should include the introduction of measures to implement the specific recommendations for improvements in domestic law under Recommendations 2 and 5 respectively.

Co-ordinating the interaction between the hybrid mismatch rules

286. The hybrid mismatch rules set out in this report should generally be applied in the following order:

(a) Hybrid financial instrument rule (Recommendation 1);

(b) Reverse hybrid rule (Recommendation 4) and disregarded hybrid payments rule (Recommendation 3);

(c) Imported mismatch rule (Recommendation 8); and

(d) Deductible hybrid payments rule (Recommendation 6) and dual resident entity rule (Recommendation 7).

287. In **Example 4.4** a hybrid entity makes an interest payment to a reverse hybrid in the same group. The example concludes that the reverse hybrid rule will apply to the arrangement to deny the deduction so that there is no scope for the operation of the deductible hybrid payments rule.

288. In **Example 3.2** the payer borrows money from its parent and the loan is attributed to the payer's foreign branch. The payment of interest on the loan is deductible under the laws of the foreign jurisdiction but is not recognised by the payee. The example considers whether the disregarded hybrid payments rule or the hybrid financial instrument rule should be applied to neutralise the D/NI outcome. The example concludes that the

payer jurisdiction should apply the hybrid financial instrument rule to deny a deduction for the interest if the mismatch in the tax treatment of the interest payment can be attributed to the terms of the instrument between the parties. If the interest payment is not treated, under the laws of the payer jurisdiction as subject to adjustment under the hybrid financial instrument rule then the payer jurisdiction should then apply the disregarded hybrid payments rule to deny the payer a deduction for the interest payment to the extent the interest expense exceeds the dual inclusion income of the branch.

Co-ordinating the interaction between hybrid mismatch rules and other transaction specific and other anti-abuse rules

289. The hybrid financial instrument rule applies whenever the mismatch can be attributed to the terms of the instrument. The fact that the mismatch can also be attributed to other factors (such as the fact that payee is tax exempt) will not prevent the rule from applying provided the mismatch would have arisen even in respect of the same payment between taxpayers of ordinary status. Because the hybrid financial instrument rule is confined to looking at the tax treatment of the instrument under the laws of the payer and payee jurisdictions, the rule will operate to make an adjustment in respect of an expected mismatch in tax outcomes and it will not be necessary for the taxpayer or tax administration to know precisely how the payments under a financial instrument have actually been taken into account in the calculation of the counterparty's taxable income in order to apply the rule. This means that transaction specific rules that adjust the tax treatment of payment based on the status of the taxpayer or the context in which the instrument is held, will not typically impact on the outcome under the hybrid financial instrument rule. For example, a taxpayer may be denied a deduction under local law in respect of interest on a loan, because the proceeds are used to acquire an asset that generates a tax exempt return. This tax treatment in the payer jurisdiction will not affect whether the payment is required to be included in income by the payee under the secondary rule.

290. The hybrid entity rules (Recommendations 3 to 7), however, only operate to the extent a taxpayer is actually entitled to a deduction for a payment under local law. Accordingly these rules will not apply to the extent the taxpayer is subject to transaction or entity specific rules under the parent or payer jurisdiction that prevent the payment from being deducted.

Interaction between hybrid mismatch rule and general limitations on deductibility

291. In addition to transaction and entity specific rules, jurisdictions may impose further restrictions on deductibility that limit the overall deduction that can be claimed by a taxpayer. Such limitations would include a general limitation on interest deductibility such as a fixed-ratio rule. The hybrid mismatch rules make adjustments in respect of particular items that are taken into account for the purposes of calculating a taxpayer's overall income or expense and therefore, as a matter of logic, would generally apply before any such general or overall limitation. This principle is illustrated in **Example 9.2** where the loan made to a subsidiary results in the subsidiary becoming subject to an interest limitation rule in the subsidiary's jurisdiction so that a portion of the interest expense on the loan is no longer deductible. The tax position of the borrower under a general interest limitation rule is not relevant to a determination of whether the payment is deductible for the purposes of the hybrid financial instrument rule. Accordingly the hybrid mismatch rule treats the interest payments as giving rise to a D/NI outcome,

notwithstanding the partial disallowance of the interest expense under the laws of the payer jurisdiction.

292. The interaction between the interest limitation rule and the hybrid mismatch rules should be co-ordinated under domestic law to achieve an overall outcome that avoids double taxation and is proportionate on an after-tax basis. The mechanism for co-ordinating the interaction between the two rules will depend on how the interest limitation rule operates; however, the interaction between these rules should not have the net effect of denying a deduction twice for the same item of expenditure. Double counting can generally be avoided by the taxpayer applying the hybrid mismatch rules first and then applying the interest limitation rule to the extent the remaining deductible interest expense exceeds the statutory ratio.

CFC inclusion

293. Domestic hybrid mismatch rules that deny a deduction for a payment that is not includible in income by the recipient should take appropriate account of the fact that the payment may be subject to taxation under the CFC or other rules operating in the jurisdiction of the recipient's investor.

294. When introducing the hybrid mismatch rules into local law, countries may choose to set materiality thresholds that a taxpayer must meet before a taxpayer can treat a CFC inclusion as reducing the amount of adjustments required under the rule. These thresholds could be based on the percentage of shareholding or the amount of income included under a CFC regime.

Rules should minimise disruption under existing domestic law

295. The hybrid mismatch rules seek to align the tax treatment of the arrangement in the affected jurisdictions with as little disruption to domestic law as possible. In order to minimise the impact on other domestic rules, the hybrid mismatch rules are intended to do no more than simply reconcile the tax consequences under the arrangement. They do not need to address the characterisation of the hybrid entity or instrument itself.

296. A country adopting hybrid mismatch rules could choose to go further under domestic law and re-characterise an instrument, entity or arrangement to achieve consistency with domestic law outcomes, however, such a re-characterisation approach is not necessary to align the ultimate tax outcome in both jurisdictions.

Rules should be clear and transparent

297. The outcome envisaged by the report is that each country will adopt a single set of integrated linking rules that provides for clear and transparent outcomes under the laws of all jurisdictions applying the same rules. The rules must therefore be drafted as simply and clearly as possible so that they can be consistently and easily applied by taxpayers and tax authorities operating in different jurisdictions. This will make it easier for multinationals and other cross-border investors to interpret and apply the hybrid mismatch rules, reducing both compliance costs and transactional risk for taxpayers.

Rules should achieve consistency while providing implementation flexibility

298. The rules must be the same in each jurisdiction while being sufficiently flexible and robust to fit within existing domestic tax systems. To achieve this, hybrid mismatch rules must strike a balance between providing jurisdiction neutral definitions that can be

applied to the same entities and arrangements under the laws of two jurisdictions while avoiding a level of detail that would make them impossible to implement under the domestic laws of a particular jurisdiction.

299. If the same hybrid mismatch rules are to be applied to the same arrangement by two jurisdictions and they are to co-ordinate the response between them, it will generally be necessary to ensure that the rules in both jurisdictions operate on the same entities and payments. For this reason, the implementing legislation should use (where appropriate) jurisdiction neutral terminology that describes the arrangement by reference to the mismatch in tax outcomes rather than the mechanism used to achieve it. For example, there are a number of different mechanisms that can be used to offset a double deduction against non-dual inclusion income and, in order to achieve consistency in the application of the hybrid entity rules across all jurisdictions, the deductible or disregarded hybrid payment rule needs to be articulated without reference to the mechanism by which the double deduction is achieved.

Rules should minimise compliance costs

300. One of the fundamental principles in the design of any tax rule is that it keeps compliance costs for taxpayers to a minimum. One of the intended outcomes of the report is to address any potential compliance costs by dealing with hybrid mismatch arrangements on a multilateral and co-ordinated basis. For example, in the context of deductible hybrid payments, rule co-ordination and ordering ensures that the limitation on deductibility needs to be applied in only one jurisdiction to neutralise the effect of the hybrid mismatch.

301. Similarly, if countries move from unilateral measures to protect their tax bases to a more co-ordinated approach, that will not only have the effect of reducing the risk posed by these structures to the tax base of all countries but it should also lead to an overall decrease in transaction costs and tax risks for cross-border investors who might otherwise find themselves exposed to the risk of economic double taxation under a unilateral hybrid mismatch measure adopted by an individual jurisdiction.

Rules should be easy for tax authorities to administer

302. Once the hybrid mismatch rules are in place they will be applied automatically by taxpayers when determining their tax liability, and should not raise significant on-going administration costs for tax authorities. It is expected that in many cases these types of arrangements will disappear which should reduce the costs associated with identifying and responding to these structures. The costs to tax administrations in applying and enforcing the rule will depend, however, on having rules that are clear and transparent so that they apply automatically with minimal need for the taxpayer or tax administration to make qualitative judgments about whether an arrangement is within scope.

303. In general the rules are intended to improve the coherence of the international tax system and remove the incentive for taxpayers to exploit gaps in the international tax architecture. This should lead to a reduction in tax administration costs. For example, in the case of the hybrid financial instruments, the alignment of tax outcomes should take some pressure off the distinction between the use of debt and equity in cross-border investment. A multilateral and co-ordinated approach also reduces administration costs as it enables one tax authority to quickly understand the rule being applied in the other jurisdiction. The work undertaken as part of Action Item 12 on mandatory disclosure and information exchange (*Mandatory Disclosure Rules*, OECD, 2015a) should also make it

easier for tax authorities to collect and exchange information on both the structure of arrangements and the payments made under them.

Recommendation 9.2 - Implementation and co-ordination

304. Recommendation 9.2 sets out further actions that countries should take to ensure that the rules are interpreted and applied consistently on a cross-border basis.

Guidance

305. This report sets out agreed guidance on the interpretation and application of the hybrid mismatch rules. Implementing and applying the recommendations in accordance with this guidance should ensure predictable and proportionate outcomes. This consistency is important for achieving the overall design objectives, which are to create a network of domestic rules that comprehensively and automatically neutralise the effect of cross-border hybrid mismatch arrangements in a way that minimises disruption to domestic laws and the risk of double taxation. The guidance set out in this report is intended to provide both taxpayers and tax administrations with a clear and consistent understanding of how the technical elements of the recommendations are intended to achieve these outcomes. It is expected that the guidance will be reviewed periodically to determine whether there is a need for any additions, clarifications, updates or amendments to the recommendations or the guidance.

Co-ordination of timing in application of the rules

306. Recommendation 9.2(b) calls for countries to develop standards that will allow them to better co-ordinate the implementation of the recommendations particularly with regards to the timing issues that can arise where the implementation of hybrid mismatch rules in one jurisdiction has tax consequences in the counterparty jurisdiction. These include situations where the introduction of hybrid mismatch rules in the payer jurisdiction has the effect of releasing the payee from the burden of making adjustments under the secondary rule or where rules the introduction of new rules governing the taxation of deductible dividends or reverse hybrids in the payee jurisdiction relieve the payer from the restrictions on the ability to deduct payments under a hybrid mismatch arrangement.

307. Complications in determining the amount of the payment caught by the primary and secondary rule during the switch-over period can be minimised by ensuring that, when the recommendations are introduced into domestic law they take effect prospectively and from the beginning of a taxpayer's accounting period. In cases where the parties to the hybrid mismatch arrangement have the same accounting period and recognise income and expenditure on a similar basis, the switch-over from the secondary to the primary rule should not generally raise significant issues. However, complexity, and the risk of double taxation, can arise where the accounting period for the counterparty commences on a date that is part-way through an existing accounting period (referred to in this guidance as the "switch-over period") and/or there are differences between the two jurisdictions in the rules for recognising the timing of income and expenditure. In this case, unless the primary and secondary rules are properly co-ordinated, there is a risk that both jurisdictions could apply the hybrid mismatch rules to the same payment or to part of the same payment.

308. When determining the amount of income or expenditure subject to adjustment under the hybrid financial instrument rule: the secondary rule should apply to any payment that is treated as made prior to the switch-over period and the primary rule should apply to any payment that is treated as made during or after the switch-over period. This approach gives priority to the primary response, while ensuring that the taxpayer in the secondary jurisdiction does not need to re-open a prior return for a period when the primary rule was not in effect.

309. This application of the co-ordination rule is illustrated in **Example 9.1** where the payee jurisdiction applies the defensive rule under Recommendation 3.1(b) to include a disregarded hybrid payment in income. In that example, the payer jurisdiction introduces hybrid mismatch rules from the beginning of the payer's accounting period. Because the payer's accounting period commences part-way through the accounting period of the payee (the switch-over period), the payee jurisdiction will only apply the secondary rule during the switch-over period to the extent the mismatch in tax treatment has not been eliminated under the primary rule in the payer jurisdiction. **Example 2.3** provides an example of how to co-ordinate the hybrid financial instrument rules with rules denying the benefit of a dividend exemption to a deductible payment. In the example a payment of interest on a bond issued by a foreign subsidiary is treated as an exempt dividend by the parent jurisdiction and the subsidiary jurisdiction denies a deduction for this payment under the hybrid financial instrument rule. However the hybrid financial instrument rule ceases to apply to the extent the payments are included in ordinary income as a consequence of the parent jurisdiction amending its domestic law consistent with Recommendation 2.1.

Transitional rules

310. Recommendation 9.2(c) provides that countries will identify the need for any transitional measures. The report expressly, however, that there will be no presumption as to the need to grandfather any existing arrangements.

311. When the hybrid mismatch rules are introduced they should generally apply to all payments under hybrid mismatch arrangements that are made after the effective date of the legislation or regulation. This would include applying the rules to arrangements that are structured even if such structuring occurred before the introduction of the rules. The effective date for the hybrid mismatch rules should be set far enough in advance to give taxpayers sufficient time to determine the likely impact of the rules and to restructure existing arrangements to avoid any adverse tax consequences associated with hybridity. In order to avoid unnecessary complication and the risk of double taxation, the rules should generally take effect from the beginning of a taxpayer's accounting period and include the co-ordination rules described above.

312. In general the need for transitional arrangements can be minimised by ensuring taxpayers have sufficient notice of the introduction of the rules. Given the hybrid mismatch rules apply to related parties, members of a control group and structured arrangements it is expected that in most cases taxpayers will be able to avoid any unintended effects by restructuring their existing arrangements. Jurisdiction specific grandfathering of existing arrangements should generally be avoided because of its potential to complicate the rules and lead to inconsistencies in their application. The effect of such jurisdiction specific grandfathering is also likely to be limited in the absence of similar carve-outs being put in place in the counterparty jurisdiction.

Review

313. The recommendations in the report are intended to tackle the problem of hybrid mismatches on a multilateral and co-ordinated basis. All of the hybrid mismatch rules are linking rules that depend on tax outcomes in the other jurisdiction and certain rules contain a defensive rule that only applies when the mismatch has not been neutralised by the primary recommendation in the counterparty jurisdiction. Therefore, when applying these rules under their domestic laws, tax administrations will be implicitly relying on the tax outcomes (including any hybrid mismatch rules) applying under the laws of the other jurisdiction in order to arrive at the right legal and policy outcome. Furthermore, when it comes to co-ordinating the interaction between the hybrid mismatch rules of two jurisdictions, tax administrations will need a clear understanding of what the rules in the counterparty jurisdiction are and how they are intended to operate. This process can be facilitated by each country that introduces the rules, providing other countries with notification that they have introduced the rule and information on how they are intended to operate in the context of their domestic tax system. This information may need to be updated, from time to time, to reflect changes in domestic law.

Exchange of information

314. Countries have recognised that, in order for the implementation of the hybrid mismatch rules to be effective, tax administrations will need to have efficient and effective information exchange processes and to increase the frequency and quality of their co-operative cross border collaboration. Applying the recommendations in this report, particularly the imported mismatch rule in Recommendation 8, may require countries to undertake multi-lateral interventions in relation to cases involving hybrid mismatch arrangements.

315. Countries have also recognised the need to engage in early and spontaneous exchanges of information that are foreseeably relevant to the administration or enforcement of the hybrid mismatch rules. The information that will need to be exchanged will typically be taxpayer specific and be based on existing legal instruments, including Double Tax Conventions and Tax Information Exchange Agreements entered into by the participating countries and the *Convention on Mutual Administrative Assistance in Tax Matters* (OECD 2010). The Forum on Tax Administration's (FTA) Joint International Tax Shelter Information and Collaboration (JITSIC) network also provides a forum for countries to work more closely and collaboratively on areas of mutual interest such as hybrid mismatch arrangements including through the sharing of information about the cross-border tax treatment of entities and instruments and increased bi-lateral and multi-lateral intervention activity.

Information to taxpayers

316. Publication of this guidance is intended to provide both taxpayers and tax administrations with a clear and consistent understanding of how the rules are intended to operate. Countries will continue to make reasonable endeavours to ensure taxpayers have accurate information on the tax treatment of entities and financial instruments under the laws of their jurisdiction.

Interaction with Action 4

317. Where a country has introduced a fixed ratio rule, the potential base erosion and profit shifting risk posed by hybrid mismatch arrangements is reduced, as the overall

level of net interest deductions an entity may claim is restricted. However, this risk is not eliminated. Within the limits imposed by a fixed ratio rule, there may still be significant scope for an entity to claim interest deductions in circumstances where a hybrid financial instrument or hybrid entity is used to give rise to a double deduction or deduction/no inclusion outcome. Where a group ratio rule applies, there is also a risk that hybrid mismatch arrangements could be used to increase a group's net third party interest expense, supporting a higher level of net interest deductions across the group. In order to address these risks, a country should implement all of the recommendations in this report, alongside the best practice approach agreed under Action 4 (OECD, 2015b). Rules to address hybrid mismatch arrangements should be applied by an entity before the fixed ratio rule and group ratio rule to determine an entity's total net interest expense. Once this total net interest expense figure has been determined, the fixed ratio rule and group ratio rule should be applied to establish whether the full amount may be deducted, or to what extent net interest expense should be disallowed.

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Chapter 10

Definition of structured arrangement

Recommendation 10

1. General Definition

Structured arrangement is any arrangement where the hybrid mismatch is priced into the terms of the arrangement or the facts and circumstances (including the terms) of the arrangement indicate that it has been designed to produce a hybrid mismatch.

2. Specific examples of structured arrangements

Facts and circumstances that indicate that an arrangement has been designed to produce a hybrid mismatch include any of the following:

(a) an arrangement that is designed, or is part of a plan, to create a hybrid mismatch;

(b) an arrangement that incorporates a term, step or transaction used in order to create a hybrid mismatch;

(c) an arrangement that is marketed, in whole or in part, as a tax-advantaged product where some or all of the tax advantage derives from the hybrid mismatch;

(d) an arrangement that is primarily marketed to taxpayers in a jurisdiction where the hybrid mismatch arises;

(e) an arrangement that contains features that alter the terms under the arrangement, including the return, in the event that the hybrid mismatch is no longer available; or

(f) an arrangement that would produce a negative return absent the hybrid mismatch.

3. When taxpayer is not a party to a structured arrangement

A taxpayer will not be treated as a party to a structured arrangement if neither the taxpayer nor any member of the same control group could reasonably have been expected to be aware of the hybrid mismatch and did not share in the value of the tax benefit resulting from the hybrid mismatch.

Overview

318. The hybrid mismatch rules apply to any person who is a party to a structured arrangement. The purpose of the structured arrangement definition is to capture those taxpayers who enter into arrangements that have been designed to produce a mismatch in tax outcomes while ensuring taxpayers will not be required to make adjustments under

the rule in circumstances where the taxpayer is unaware of the mismatch and derives no benefit from it.

319. The test for whether an arrangement is structured is objective. It applies, regardless of the parties' intentions, whenever the facts and circumstances would indicate to an objective observer that the arrangement has been designed to produce a mismatch in tax outcomes. The structured arrangement rule asks whether the mismatch has been priced into the terms of the arrangement or whether the arrangement's design and the surrounding facts and circumstances indicate that the mismatch in tax outcomes was an intended feature of the arrangement. The test identifies a set of non-exhaustive factors that indicate when an arrangement should be treated as structured.

320. The structured arrangement definition does not apply to a taxpayer who is not a party to the arrangement. A person will be a party to an arrangement when that person has sufficient involvement in the design of the arrangement to understand how it has been structured and what its tax effects might be. A person will not be a party to a structured arrangement, however, if that person (or any member of the control group) does not benefit from, and could not reasonably have been expected to be aware of, the mismatch arising under a structured arrangement.

Recommendation 10.1 - General definition

321. Recommendation 10.1 sets out the general definition of a structured arrangement. The test is objective. It is based on what can reasonably be concluded from the terms of the arrangement and the surrounding facts and circumstances. If the tax benefit of the mismatch is priced into the arrangement or if a reasonable person, looking at the facts of the arrangement, would otherwise conclude that it was designed to engineer a mismatch in tax outcomes, then the arrangement should be caught by the definition regardless of the actual intention or understanding of the taxpayer when entering into an arrangement. The fact that an arrangement is structured, however, does not mean that every person with tax consequences under that arrangement should be treated as a party to it (see Recommendation 10.3 below).

Definition of arrangement

322. The definition of arrangement will include a number of separate arrangements that all form part of the same plan or understanding and will include all the steps and transactions by which that plan or understanding is carried into effect. When looking into whether a hybrid mismatch has been "priced into the terms of the arrangement" or whether the facts and circumstances "indicate that [the arrangement] has been designed to produce a mismatch" taxpayers and tax administrations should look to the entire arrangement rather than simply to the transaction that gives rise to the mismatch in tax outcomes.

Priced into the arrangement

323. The hybrid mismatch will be priced into the terms of the arrangement if the mismatch has been factored into the calculation of the return under the arrangement. The test looks to the actual terms of the arrangement, as they affect the return on the arrangement, and as agreed between the parties, to determine whether the pricing of the transaction is different from what would have been agreed had the mismatch not arisen. This is a legal and factual test that looks only to the terms of the arrangement itself and

the allocation of risk and return under the arrangement rather than taking into account broader factors such as the relationship between the parties or the circumstances in which the arrangement was entered into. The test would not, for example, take into account the consideration paid by a taxpayer to acquire a hybrid financial instrument unless the instrument is issued and sold as part of the same arrangement.

324. **Example 10.1** illustrates a situation where the hybrid mismatch can be described as "priced into the terms of the arrangement". In that example the taxpayer subscribes for a hybrid financial instrument that provides for what would otherwise be considered a market rate of return minus an amount that is calculated by reference to the holder's tax saving on the instrument. In this case the example concludes that the mismatch in tax outcomes is priced into the terms of the instrument and that, accordingly, the arrangement is a structured arrangement.

325. The pricing of the arrangement includes more than just the return under the transaction that gives rise to the hybrid mismatch. **Example 10.2** describes a situation where back-to-back loans are structured through an unrelated intermediary in order to produce a hybrid mismatch. In that example, the tax benefit under the hybrid mismatch arrangement is returned to the parent company in the form of an above-market rate of interest. In such a case, the arrangement includes the back-to-back financing and the tax consequences of the hybrid mismatch will be considered to have been priced into the terms of the arrangement in the form of an above market rate of interest on the loan.

Facts and circumstances of the arrangement

326. The facts and circumstances test is a wider test that looks to: the relationship between the parties; the circumstances under which the arrangement was entered into; the steps and transactions that were undertaken to put the arrangement into effect; the terms of the arrangement itself and the economic and commercial benefits of the transaction; to determine whether the arrangement can be described as having been "designed to produce a hybrid mismatch". The fact that an arrangement also produces a combination of tax and commercial benefits does not prevent the arrangement from being treated as structured if an objective and well informed observer would conclude that part of the explanation for the design of the arrangement was to generate a hybrid mismatch.

327. Recommendation 10.2 sets out a list of factors that point to the existence of a structured arrangement. These factors are not exclusive or exhaustive and there may be other factors in an arrangement that would lead an objective observer to conclude that the arrangement has been designed to produce a mismatch in tax outcomes.

328. The facts and circumstances test could, for example, take into account any relationship between the parties that makes it more likely that the arrangement has been structured. For example, in **Example 1.36**, two taxpayers are joint shareholders in third company. One shareholder transfers a bond that has been issued by the subsidiary to the other shareholder. This transfer relieves the subsidiary company of liability under the hybrid financial instrument rule. The fact that the parties to the transfer were both investors in the issuer and the fact that the transaction had the effect of relieving the issuer from an impending tax liability should be taken into account in considering whether the arrangement has been designed to produce a mismatch in tax outcomes.

Recommendation 10.2 - Specific examples of structured arrangements

329. The list of factors in Recommendation 10.2 should be used as a guide for taxpayers and tax administrations as to the kinds of transactions and activities that will bring a hybrid mismatch arrangement within the structured arrangement definition. In many cases more than one of the factors may be present in the same arrangement.

Arrangement that is designed or part of a plan to produce a mismatch

330. An arrangement will be part of a plan to produce a hybrid mismatch where a person with material involvement in, or awareness of, the design of the arrangement (such as a tax advisor) has identified, before the arrangement was entered into, that it will give rise to mismatch in tax outcomes. This element will be present if there is a written or oral advice given in connection with the arrangement, or working papers or documents produced before the arrangement is entered into, that indicate that the transaction will give rise to a mismatch. This factor ensures that if a taxpayer is advised of the hybrid mismatch then the arrangement will be a structured arrangement.

331. An illustration of a structured arrangement that is part of a plan to produce a mismatch is set out in **Example 1.31**. In that example a company wishes to borrow money from an unrelated lender. The lender suggests structuring the loan as a repo transaction in order to secure a lower tax cost for the parties under the arrangement. The facts of the arrangement therefore indicate that it has been designed to produce a mismatch. Furthermore, as indicated in the example, structuring the loan in this way may result in a lower cost of funds for the borrower which will mean that that the mismatch has been priced into the terms of the arrangement.

332. In **Example 10.2** a tax advisor advises a company to loan money under a hybrid financial instrument to a subsidiary through an unrelated intermediary in order to avoid the effect of the related party test under the hybrid financial instrument rule. In this case the arrangement has been designed to avoid the effect of the related party rules in order to produce a mismatch in tax outcomes and the arrangement can therefore be described as having been designed to produce a hybrid mismatch.

An arrangement that uses a term, step or transaction to create a mismatch

333. An arrangement will be structured if it incorporates a term, step or transaction that has been inserted into the arrangement to achieve a hybrid mismatch. A term, step or transaction will be treated as inserted into an arrangement to produce a mismatch in tax outcomes if that mismatch would not have arisen in the absence of that term, step or transaction and where there was no substantial business, commercial or other reason for inserting that term into the arrangement or undertaking that step or transaction. An assessment of purpose of a transaction should take into account other reasonable alternatives that would have achieved the same effect without triggering a mismatch in tax outcomes. This factor ensures that a taxpayer does not go out of their way to create a hybrid mismatch. The factors listed in Recommendation 10.2 do not limit the scope of the general wording in Recommendation 10.1 so that a hybrid mismatch should still be treated as structured even if every step in the transaction has a non-tax justification if it is reasonable to conclude that part of the explanation for the overall design of the arrangement was to generate a hybrid mismatch.

334. The application of this factor is discussed in **Example 10.2** where a company causes its subsidiary to enter into a hybrid financial instrument with an unrelated

intermediary in order to avoid the effect of the related party test under the hybrid mismatch rules. In that case the intermediary has been inserted into the financing arrangement in an attempt to circumvent the effect of the hybrid mismatch rules. There is no substantial business, commercial or other reason that explains why the financing is routed through a third party and, accordingly, the use of the intermediary and the back-to-back financing structure has been inserted into the structure in order to produce a mismatch in tax outcomes. In **Example 4.2** two individuals wish to make a loan to a company that is wholly-owned by one of them. Instead of making the loan directly, they contribute equity to B Co, a reverse hybrid which makes the loan. The example concludes that the intermediary has been inserted into the financing arrangement in an attempt to produce a hybrid mismatch. Given the relatively simple nature of the financing arrangement, there is no substantial business, commercial or other reason for providing the financing through a reverse hybrid other than to produce a mismatch in tax outcomes.

An arrangement is marketed as a tax advantaged product

335. An arrangement will be treated as marketed as a tax advantaged product if there is written, electronic or oral communication provided to the parties to the arrangement or potential parties to the arrangement that identifies the potential tax benefits of the structure. As indicated in **Example 10.3** the marketing material need not specifically refer to the existence of the hybrid mismatch but must identify an advantage that flows from the hybrid mismatch arrangement. This could include, for example, material that points out, to an investor in a double deduction structure, that the investor will be able to claim the benefit of any losses incurred by the investment vehicle, or, in a D/NI structure that indicates that the borrower should be entitled to a tax deduction for the payments. Marketing information would include any information in a prospectus or other offering documents that are required to be provided to an investor as part of an offer of investment securities. This factor ensures that tax benefits derived from the hybrid mismatch arrangement cannot be used to market the arrangement.

An arrangement that is primarily marketed to taxpayers in a particular jurisdiction

336. In the absence of marketing material, the arrangement should still be considered structured if, in practice, the arrangement is primarily marketed to taxpayers who will benefit from the mismatch. The fact that the arrangement is also available to taxpayers in other jurisdictions who do not benefit from the mismatch will not prevent that transaction from being treated as part of a structured arrangement if the majority of the arrangements, by number or value, are entered into with taxpayers located in jurisdictions that do benefit from the mismatch.

337. In **Example 6.1** a company seeking to raise money, approaches several potential investors that are resident in the same jurisdiction inviting them to make an investment in the company on particular terms. Differences in the way the jurisdictions of the issuer and investors treat an instrument of this nature mean that payments under the instrument will give rise to a hybrid mismatch under the hybrid financial instrument rule. The potential investors are sent an investment memorandum that includes a summary of the expected tax treatment of the instrument. The arrangement will be treated as a structured arrangement because the tax advantages arising under the hybrid mismatch have been marketed to investors and the investment is primarily marketed to taxpayers in a jurisdiction that can take advantage of the mismatch. While the issuer will be subject to the hybrid mismatch rule for as long as the instrument remains outstanding, the example

notes that a subsequent purchaser of the notes may not be required to apply the hybrid mismatch rule if they do not have sufficient information about the arrangement to understand its hybrid effect.

Change to the economic return under the instrument

338. Features of an arrangement that alter the economic return for the parties in the event that the hybrid mismatch is no longer available can evidence that the benefit of the hybrid mismatch has been priced into the arrangement. The potential presence of this factor is discussed in **Example 10.2** where a company causes its subsidiary to enter into a hybrid financial instrument with an unrelated intermediary in order to avoid the effect of the related party test under the hybrid mismatch rules. In that case, it is noted that the intermediary will typically insist on the structure being unwound in the event the tax benefit is no longer available. This factor ensures that parties to the structured arrangement cannot enter into arrangements allocating the risk and benefits of an adjustment under the hybrid mismatch rules without actually triggering such an adjustment.

339. It is not unusual for financing arrangements to include provisions dealing with tax risk (particularly change of law risk). Clauses that permit a lender to increase the cost of financing due to a change in circumstances beyond the lender's control and clauses that permit a bond issuer to redeem an instrument for its face value in the event of a change in tax law, do not necessarily indicate that the parties intended to enter into a structured arrangement provided the taxpayer can show that such contractual terms would ordinarily be expected to be found in a financing arrangement of that nature. If, on the other hand, the evidence suggests that such provisions were inserted primarily to deal with the risk that the hybrid mismatch rules may apply to the arrangement, then the structured arrangement rule is likely to apply.

Pre-tax negative return

340. The fact that it would be uneconomic for the taxpayer to enter into the arrangement but for the benefit under the hybrid mismatch may be evidence that the arrangement is a structured arrangement. This factor is also related to the pricing of the arrangement and is intended to prevent a taxpayer from passing the tax benefits under a hybrid mismatch arrangement to another contracting party. An example of pre-tax negative return transaction is given in **Example 10.2** in respect of a back-to-back loan structure. In that example, the tax benefit under the hybrid mismatch arrangement is returned to the parent company in the form of an above-market rate of interest so that, on the facts of that case, the intermediary is borrowing money at a more expensive rate than it is earning under the hybrid financial instrument.

Recommendation 10.3 - When taxpayer is not a party to a structured arrangement

341. Recommendation 10.3 excludes a taxpayer from the structured arrangement rule where the taxpayer is not a party to the structured arrangement.

342. A person will be a party to a structured arrangement when that person has a sufficient level of involvement in the arrangement to understand how it has been structured and what its tax effects might be. A taxpayer will not be treated as a party to a structured arrangement, however, where neither the taxpayer nor any member of the same

control group was aware of the mismatch in tax outcomes or obtained any benefit from the mismatch.

343. The test for whether a person is a party to structured arrangement is intended to capture situations where the taxpayer or any member of the taxpayer's control group was aware of the mismatch in tax outcomes and should apply to any person with knowledge of the arrangement and its tax effects regardless of whether that person has derived a tax advantage under that arrangement. The policy of the hybrid mismatch rules is to neutralise the mismatch in tax outcomes by adjusting the tax outcomes in the payer or payee jurisdiction without the need to consider whether, or to what extent, the person subject to the adjustment has benefited from that mismatch. While a taxpayer must be aware of the existence of the hybrid mismatch arrangement in order to make the adjustment, a tax administration should not be required to establish that the taxpayer has benefited from the mismatch before requiring that the adjustment be made. The knowledge test is an objective test based on the information available to the taxpayer and should not impose an obligation on a taxpayer to undertake additional due diligence on a commercial transaction over and above what would be expected of a reasonable and prudent person.

344. Whether a taxpayer is a party to a structured arrangement is likely to have the most practical significance in the context of payments made to a reverse hybrid or under an imported mismatch arrangement. In the cases of a reverse hybrid, for example, the relationship between the investor and the reverse hybrid will often satisfy the conditions of a structured arrangement. This is particularly the case in respect of investment funds where investors may look to invest in vehicles that are tax neutral under the laws of the establishment jurisdiction and to ensure that the investment return will only be taxable on distribution. While fund structures such as this could be described as having been designed to create a mismatch in tax outcomes, the payer will not be considered a party to such an arrangement if it did not benefit from the mismatch (i.e. the payment was at fair market value) and the payer could not reasonably have been expected to be aware of the mismatch in tax treatment.

345. This principle is illustrated in **Example 4.1** where the use of a reverse hybrid as a single-purpose lending entity prima facie indicates that the arrangement between the investor and the reverse hybrid has been engineered to produce a mismatch in tax outcomes. In that case, however, the payer is not treated as a party to the structured arrangement because it pays a market rate of interest under the loan and would not have been expected, as part of its ordinary commercial due diligence, to take into consideration the tax position of the underlying investor or the tax treatment of the interest payment under the laws of the investor jurisdiction when making the decision to borrow money from the reverse hybrid..

346. The outcome described in **Example 4.1** can be contrasted with that described below in **Example 10.5** where the hybrid element is introduced into the structure after financing discussions between the investor and the payer have commenced. In that example a fund that is in the business of providing loans to medium-sized enterprises enters into negotiations to provide a company with an unsecured loan that will be used to meet the company's working capital requirements. The fund uses a subsidiary in a third jurisdiction to make the loan and finances that loan through the use of a hybrid financial instrument. Neither the fund nor the subsidiary is resident in a jurisdiction that has introduced the hybrid mismatch rules. The financing arrangement is conceived as a single plan that includes both the transaction that gives rise to the original hybrid deduction (the

hybrid financial instrument) and the loan by the subsidiary to the taxpayer. The taxpayer will be treated as a party to that structured arrangement if it is involved in the design or has sufficient information about the arrangement to understand its operation and effect. A taxpayer will not be treated as a party to a structured arrangement, however, where neither the taxpayer nor any member of the taxpayer's control group obtained any benefit under a hybrid mismatch arrangement or had sufficient information about the arrangement to be aware of the fact that it gave rise to a mismatch in tax outcomes. The principle is further illustrated in **Example 10.3** where a hybrid financial instrument is sold to a taxpayer. The example notes that, while the purchaser can be taken to be aware of its own tax treatment under the financial instrument it would not typically be expected to enquire into the tax position of the issuer and, provided the instrument was acquired for its fair market value (and not under the same arrangement that gave rise to the hybrid mismatch) such a person would not typically be brought within the scope of the structured arrangement rules.

Arrangements entered into on behalf of a taxpayer

347. When applying the structured arrangement rule, the actions of a taxpayer's agent should be attributed to the taxpayer. Where a transparent entity enters into a hybrid mismatch arrangement and the tax consequences of a payment under that arrangement are attributed to the investor, the structured arrangement rule should be applied to the investor as if the investor was a direct party to that structured arrangement and had entered into that arrangement on the same basis as the transparent entity. In **Example 10.4** a trust subscribes for an investment in the company on particular terms. Differences in the way the jurisdiction of the issuer and the jurisdiction of the investors treat an instrument of this nature mean that payments under the instrument will give rise to a hybrid mismatch under the hybrid financial instrument rule. Potential investors, including the trust, are sent an investment memorandum that includes a summary of the expected tax treatment of the instrument. The payment under the instrument is allocated by the trust to a beneficiary who has no knowledge of the investment made by the trustee. In this case, the trust's status as a party to a structured arrangement is attributed to the beneficiary, together with the payment, so that the payment to the beneficiary is caught by the hybrid financial instrument rule.

Chapter 11

Definitions of related persons, control group and acting together

Recommendation 11

1. General definition

For the purposes of these recommendations:

(a) Two persons are related if they are in the same control group or the first person has a 25% or greater investment in the second person or there is a third person that holds a 25% or greater investment in both.

(b) Two persons are in the same control group if:

(i) they are consolidated for accounting purposes;

(ii) the first person has an investment that provides that person with effective control of the second person or there is a third person that holds investments which provides that person with effective control over both persons;

(iii) the first person has a 50% or greater investment in the second person or there is a third person that holds a 50% or greater investment in both; or

(iv) they can be regarded as associated enterprises under Article 9.

(c) A person will be treated as holding a percentage investment in another person if that person holds directly or indirectly through an investment in other persons, a percentage of the voting rights of that person or of the value of any equity interest in that person.

2. Aggregation of interests

For the purposes of the related party rules a person who acts together with another person in respect of ownership or control of any voting rights or equity interests will be treated as owning or controlling all the voting rights and equity interests of that person.

3. Acting together

Two persons will be treated as acting together in respect of ownership or control of any voting rights or equity interests if:

(a) they are members of the same family;

(b) one person regularly acts in accordance with the wishes of the other person;

(c) they have entered into an arrangement that has material impact on the value or control of any such rights or interests; or

(d) the ownership or control of any such rights or interests are managed by the same person or group of persons.

If a manager of a collective investment vehicle can establish to the satisfaction of the tax authority, from the terms of any investment mandate, the nature of the investment and the circumstances that the hybrid mismatch was entered into, that the two funds were not acting together in respect of the investment then the interest held by those funds should not be aggregated for the purposes of the acting together test.

Overview

348. The report treats hybrid financial instruments and hybrid transfers between related parties as within the scope of the hybrid mismatch rules. Other hybrid mismatch arrangements are generally treated as within scope of the recommendations where the parties to the mismatch are members of the same control group.

349. The related party and control group tests apply regardless of the circumstances in which the hybrid mismatch arrangement was entered into. The principle is illustrated in **Example 1.1** where it is noted that a debt instrument that is acquired by the issuer's parent in an unrelated transaction will still constitute a financial instrument between related parties and is potentially subject to the application of the hybrid financial instrument rule notwithstanding that it was not caught by the rule at the time it was originally issued.

350. Two persons will be treated as related if they form part of the same control group or if one person has a 25% investment in the other person or a third person has a 25% investment in both. The test measures both direct and indirect investment, which includes both voting rights and the value of any equity interests. Persons who are acting together in respect of the ownership or control of an investment in certain circumstances are required to aggregate their ownership interests for the purposes of the related party test.

351. Parties will be treated as members of the same control group if:

(a) they form part of the same consolidated group for accounting purposes or the provision between them can be regarded as a provision between associated enterprises under Article 9 of the *OECD Model Tax Convention* (OECD, 2014);

(b) one person has a 50% investment or effective control of the other person (or a third person has a 50% or effective control of both).

352. The hybrid mismatch rules also apply to any person who is a party to a "structured" arrangement that has been designed to produce a mismatch. For the discussion of structured arrangements see the guidance to Recommendation 10.

Recommendation 11.1 - General definition

353. Recommendation 11.1 sets out the general definition of related persons and control group.

Related parties

354. Persons are treated as related parties for the purposes of the hybrid mismatch rules if they are in the same control group or one person holds a 25% investment in the other or the same person holds a 25% investment in both. A person's investment in another person is determined by looking to the percentage of voting rights or of the value of any equity interests that the first person holds in the second person. The terms "voting rights" and "equity interests" are defined in Recommendation 12.

Voting interests

355. While the measurement of voting interests will be easiest in the context of corporate entities that issue equity share capital, the term also includes equivalent control rights in other types of investment vehicles such as partnerships, joint ventures and trusts.

A person's voting interest is the right of that person to participate in the decision-making concerning a distribution by that person, a change in that person's constitutional structure or in the appointment of a director. The term director refers to any person who has power, under the constitutional documents, to manage and control a person (such as the trustee of a trust).

356. The right to participate in any one of the decision-making functions of a person is sufficient to constitute a voting right in that person but the right must be conferred under the constitutional documents of the entity itself. **Example 11.1** concerns a trust where the settlor has the right, under the trust deed, to appoint trustees but has no right to distributions or to amend the trust deed. In this case the settlor is, nevertheless, treated as a related party of the trust as the settlor effectively holds 100% of the decision-making rights concerning any trustee appointment.

357. **Example 11.2** concerns a partnership formed between four individuals. All partners have the same voting rights and an equal share in the profits of the partnership. In this case each partner should be treated as having a 25% investment in the partnership and will be considered related to the partnership. The partners will not, however, be considered related to each other.

358. The rights must be actual decision-making rights rather than rights that might arise at some point in the future, although contingencies that are procedural in nature and within the control of the holder can be ignored for these purposes. Thus a convertible bond holder who can elect, at any time, to convert such bonds into ordinary shares should be treated as holding voting interests in the issuer on a diluted basis, while a lender who has the right to appoint a receiver in the event of default under a loan will not be treated as holding voting rights in the borrower as such rights are contingent on default by the borrower and are not conferred under the articles of association of the company but by the terms of the security granted under the loan.

Value of equity interests

359. An instrument should be treated as giving rise to an equity interest if it provides the holder with an equity return. An equity return means an entitlement to profits or eligibility to participate in distributions. While the definition of "equity return" in Recommendation 12 also includes derivative equity returns, this extended definition does not apply in the measurement of equity interests for the purposes of the related party and control tests. An instrument may be treated as an equity interest, even if it is in the form of a debt instrument, if it confers a right to participate in the profits of the issuer or in any surplus on liquidation.

360. In the case of a company with only one class of ordinary shares on issue, it should generally be the case that voting interests and equity interests are held in the same proportions. Non-voting shares, bonds, warrants or other financial instruments that carry an entitlement to an equity return and that are widely-held or regularly traded may be excluded from the measurement of the value of equity interests where the way these instruments are issued, held or traded does not give rise to significant structuring concerns.

Indirect holding

361. A person that holds voting rights or equity interest in another person will be treated as holding a proportionate amount of the voting rights or equity interests held by

that person. Indirect holdings should be measured on a dilution basis so that if Individual A holds 50% of the voting or equity interests in B Co and B Co holds 50% of the voting or equity interests in C Co, then A should be treated as holding 25% of the interests C Co. A more detailed example setting out the calculation of indirect voting rights is set out in **Example 11.3**. In that example, A Co owns 100% of voting rights in C Co and 20% of voting rights in D Co. F Co is owned 20% by C Co and 40% by D Co. A Co is therefore related to C Co and F Co and F Co is related to D Co, but A Co is not related to D Co (unless it can be shown that they are members of the same control group).

Control group

362. Two persons should be treated as being in the same control group if they meet one of the conditions listed in Recommendation 11.1(b).

Consolidation

363. A subsidiary entity should be treated as related to its ultimate parent if the subsidiary is required to be consolidated, on a line-by-line basis in the parent's consolidated financial statements prepared under International Financial Reporting Standards (IFRS) or applicable local Generally Accepted Accounting Principles (GAAP).

Effective control

364. Persons are members of the same control group if the first person can effectively control the second person through an investment in that person or if there is a third person that has a sufficiently significant investment in both persons that gives it an effective control over both of them. This will be the case, for example, where a person is a substantial shareholder in a widely-held company and that shareholding gives that person effective control over the appointment of directors.

Voting or equity interests

365. Persons are treated as part of the same control group if one person holds at least a 50% investment in the other or the same person holds at least a 50% investment in both. A percentage investment in another person is to be determined by reference to the percentage voting rights of that person or of the value of any equity interests of that person. The measurement of voting and value rights is discussed above.

Associated enterprises

366. Two persons should be regarded as members of the same control group if they are treated as associated enterprises under Article 9 of the *OECD Model Tax Convention* (OECD, 2014). According to Article 9.1 "associated enterprises" are found where:

(a) An enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State, or

(b) The same persons participate directly or indirectly in the management control or capital enterprise of a Contracting State and an enterprise of the other Contracting State.

367. The *OECD Model Tax Convention* (OECD, 2014) and the Commentaries do not establish the threshold or criteria to determine when participation in capital, management or control is sufficient to make two enterprises "associated enterprises" within the scope

of Article 9. It is left for countries to set the criteria to assess when the transfer pricing rules will apply under domestic law and especially as to the meaning of “control”. The effect of including associated enterprises within the definition of control group is that the hybrid mismatch rules should apply to any transaction that is also subject to adjustment under a country’s transfer pricing rules.

Recommendation 11.2 - Aggregation of interests

368. Recommendation 11.2 defines when a person’s equity interests should be aggregated with those of another person for the purposes of the related party or control group tests.

Recommendation 11.3 - Acting together

369. The purpose of the “acting together” requirement is to prevent taxpayers from avoiding the related party or control group requirements by transferring their voting interest or equity interests to another person, who continues to act under their direction in relation to those interests. The other situation targeted by the acting together requirement is where a taxpayer or group of taxpayers who individually hold minority stakes in an entity, enter into arrangements that would allow them to act together (or under the direction of a single controlling mind) to enter into a hybrid mismatch arrangement with respect to one of them.

370. The acting together test covers voting rights or equity interests held by a single economic unit such as a family and covers the following three basic scenarios:

(a) where one person is required, or can be expected to act, in accordance with the wishes of another person in respect of the voting rights or equity interests held by that first person;

(b) where two or more people agree to act together in respect of voting rights or equity interests that they hold;

(c) where a person (or people) agree that a third person can act on their behalf in respect of voting rights or equity interests that they hold.

Members of the same family

371. A person will be deemed to hold any equity or voting interests that are held by the members of that person’s family. Family is defined in Recommendation 12. This test would include a person’s spouse (including civil partner), the relatives of that person and their spouses. A relative includes grandparents, parents, children, grandchildren and brothers and sisters (including adopted persons and step-siblings) but it would not include indirect or non-lineal descendants such as a person’s nephew or niece.

Regularly acts in accordance with the wishes of the other person

372. A person will be treated as acting in accordance with the wishes of another person where the person is legally bound to act in accordance with another’s instructions or if it can be established that one person is expected to act, or typically acts, in accordance with another’s instructions. The focus of the test is on the actions of that person in relation to the voting rights or equity interests. The equity interests or voting rights held by a lawyer for example, will not be treated as held by the lawyer’s client under the acting together

test, unless it can be established that such rights or interest are held as part of the lawyer – client relationship.

Entered into an arrangement that has material impact on the value or control of any such rights or interests

373. One person will be treated as holding the equity or voting interests of another person if they have entered into an arrangement regarding the ownership or control of those rights or interests. The test covers both arrangements concerning the exercise of voting interests (such as the right to participate in any decision-making) and or regarding beneficial entitlements (such as entitlement to profits or eligibility to participate in distributions) or arrangements concerning the ownership of those rights (such as agreements or options to sell such rights). The test is intended to capture arrangements that are entered into with other investors and does not cover arrangements that are simply part of the terms of the equity or voting interest or operate solely between the holder and issuer.

374. The arrangement regarding the ownership or control of voting rights or interests must have a material impact on the value of those rights or interests. The materiality threshold prevents an investor having their equity or voting interests treated as part of a common holding arrangement simply because the investor is a party to a commercially standard shareholder or investor agreement that does not have a material impact on the ability of a holder to exercise ownership or control over its equity or voting interest.

375. This point is illustrated in **Example 11.4** where an investor is a party to a shareholder's agreement that requires the investor to first offer his equity interest to existing investors (at market value) before selling to a third party. Such an agreement will not generally have a material impact on the value of the holder's equity interest and should not be taken into account for the purposes of the acting together requirement.

376. The acting together test does not impose any definitional limits on the content of the common control arrangement and the acting together test can capture transactions between otherwise unrelated taxpayers even if the common control arrangement has not played any direct role in the transaction that has given rise to the mismatch. This is illustrated by **Example 11.4**. In that example an unrelated investor acquires a listed financial instrument issued by a company. Payments under that instrument give rise to a hybrid mismatch. The fact that an investor is also a minority investor in that company and has entered into a voting rights agreement with a majority shareholder automatically brings that investor within the scope of the hybrid financial instrument rule.

The ownership or control of any such rights or interests are managed by the same person or group of persons

377. This element of the acting together test treats investors as acting together if their interests are managed by the same person or group of persons. This requirement would pick up a number of investors whose investments were managed under a common investment mandate or partners in an investment partnership.

378. This element of the acting together test contains an exception for investors that are collective investment vehicles where the nature of the investment mandate and the investment means that two funds under the common control of the same investment manager will not be treated as acting together if the circumstances in which they make the investment (including the terms of the investment mandate) mean that the funds should

not be treated as acting together for the purposes of the test. The application of this exception is illustrated in **Example 11.5**.

Bibliography

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Chapter 12

Other definitions

Recommendation 12

1. Definitions

For the purpose of these recommendations:

Accrued income	Accrued income, in relation to any payee and any investor, means income of the payee that has accrued for the benefit of that investor.
Arrangement	Arrangement refers to an agreement, contract, scheme, plan, or understanding, whether enforceable or not, including all steps and transactions by which it is carried into effect. An arrangement may be part of a wider arrangement, it may be a single arrangement, or it may be comprised of a number of arrangements.
Collective investment vehicle	Collective investment vehicle means a collective investment vehicle as defined in paragraph 4 of the *Granting of Treaty Benefits with Respect to the Income of Collective Investment Vehicles* (2010, OECD).
Constitution	Constitution, in relation to any person, means the rules governing the relationship between the person and its owners and includes articles of association or incorporation.
D/NI outcome	A payment gives rise to a D/NI outcome to the extent the payment is deductible under the laws of the payer jurisdiction but is not included in ordinary income by any person in the payee jurisdiction. A D/NI outcome is not generally impacted by questions of timing in the recognition of payments or differences in the way jurisdictions measure the value of that payment. In some circumstances however a timing mismatch will be considered permanent if the taxpayer cannot establish to the satisfaction of a tax authority that a payment will be brought into account within a reasonable period of time (see Recommendation 1.1(c)).
DD outcome	A payment gives rise to a DD outcome if the payment is deductible under the laws of more than one jurisdiction.
Deduction	Deduction (including deductible), in respect of a payment, means that, after a proper determination of the character and treatment of the payment under the laws of the payer jurisdiction, the payment is taken into account as a deduction or equivalent tax relief under the laws of that jurisdiction in calculating the taxpayer's net income.
Director	Director, in relation to any person, means any person who has the power under the constitution to manage and control that person and includes a trustee.
Distribution	Distribution, in relation to any person, means a payment of profits or gains by that person to any owner.

Recommendation 12 (*continued*)

Dual inclusion income	Dual inclusion income, in the case of both deductible payments and disregarded payments, refers to any item of income that is included as ordinary income under the laws of the jurisdictions where the mismatch has arisen. An item that is treated as income under the laws of both jurisdictions may, however, continue to qualify as dual inclusion income even if that income benefits from double taxation relief, such as a foreign tax credit (including underlying foreign tax credit) or a domestic dividend exemption, to the extent such relief ensures that income, which has been subject to tax at the full rate in one jurisdiction, is not subject to an additional layer of taxation under the laws of either jurisdiction.
Equity interest	Equity interest means any interest in any person that includes an entitlement to an equity return.
Equity return	Equity return means an entitlement to profits or eligibility to participate in distributions of any person and, in respect of any arrangement is a return on that arrangement that is economically equivalent to a distribution or a return of profits or where it is reasonable to assume, after consideration of the terms of the arrangement, that the return is calculated by reference to distributions or profits.
Establishment jurisdiction	Establishment jurisdiction, in relation to any person, means the jurisdiction where that person is incorporated or otherwise established.
Family	A person (A) is a member of the same family as another person (B) if B is: • the spouse or civil partner of A; • a 'relative' of A (brother, sister, ancestor or lineal descendant); • the spouse or civil partner of a relative of A; • a relative of A's spouse or civil partner; • the spouse or civil partner of a relative of A's spouse or civil partner; or • an adopted relative.
Financing return	Financing return, in respect of any arrangement is a return on that arrangement that is economically equivalent to interest or where it is reasonable to assume, after consideration of the terms of the arrangement, that the return is calculated by reference to the time value of money provided under the arrangement.
Hybrid mismatch	A hybrid mismatch is defined in paragraph 3 in Recommendations 1, 3, 4, 6 and 7 for the purposes of those recommendations.
Included in ordinary income	A payment will be treated as included in ordinary income to the extent that, after a proper determination of the character and treatment of the payment under the laws of the relevant jurisdiction, the payment has been incorporated as ordinary income into a calculation of the payee's income under the law of that jurisdiction.
Investor	Investor, in relation to any person, means any person directly or indirectly holding voting rights or equity interests in that person.
Investor jurisdiction	Investor jurisdiction is any jurisdiction where the investor is a taxpayer.

Recommendation 12 (*continued*)

Mismatch	A mismatch is a DD outcome or a D/NI outcome and includes an expected mismatch.
Money	Money includes money in any form, anything that is convertible into money and any provision that would be paid for at arm's length.
Offshore investment regime	An offshore investment regime includes controlled foreign company and foreign investment fund rules and any other rules that require the investor's accrued income to be included on a current basis under the laws of the investor's jurisdiction.
Ordinary income	Ordinary income means income that is subject to tax at the taxpayer's full marginal rate and does not benefit from any exemption, exclusion, credit or other tax relief applicable to particular categories of payments (such as indirect credits for underlying tax on income of the payer). Income is considered subject to tax at the taxpayer's full marginal rate notwithstanding that the tax on the inclusion is reduced by a credit or other tax relief granted by the payee jurisdiction for withholding tax or other taxes imposed by the payer jurisdiction on the payment itself.
Payee	Payee means any person who receives a payment under an arrangement including through a permanent establishment of the payee.
Payee jurisdiction	Payee jurisdiction is any jurisdiction where the payee is a taxpayer.
Payer	Payer means any person who makes a payment under an arrangement including through a permanent establishment of the payer.
Payer jurisdiction	Payer jurisdiction is any jurisdiction where the payer is a taxpayer.
Payment	Payment includes any amount capable of being paid including (but not limited to) a distribution, credit, debit, accrual of money but it does not extend to payments that are only deemed to be made for tax purposes and that do not involve the creation of economic rights between parties.
Person	Person includes any natural or legal person or unincorporated body of persons and a trust.
Taxpayer	Taxpayer, in respect of any jurisdiction, means any person who is subject to tax in that jurisdiction whether as a resident or by virtue of applicable source rules (such as maintaining a permanent establishment in that jurisdiction).
Trust	Trust includes any person who is a trustee of a trust acting in that capacity.
Voting rights	Voting rights means the right to participate in any decision-making concerning a distribution, a change to the constitution or the appointment of a director.

Overview

379. The recommendations in the report set out requirements for the design of domestic laws. The language of the recommendations is not meant to be translated directly into domestic legislation. Rather countries are expected to implement these recommendations into domestic law using their own concepts and terminology. At the same time, in order for the recommended rules to be effective and to avoid double taxation, they need to be co-ordinated with the rules in other countries. To this end,

Recommendation 12 sets out a common set of defined terms intended to ensure consistency in the application of the rules.

Recommendation 12.1 - Other definitions

Accrued income

380. The definition of *accrued income* is used as part of the definition of *offshore investment regime* and in Recommendation 5, which sets out specific recommendations on the treatment of reverse hybrids. The concept of accrued income, in relation to any investor, includes any amount that is paid to an investment entity that increases the value of that investor's interest in that entity.

Arrangement

381. The term *arrangement* is used as part of the definition of *financial instrument,* in Recommendation 1.2, and as part of the definition of *structured arrangement* in Recommendation 10.

Collective investment vehicle

382. The rules on aggregation of ownership interests set out in Recommendation 11.3 of the report, state that two persons will be treated as *acting together* in respect of their ownership interest in an entity if the ownership interests are managed by the same person or group of persons. The rule does not, however, apply to any person that is a *collective investment vehicle* if the investment manager can establish to the satisfaction of the tax authority, from the terms of the investment mandate and the circumstances in which the investment was made, that two funds were not acting together in respect of the investment. The definition of collective investment vehicle cross-refers to the definition set out in the 2010 Report on the Granting of Treaty Benefits with Respect to the Income of Collective Investment Vehicles.

Constitution

383. The term *constitution* is used in the definition of *director* and *voting rights*. These terms are used for determining the amount of investment held by one person in another person for the purposes of the related party and control group tests in Recommendation 11.

D/NI outcome

384. The hybrid mismatch rules in Chapters 1, 3 and 4 of the report neutralise the effects of *mismatches* that are *D/NI outcomes*. A D/NI outcome arises where a payment is deductible under the laws of one jurisdiction (the payer jurisdiction) and is not *included in ordinary income* under the laws of any other jurisdiction where the payment is treated as being received (the payee jurisdiction).

Differences in valuation

385. A D/NI outcome can arise from differences between tax jurisdictions in the way they measure the value ascribed to a payment. This principle is illustrated in **Example 1.13** and **Example 1.16** where a taxpayer treats a loan from its parent as having been issued at a discount and accrues this discount as an expense over the life of the loan. A mismatch could arise, on the facts of these examples, if the parent adopted the same

accounting treatment as the subsidiary but attributed a lower value to the discount. In such a case the amount accrued as a deduction in each accounting period would not be matched by the same inclusion in the parent jurisdiction.

386. If however, both jurisdictions characterise the payment in the same way and arrive at the same monetary value for a payment then there will generally be no mismatch in tax outcomes within the scope of the recommendations (see **Example 1.15**). While there may be differences in tax outcomes that arise from the valuation of a payment or in translating a payment into local currency, these differences in will not give rise to a D/NI outcome. This principle is illustrated in **Example 1.17** where payments of interest and principal under the loan are payable in a foreign currency. A fall in the value of the local currency results in the payments under the loan becoming more expensive in local currency terms. Under local law, the payer is entitled to a deduction for this increased cost. This deduction, however, is not reflected by a corresponding inclusion in the payee jurisdiction. The difference in tax treatment does not give rise to a D/NI outcome, however, as the proportion of the interest and principal payable under the loan is the same under the laws of both jurisdictions.

Entity located in a no tax jurisdiction

387. The recommendations in the report with respect to D/NI arrangements are not intended to capture payments made to a person resident in a no-tax jurisdiction. As illustrated in **Example 1.6** a payment will not be treated as giving rise to a D/NI outcome if it is received by a person who is not subject to tax in any jurisdiction.

DD outcome

388. The hybrid mismatch rules in Chapter 6 and 7 of the report neutralise the effects of *mismatches* that are *DD outcomes*. A DD outcome arises where a payment that is deductible under the laws of one jurisdiction (the payer jurisdiction) triggers a duplicate deduction under the laws of another jurisdiction.

Deduction

389. The concept of “deduction” and “deductible” refer to an item of expenditure that is eligible to be offset against a taxpayer’s *ordinary income* when that person’s liability to income tax under the laws of the taxpayer’s jurisdiction. The definition should include any tax relief that is economically equivalent to a deduction such as a tax credit for dividends paid.

390. The recommendations focus on whether a payment falls into the category of a “deductible” item under the laws of the relevant jurisdiction and the jurisdiction specific details of the taxpayer’s net income calculation should not generally affect the question of whether a payment is deductible for tax purposes. Interest that is capitalised into the cost of an asset should, for example, be treated as deductible for the purposes of this rule.

391. Under the hybrid mismatch rules a deduction must arise in respect of a “payment”. Therefore the starting point in applying the hybrid mismatch rules is to look for the legal basis for the deduction to determine whether the deduction relates to actual expenditure or transfer or value rather than it being a purely notional amount for tax purposes.

Director

392. A "director" includes a director of a company. The term also applies to anyone, such as a trustee of a trust, who has been formally appointed under the constituent documents to manage and control another person. The ability to appoint a director is used as part of the determination of "voting rights". These terms are used for determining the amount of investment held by one person in another for the purposes of the related party and control group tests in Recommendation 11.

Distribution

393. The term distribution is used to determine a person's *voting rights* under the related party and control group tests in Recommendation 11 and as part of the definition of *equity return,* which is used for calculating the amount of a person's equity interest and for defining what arrangements should be treated as a *financial instrument* in Recommendation 1.3.

Dual inclusion income

394. The measurement of dual inclusion income is relevant to determining the amount of deduction restricted under the hybrid mismatch rules in Chapters 3, 6 and 7 of the report.

Equity interest

395. An amount of a person's equity interest is used to determine whether they fall within the related party or control group tests in Recommendation 11.

Equity return

396. The definition of *equity return* is used for calculating the amount of a person's equity interest in another person in order to determine whether they fall within the related party or control group tests in Recommendation 11. The definition is also used to determine the scope of the term *financial instrument* in Recommendation 1.2(c).

Establishment jurisdiction

397. The term establishment jurisdiction is used in Recommendation 1.5 in describing an exception to the hybrid financial instrument rule and in Recommendation 4 in respect of the definition of a reverse hybrid. The term refers to the jurisdiction where a person is incorporated or otherwise established. For entities such as companies that are established by formal registration this will be the jurisdiction where the entity is registered. For entities such as partnerships or trusts that may not require formal registration, this will be the jurisdiction under whose laws the entity is created or operates.

Family

398. The rules on aggregation of ownership interests set out in Recommendation 11.3 of the report, state that two persons will be treated as *acting together* in respect of their interest in an entity if they are members of the same family.

399. When introducing this test into domestic law, jurisdictions should ensure that the applicable test for family captures:

(a) a person's spouse (including civil partner);

(b) a person’s brother, sister, child, parent, grandparent or grandchild (i.e. a relative);

(c) anyone who is a relative of that person’s spouse or a spouse of a relative.

400. The test should include adopted persons but does not extend to indirect and non-lineal descendants (such as a person’s nephew or niece).

Financing return

401. The definition of *financing return* is used to determine the scope of the term *financial instrument* in Recommendation 1.2(c). It includes any arrangement that is designed to provide a person with a return for the time value of money.

Hybrid mismatch

402. Each recommendation for hybrid mismatch rules contains its own definition of when a mismatch constitutes a hybrid mismatch. The definition in Recommendation 12 serves as a collective definition for the specific definitions set out in each of the recommendations.

Included in ordinary income

403. A payment that is *included in ordinary income* under the laws of the payee jurisdiction will not give rise to D/NI outcome.

404. The requirement that the payment be *included as ordinary income* by the payee means that the payment is required to be incorporated into the payee’s income tax calculation as *ordinary income*. The concept of ordinary income is discussed further below.

405. A consideration of whether a payment has been included in ordinary income requires a proper determination of the character and treatment of the payment under the laws of the counterparty jurisdiction.

A payment treated as included in ordinary income if offset against losses

406. A payment that is offset against deductible expenditure or losses that have been carried-forward would, on this definition, be treated as having been included in income.

Withholding taxes

407. A country will continue to levy withholding taxes on payments that are subject to adjustment under the hybrid mismatch rules in accordance with its domestic law and consistent with its treaty obligations. The function of withholding taxes under the laws of the payer jurisdiction is generally not to address mismatches in tax outcomes and a payment should not be treated as included in ordinary income simply because it has been subject to withholding at source. The primary rule denying the deduction may apply in cases in which the payer jurisdiction also imposes a withholding tax on the payment as it is still important to neutralise the hybrid mismatch in those cases. Withholding taxes alone do not neutralise the hybrid mismatch as withholding taxes, where applicable, often are imposed with respect to equity instruments.

Investor

408. The definition of investor is incorporated into the recommendations dealing with hybrid entities as follows:

(a) An entity will be treated as a reverse hybrid under Recommendation 5 where it is treated as transparent under the laws of its own jurisdiction but as a separate entity by an investor.

(b) Further a D/NI outcome that arises in respect of a payment made to that reverse hybrid will be treated as a hybrid mismatch if the D/NI outcome would not have arisen had the accrued income been paid directly to the investor.

Money

409. The definition of money forms part of the definition of payment. The broad definition of money means that the term payment will generally include the transfer of anything that has exchangeable value.

410. A D/NI outcome can arise from differences between tax jurisdictions in the way they measure the value ascribed to a payment, however, if both jurisdictions arrive at the same monetary value for a payment then the value attributed to that payment will be the same. Differences in the valuation of money itself (such as gains and losses from foreign currency fluctuations) will not give rise to a D/NI outcome provided the proportion of the interest and principal payable under the loan is the same under the laws of both jurisdictions.

Offshore investment regime

411. Recommendation 5.1 provides that jurisdictions should introduce, or make changes to their, *offshore investment regimes* in order to prevent *D/NI outcomes* from arising in respect of payments to a *reverse hybrid*.

Ordinary income

412. The definition of ordinary income is used to both identify hybrid mismatch arrangements that produce D/NI outcomes and to neutralise their effect.

A payment will not qualify as ordinary income unless it is taxed at the full marginal rate

413. A payment will not treated as included in ordinary income if the payee jurisdiction does not tax the payment at the taxpayer's full marginal rate. The definition of "ordinary income" excludes any type of income that is subject to preferential tax treatment regardless of the form in which the tax relief is provided.

414. A payment will not be treated as ordinary income if tax on the payment is relieved by excluding or exempting all or part of a payment from taxation (see **Example 1.1**) or the full payment is subject to tax but at a lower rate (see **Example 1.3**). Alternatively, the entire amount of the payment may be taxed at the full tax rate but the jurisdiction may permit the taxpayer to claim some other form of tax relief that attaches to a payment of that nature, such as a credit for underlying foreign taxes (see **Example 1.4**) or a deemed deduction. Income is considered subject to tax at the taxpayer's full marginal rate, however, notwithstanding that the tax on the inclusion is reduced by a credit or other tax

relief granted by the payee jurisdiction for withholding tax or other taxes imposed by the source jurisdiction on the payment itself.

A taxpayer's full marginal rate is the expected rate of tax on ordinary income under that arrangement.

415. In the context of the hybrid financial instrument rule, the payee's *full marginal rate* is the tax the payee would be expect to pay on ordinary income derived under a financial instrument, so that a mismatch will not arise, for the purposes of the hybrid financial instrument rule, simply because the payee jurisdiction taxes financial instruments at a lower rate from other types of income.

Treating a payment as ordinary income under the secondary rule

416. If the arrangement gives rise to a mismatch and the hybrid mismatch rule calls for an adjustment to be made under the secondary rule, the adjustment is confined to adjusting the taxation of the payment itself. Changing the tax treatment of the payment will not necessarily result in an increased tax liability for the payee. As illustrated in **Example 1.5** and **Example 1.8** no additional tax liability will arise under the secondary rule if the payee is not subject to tax on ordinary income or exempt from tax on income from particular sources.

Payee

417. A payee means any person who receives a payment. The payee will generally be the person with the legal right to the payment. There may be cases, however, where, due to tax transparency of the direct recipient, the payment is not included in ordinary income by the direct payee but is included in the income of an underlying investor. In this case the taxpayer will have the burden of establishing, to the reasonable satisfaction of the tax administration, how the tax transparency of the direct recipient and the tax treatment of the payment by the underlying investor impacts on the amount of the adjustment required under the rule.

Payee jurisdiction

418. The payee jurisdiction includes any jurisdiction where the payee is a taxpayer. It therefore includes a non-resident receiving a payment through a PE in the payee jurisdiction. As illustrated in **Example 1.8**, a person may therefore receive the same payment in more than one jurisdiction (i.e. there can be one payee that receives the payment in two jurisdictions). In such cases the taxpayer will generally have the burden of establishing, to the reasonable satisfaction of the tax administration, how the tax treatment in the third jurisdiction impacts on the amount of the adjustment required under the rule.

419. Although D/NI outcomes most commonly arise where the payer and payee jurisdictions are different, this is not a requirement of the hybrid mismatch rules. **Example 1.10** illustrates a case where the payer and payee are in the same jurisdiction, but the arrangement still gives rise to a hybrid mismatch owing to differences in the way payments are accounted for under the arrangement. **Example 1.21** also illustrates a case where the payer and payee are in the same jurisdiction.

Payer

420. A payer means any person who makes a payment. This will generally be the person with the legal obligation to the payment. There may be cases, however, where, due to tax transparency of the direct payer, the payment is treated as made by an underlying investor. In this case the taxpayer will have the burden of establishing, to the reasonable satisfaction of the tax administration, how the tax transparency of the payer and the tax treatment of the payment by the underlying investor impacts on the amount of the adjustment required under the rule.

Payer jurisdiction

421. The payer jurisdiction includes any jurisdiction where the payer is a taxpayer. It therefore includes a non-resident making a payment through a PE in the payer jurisdiction. As illustrated in **Example 1.23** and **Example 4.4**, and as is evident in the context of DD outcomes a payment may be treated as made by taxpayers in more than one jurisdiction (i.e. there can be one payer that is treated as making the same payment). In such cases, the taxpayer will generally have the burden of establishing, to the reasonable satisfaction of the tax administration, how the tax treatment in the other payer jurisdiction impacts on the amount of the adjustment required under the rule.. Although, in the context of DD outcomes, there are, in effect, two payer jurisdictions, Recommendation 6 uses the terms "payer jurisdiction" and "parent jurisdiction" to distinguish between the jurisdictions where the deduction and the duplicate deduction arises.

422. Although mismatches in tax outcomes most commonly arise in cross-border situations, this is not a requirement of the hybrid mismatch rules. The restrictions on double deductions apply equally to residents and non-residents and, as discussed above, in respect of the definition of *payee jurisdiction*, D/NI outcomes can also arise in circumstances where the payer and payee are residents of the same jurisdiction.

Payment

423. Payment means a payment of money (which includes money's worth) made under the financing instrument and includes a distribution, credit or accrual. It includes an amount that is *capable of being paid* and includes any future or contingent obligation to make a payment. The definition of payment includes notional amounts that accrue in respect of a future payment obligation even when the amount accrued does not correspond to any increase in the payment obligation during that period. Where the context requires, payment should include part of any payment.

424. A payment will be treated as having been made when the relevant payment obligation is incurred under the laws of the payer jurisdiction or the payment is derived under the laws of the recipient jurisdiction.

Taxpayer

425. A reference to "taxpayer" in respect of a jurisdiction should generally include a person who is tax resident in that jurisdiction and any other person to the extent they are subject to net income taxation in that jurisdiction through a PE. A person established in a jurisdiction that does not impose a corporate income tax will not be treated as a taxpayer of that jurisdiction.

Voting rights

426. An amount of a person's voting rights is used to determine whether they fall within the related party or control group tests in Recommendation 11.

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Part II

Recommendations on treaty issues

Introduction to Part II

427. Part II of this report complements Part I and deals with the parts of Action 2 that indicate that the outputs of the work on that action item may include "changes to the *OECD Model Tax Convention* (OECD, 2014) to ensure that hybrid instruments and entities (as well as dual resident entities) are not used to obtain the benefits of treaties unduly" and that stress that "[s]pecial attention should be given to the interaction between possible changes to domestic law and the provisions of the *OECD Model Tax Convention*."[1]

428. This part first examines treaty issues related to dual resident entities (Chapter 13). It then includes a proposal for a new treaty provision dealing with transparent entities (Chapter 14). Chapter 15 addresses the issue of the interaction between the recommendations included in Part I of this report and the provisions of tax treaties.

429. At the outset, it should be noted that a number of treaty provisions resulting from the work on Action 6 (Preventing Treaty Abuse) may play an important role in ensuring "that hybrid instruments and entities (as well as dual resident entities) are not used to obtain the benefits of treaties unduly". The following provisions included in the report on Action 6 may be of particular relevance:

(a) limitation-on-benefits rules;[2]

(b) rule aimed at arrangements one of the principal purposes of which is to obtain treaty benefits; [3]

(c) rule aimed at dividend transfer transactions (i.e. to subject the lower rate of tax provided by Art. 10(2)a) or by a treaty provision applicable to pension funds to a minimum shareholding period); [4]

(d) rule concerning a Contracting State's right to tax its own residents; [5]

(e) anti-abuse rule for permanent establishments situated in third States. [6]

Notes

1. See Action 2 – Neutralise the effects of hybrid mismatch arrangements (BEPS Action Plan, OECD 2013), pp. 15-16.
2. See paragraph 25 of the report Action 6: *Preventing the Granting of Treaty Benefits in Inappropriate Circumstances* (OECD, 2015).
3. Paragraph 26 of the report on Action 6 (OECD, 2015).
4. Paragraph 36 of the report on Action 6 (OECD, 2015).
5. Paragraph 63 of the report on Action 6 (OECD, 2015).
6. Paragraph 52 of the report on Action 6 (OECD, 2015).

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OECD (2014), *Model Tax Convention on Income and on Capital: Condensed Version 2014,* OECD Publishing, Paris, http://dx.doi.org/ DOI:10.1787/mtc_cond-2014-en.

Chapter 13

Dual-resident entities

430. Action 2 refers expressly to possible changes to the *OECD Model Tax Convention* (OECD, 2014) to ensure that dual resident entities are not used to obtain the benefits of treaties unduly.

431. The change to Art. 4(3) of the *OECD Model Tax Convention* (OECD, 2014) that will result from the work on Action 6[1] will address some of the BEPS concerns related to the issue of dual resident entities by providing that cases of dual treaty residence would be solved on a case-by-case basis rather than on the basis of the current rule based on place of effective management of entities, which creates a potential for tax avoidance in some countries. The new version of Art. 4(3) reads as follows:

> *3. Where by reason of the provisions of paragraph 1 a person other than an individual is a resident of both Contracting States, the competent authorities of the Contracting States shall endeavour to determine by mutual agreement the Contracting State of which such person shall be deemed to be a resident for the purposes of the Convention, having regard to its place of effective management, the place where it is incorporated or otherwise constituted and any other relevant factors. In the absence of such agreement, such person shall not be entitled to any relief or exemption from tax provided by this Convention except to the extent and in such manner as may be agreed upon by the competent authorities of the Contracting States.*

432. This change, however, will not address all BEPS concerns related to dual resident entities. It will not, for instance, address avoidance strategies resulting from an entity being a resident of a given State under that State's domestic law whilst, at the same time, being a resident of another State under a tax treaty concluded by the first State, thereby allowing that entity to benefit from the advantages applicable to residents under domestic law without being subject to reciprocal obligations (*e.g.* being able to shift its foreign losses to another resident company under a domestic law group relief system while claiming treaty protection against taxation of its foreign profits). That issue arises from a mismatch between the treaty and domestic law concepts of residence and since the treaty concept of residence cannot simply be aligned on the domestic law concept of residence of each Contracting State without creating situations where an entity would be a resident of the two States for the purposes of the treaty, the solution to these avoidance strategies must be found in domestic law. Whilst such avoidance strategies may be addressed through domestic general anti-abuse rules, States for which this is a potential problem may wish to consider inserting into their domestic law a rule, already found in the domestic law of some States,[2] according to which an entity that is considered to be a resident of another State under a tax treaty will be deemed not to be a resident under domestic law.

433. Also, the change to Art. 4(3) will not address BEPS concerns that arise from dual-residence where no treaty is involved. **Example 7.1** of the report illustrates a dual consolidation structure where BEPS concerns arise from the fact that two States consider the same entity as a resident to which each country applies its consolidation regime. In such a case, the same BEPS concerns arise whether or not there is a tax treaty between the two States, which indicates that the solution to such a case needs to be found in domestic laws. It should be noted, however, that if a treaty existed between the two States and the domestic law of each State included the provision referred to in the preceding paragraph, the entity would likely be a resident under the domestic law of only one State, i.e. the State of which it would be a resident under the treaty.

Notes

1. Paragraph 48 of the report on Action 6, *Preventing the Granting of Treaty Benefits in Inappropriate Circumstances* (OECD, 2015).
2. See subsection 250(5) of the Income Tax Act of Canada and section 18 of the Corporation Tax Act 2009 of the United Kingdom.

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OECD (2015), *Preventing the Granting of Treaty Benefits in Inappropriate Circumstances, Action 6 - 2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris, http://dx.doi.org/10.1787/9789264241695-en.

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Chapter 14

Treaty provision on transparent entities

434. The 1999 OECD report on *The Application of the OECD Model Tax Convention to Partnerships* (the Partnership Report, OECD, 1999)[1] contains an extensive analysis of the application of treaty provisions to partnerships, including in situations where there is a mismatch in the tax treatment of the partnership. The main conclusions of the Partnership Report, which have been included in the Commentary of the *OECD Model Tax Convention* (OECD, 2014), seek to ensure that the provisions of tax treaties produce appropriate results when applied to partnerships, in particular in the case of a partnership that constitutes a hybrid entity.

435. The Partnership Report (OECD, 1999), however, did not expressly address the application of tax treaties to entities other than partnerships. In order to address that issue, as well as the fact that some countries have found it difficult to apply the conclusions of the Partnership Report, it was decided to include in the *OECD Model Tax Convention* (OECD, 2014), the following provision and Commentary, which will ensure that income of transparent entities is treated, for the purposes of the Convention, in accordance with the principles of the Partnership report. This will ensure not only that the benefits of tax treaties are granted in appropriate cases but also that these benefits are not granted where neither Contracting State treats, under its domestic law, the income of an entity as the income of one of its residents.

Replace Article 1 of the Model Tax Convention by the following (additions to the existing text appear in **bold italics**):

Article 1

PERSONS COVERED

1. This Convention shall apply to persons who are residents of one or both of the Contracting States.

2. For the purposes of this Convention, income derived by or through an entity or arrangement that is treated as wholly or partly fiscally transparent under the tax law of either Contracting State shall be considered to be income of a resident of a Contracting State but only to the extent that the income is treated, for purposes of taxation by that State, as the income of a resident of that State.

Add the following paragraphs 26.3 to 26.16 to the Commentary on Article 1 (other consequential changes to the Commentary on Article 1 would be required):

Paragraph 2

26.3 This paragraph addresses the situation of the income of entities or arrangements that one or both Contracting States treat as wholly or partly fiscally transparent for tax purposes. The provisions of the paragraph ensure that income of such entities or arrangements is treated, for the purposes of the Convention, in accordance with the

principles reflected in the 1999 report of the Committee on Fiscal Affairs entitled "The Application of the OECD Model Tax Convention to Partnerships".[2] That report therefore provides guidance and examples on how the provision should be interpreted and applied in various situations.

26.4 The report, however, dealt exclusively with partnerships and whilst the Committee recognised that many of the principles included in the report could also apply with respect to other non-corporate entities, it expressed the intention to examine the application of the Model Tax Convention to these other entities at a later stage. As indicated in paragraph 37 of the report, the Committee was particularly concerned with "cases where domestic tax laws create intermediary situations where a partnership is partly treated as a taxable unit and partly disregarded for tax purposes." According to the report

> ***Whilst this may create practical difficulties with respect to a very limited number of partnerships, it is a more important problem in the case of other entities such as trusts. For this reason, the Committee decided to deal with this issue in the context of follow-up work to this report.***

26.5 Paragraph 2 addresses this particular situation by referring to entities that are "wholly or partly" treated as fiscally transparent. Thus, the paragraph not only serves to confirm the conclusions of the Partnership Report but also extends the application of these conclusions to situations that were not directly covered by the report (subject to the application of specific provisions dealing with collective investment vehicles, see paragraphs 6.17 to 6.34 above).

26.6 The paragraph not only ensures that the benefits of the Convention are granted in appropriate cases but also ensures that these benefits are not granted where neither Contracting State treats, under its domestic law, the income of an entity or arrangement as the income of one of its residents. The paragraph therefore confirms the conclusions of the report in such a case (see, for example, example 3 of the report). Also, as recognised in the report, States should not be expected to grant the benefits of a bilateral tax convention in cases where they cannot verify whether a person is truly entitled to these benefits. Thus, if an entity is established in a jurisdiction from which a Contracting State cannot obtain tax information, that State would need to be provided with all the necessary information in order to be able to grant the benefits of the Convention. In such a case, the Contracting State might well decide to use the refund mechanism for the purposes of applying the benefits of the Convention even though it normally applies these benefits at the time of the payment of the relevant income. In most cases, however, it will be possible to obtain the relevant information and to apply the benefits of the Convention at the time the income is taxed (see for example paragraphs 6.29 to 6.31 above which discuss a similar issue in the context of collective investment vehicles).

26.7 The following example illustrates the application of the paragraph:

> ***Example: State A and State B have concluded a treaty identical to the Model Tax Convention. State A considers that an entity established in State B is a company and taxes that entity on interest that it receives from a debtor resident in State A. Under the domestic law of State B, however, the entity is treated as a partnership and the two members in that entity, who share equally all its income, are each taxed on half of the interest. One of the members is a resident of State B and the other one is a resident of a country with which States A and B do not have a***

treaty. The paragraph provides that in such case, half of the interest shall be considered, for the purposes of Article 11, to be income of a resident of State B.

26.8 The reference to "income derived by or through an entity or arrangement" has a broad meaning and covers any income that is earned by or through an entity or arrangement, regardless of the view taken by each Contracting State as to who derives that income for domestic tax purposes and regardless of whether or not that entity or arrangement has legal personality or constitutes a person as defined in subparagraph 1 a) of Article 3. It would cover, for example, income of any partnership or trust that one or both of the Contracting States treats as wholly or partly fiscally transparent. Also, as illustrated in example 2 of the report, it does not matter where the entity or arrangement is established: the paragraph applies to an entity established in a third State to the extent that, under the domestic tax law of one of the Contracting States, the entity is treated as wholly or partly fiscally transparent and income of that entity is attributed to a resident of that State.

26.9 The word "income" must be given the wide meaning that it has for the purposes of the Convention and therefore applies to the various items of income that are covered by Chapter III of the Convention (Taxation of Income), including, for example, profits of an enterprise and capital gains.

26.10 The concept of "fiscally transparent" used in the paragraph refers to situations where, under the domestic law of a Contracting State, the income (or part thereof) of the entity or arrangement is not taxed at the level of the entity or the arrangement but at the level of the persons who have an interest in that entity or arrangement. This will normally be the case where the amount of tax payable on a share of the income of an entity or arrangement is determined separately in relation to the personal characteristics of the person who is entitled to that share so that the tax will depend on whether that person is taxable or not, on the other income that the person has, on the personal allowances to which the person is entitled and on the tax rate applicable to that person; also, the character and source, as well as the timing of the realisation, of the income for tax purposes will not be affected by the fact that it has been earned through the entity or arrangement. The fact that the income is computed at the level of the entity or arrangement before the share is allocated to the person will not affect that result.[3] States wishing to clarify the definition of "fiscally transparent" in their bilateral conventions are free to include a definition of that term based on the above explanations.

26.11 In the case of an entity or arrangement which is treated as partly fiscally transparent under the domestic law of one of the Contracting States, only part of the income of the entity or arrangement might be taxed at the level of the persons who have an interest in that entity or arrangement as described in the preceding paragraph whilst the rest would remain taxable at the level of the entity or arrangement. This, for example, is how some trusts and limited liability partnerships are treated in some countries (i.e. in some countries, the part of the income derived through a trust that is distributed to beneficiaries is taxed in the hands of these beneficiaries whilst the part of that income that is accumulated is taxed in the hands of the trust or trustees; similarly, in some countries, income derived through a limited partnership is taxed in the hands of the general partner as regards that partner's share of that income but is considered to be the income of the limited partnership as regards the limited partners' share of the income). To the extent that the entity or arrangement qualifies as a resident of a Contracting State, the paragraph will ensure that the benefits of the treaty also apply to

the share of the income that is attributed to the entity or arrangement under the domestic law of that State (subject to any anti-abuse provision such as a limitation-on-benefits rule).

26.12 As with other provisions of the Convention, the provision applies separately to each item of income of the entity or arrangement. Assume, for example, that the document that establishes a trust provides that all dividends received by the trust must be distributed to a beneficiary during the lifetime of that beneficiary but must be accumulated afterwards. If one of the Contracting States considers that, in such a case, the beneficiary is taxable on the dividends distributed to that beneficiary but that the trustees are taxable on the dividends that will be accumulated, the paragraph will apply differently to these two categories of dividends even if both types of dividends are received within the same month.

26.13 By providing that the income to which it applies will be considered to be income of a resident of a Contracting State for the purposes of the Convention, the paragraph ensures that the relevant income is attributed to that resident for the purposes of the application of the various allocative rules of the Convention. Depending on the nature of the income, this will therefore allow the income to be considered, for example, as "income derived by" for the purposes of Articles 6, 13 and 17, "profits of an enterprise" for the purposes of Articles 7, 8 and 9 (see also paragraph 4 of the Commentary on Article 3) or dividends or interest "paid to" for the purposes of Articles 10 and 11. The fact that the income is considered to be derived by a resident of a Contracting State for the purposes of the Convention also means that where the income constitutes a share of the income of an enterprise in which that resident holds a participation, such income shall be considered to be the income of an enterprise carried on by that resident (e.g. for the purposes of the definition of enterprise of a Contracting State in Article 3 and paragraph 2 of Article 21).

26.14 Whilst the paragraph ensures that the various allocative rules of the Convention are applied to the extent that income of fiscally transparent entities is treated, under domestic law, as income of a resident of a Contracting State, the paragraph does not prejudge the issue of whether the recipient is the beneficial owner of the relevant income. Where, for example, a fiscally transparent partnership receives dividends as an agent or nominee for a person who is not a partner, the fact that the dividend may be considered as income of a resident of a Contracting State under the domestic law of that State will not preclude the State of source from considering that neither the partnership nor the partners are the beneficial owners of the dividend.

26.15 The paragraph only applies for the purposes of the Convention and does not, therefore, require a Contracting State to change the way in which it attributes income or characterises entities for the purposes of its domestic law. In the example in paragraph 26.7 above, whilst paragraph 2 provides that half of the interest shall be considered, for the purposes of Article 11, to be income of a resident of State B, this will only affect the maximum amount of tax that State A will be able to collect on the interest and will not change the fact that State A's tax will be payable by the entity. Thus, assuming that the domestic law of State A provides for a 30 per cent withholding tax on the interest, the effect of paragraph 2 will simply be to reduce the amount of tax that State A will collect on the interest (so that half of the interest would be taxed at 30 per cent and half at 10 per cent under the treaty between States A and B) and will not change the fact that the entity is the relevant taxpayer for the purposes of State A's domestic law. Also, the provision does not deal exhaustively with all treaty issues that

may arise from the legal nature of certain entities and arrangements and may therefore need to be supplemented by other provisions to address such issues (such as a provision confirming that a trust may qualify as a resident of a Contracting State despite the fact that, under the trust law of many countries, a trust does not constitute a "person").

26.16 As confirmed by paragraph 3, paragraph 2 does not restrict in any way a State's right to tax its own residents. This conclusion is consistent with the way in which tax treaties have been interpreted with respect to partnerships (see paragraph 6.1 above).This, however, does not restrict the obligation to provide relief of double taxation that is imposed on a Contracting State by Articles 23 A and 23 B where income of a resident of that State may be taxed by the other State in accordance with the Convention, taking into account the application of the paragraph].[4]

Notes

1. OECD (1999), *The Application of the OECD Model Tax Convention to Partnerships*, Issues in International Taxation, No. 6, OECD Publishing, Paris.
2. Reproduced in Volume II of the full-length version of the *OECD Model Tax Convention* (OECD, 2014) at page R(15)-1.
3. See paragraphs 37-40 of the Partnership Report.
4. [Double taxation issues related to the transparent entity provision will be addressed as part of the work that will be done on the draft proposal included in paragraph 64 of the report on Action 6.]

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Chapter 15

Interaction between part I and tax treaties

436. Part I of this report includes various recommendations for the domestic law treatment of hybrid financial instruments and hybrid entity payments. Since Action 2 provides that "[s]pecial attention should be given to the interaction between possible changes to domestic law and the provisions of the *OECD Model Tax Convention*", it is necessary to examine treaty issues that may arise from these recommendations.

Rule providing for the denial of deductions

437. Chapter 1 of Part I includes a recommended hybrid mismatch rule under which "the payer jurisdiction will deny a deduction for such payment to the extent it gives rise to a D/NI outcome" to neutralise the effects of hybrid mismatches with respect to a payment under a financial instrument. This raises the question of whether tax treaties, as currently drafted, would authorise such a denial of deduction.

438. Apart from the rules of Articles 7 and 24, the provisions of tax treaties do not govern whether payments are deductible or not and whether they are effectively taxed or not, these being matters of domestic law. The possible application of the provisions of Article 24 with respect to the recommendations set out in Part I of this report is discussed below; as regards Article 7, paragraph 30 of the Commentary on that Article is particularly relevant:

> *30. Paragraph 2 [of Article 7] determines the profits that are attributable to a permanent establishment for the purposes of the rule in paragraph 1 that allocates taxing rights on these profits. Once the profits that are attributable to a permanent establishment have been determined in accordance with paragraph 2 of Article 7, it is for the domestic law of each Contracting State to determine whether and how such profits should be taxed as long as there is conformity with the requirements of paragraph 2 and the other provisions of the Convention. Paragraph 2 does not deal with the issue of whether expenses are deductible when computing the taxable income of the enterprise in either Contracting State. The conditions for the deductibility of expenses are a matter to be determined by domestic law, subject to the provisions of the Convention and, in particular, paragraph 3 of Article 24 …*

Defensive rule requiring the inclusion of a payment in ordinary income

439. Chapter 1 of Part I also includes a recommended "defensive" rule under which "[i]f the payer jurisdiction does not neutralise the mismatch then the payee jurisdiction will require such payment to be included in ordinary income to the extent the payment gives rise to a D/NI outcome". The provisions of tax treaties could be implicated if such a

rule would seek the imposition of tax on a non-resident whose income would not, under the provisions of the relevant tax treaty, be taxable in that State. By virtue of the combination of the definitions of "payee" and "taxpayer" in the recommendations (Part I, Chapter 12), that rule contemplates the imposition of tax by a jurisdiction only in circumstances where the recipient of the payment is a resident of that jurisdiction or maintains a permanent establishment in that jurisdiction. Since the allocative rules of tax treaties generally do not restrict the taxation rights of the State in such circumstances, any interaction between the recommendation and the provisions of tax treaties will therefore appear to relate primarily to the rules concerning the elimination of double taxation (Articles 23 A and 23 B of the *OECD Model Tax Convention*, OECD, 2014).

440. The following two recommendations included in Part I of this report deal with the elimination of double taxation by the State of residence:

(a) "In order to prevent D/NI outcomes from arising under a financial instrument, a dividend exemption that is provided for relief against economic double taxation should not be granted under domestic law to the extent the dividend payment is deductible by the payer. Equally, jurisdictions should consider adopting similar restrictions for other types of dividend relief granted to relieve economic double taxation on underlying profits." [Recommendation 2.1].

(b) "In order to prevent duplication of tax credits under a hybrid transfer, any jurisdiction that grants relief for tax withheld at source on a payment made under a hybrid transfer should restrict the benefit of such relief in proportion to the net taxable income of the taxpayer under the arrangement." [Recommendation 2.2].

441. As explained below, these recommendations do not appear to raise any issues with respect to the application of Articles 23 A and Articles 23 B of the *OECD Model Tax Convention* (OECD, 2014).

Exemption method

442. As regards Articles 23 A (Exemption Method), paragraph 2 of that Article provides that in the case of dividends (covered by Article 10 of the *OECD Model Tax Convention*, OECD, 2014), it is the credit method, and not the exemption method, that is applicable. The Recommendation that "a dividend exemption that is provided for relief against economic double taxation should not be granted under domestic law to the extent the dividend payment is deductible by the payer" should not, therefore, create problems with respect to bilateral tax treaties that include the wording of Article 23 A.

443. It is recognised, however, that a number of bilateral tax treaties depart from the provisions of Article 23 A and provide for the application of the exemption method with respect to dividends received from foreign companies in which a resident company has a substantial shareholding. This possibility is expressly acknowledged in the *OECD Model Tax Convention* (OECD, 2014)(see paragraphs 49 to 54 of the Commentary on Articles 23 A and 23 B).

444. Problems arising from the inclusion of the exemption method in tax treaties with respect to items of income that are not taxed in the State of source have long been recognised in the *OECD Model Tax Convention* (OECD, 2014) (see, for example, paragraph 35 of the Commentary on Articles 23 A and 23 B). Whilst paragraph 4 of Article 23 A[1] may address some situations of hybrid mismatch arrangements where a dividend would otherwise be subject to the exemption method, many tax treaties do not

include that provision. At a minimum, therefore, States that wish to follow the above recommendations included in Part I of this report but that enter into tax treaties providing for the application of the exemption method with respect to dividends should consider the inclusion of paragraph 4 of Article 23 A in their tax treaties, although these States should also recognise that the provision will only provide a partial solution to the problem. A more complete solution that should be considered by these States would be to include in their treaties rules that would expressly allow them to apply the credit method, as opposed to the exemption method, with respect to dividends that are deductible in the payer State. These States may also wish to consider a more general solution to the problems of non-taxation resulting from potential abuses of the exemption method, which would be for States not to include the exemption method in their treaties. Under that approach, the credit method would be provided for in tax treaties, thereby ensuring the relief of juridical double taxation, and it would be left to domestic law to provide whether that should be done through the credit or exemption method (or probably through a combination of the two methods depending on the nature of the income, as is the case of the domestic law of many countries). The issue that may arise from granting a credit for underlying taxes (which is not a feature of Articles 23 A and 23 B of the *OECD Model Tax Convention,* OECD, 2014) is discussed below.

Credit method

445. As regards the application of the credit method provided for by paragraph 2 of Article 23 A and by Article 23 B, the recommendation that relief should be restricted "in proportion to the net taxable income under the arrangement" appears to conform to the domestic tax limitation provided by that method. As noted in paragraphs 60 and 63 of the Commentary on Articles 23 A and 23 B, Article 23 B leaves it to domestic law to determine the domestic tax against which the foreign tax credit should be applied (the "maximum deduction") and one would normally expect that this would be the State of residence's tax as computed after taking into account all relevant deductions:

> *60. Article 23 B sets out the main rules of the credit method, but does not give detailed rules on the computation and operation of the credit. ... Experience has shown that many problems may arise. Some of them are dealt with in the following paragraphs. In many States, detailed rules on credit for foreign tax already exist in their domestic laws. A number of conventions, therefore, contain a reference to the domestic laws of the Contracting States and further provide that such domestic rules shall not affect the principle laid down in Article 23 B.*
>
> *63. The maximum deduction is normally computed as the tax on net income, i.e. on the income from State E (or S) less allowable deductions (specified or proportional) connected with such income...*

446. It is recognised, however, that double non-taxation situations may arise in the application of the credit method by reasons of treaty or domestic law provisions that either supplement, or depart from, the basic approach of Article 23 B (Credit Method) of the *OECD Model Tax Convention* (OECD, 2014). One example would be domestic law provisions that allow the foreign tax credit applicable to one item of income to be used against the State of residence's tax payable on another item of income. Another example would be where treaty or domestic law provisions provide for an underlying foreign tax credit with respect to dividends, which may create difficulties with respect to the part of Recommendation 2.1 according to which "jurisdictions should consider adopting similar restrictions for other types of dividend relief granted to relieve economic double taxation

on underlying profits". These are other situations where Contracting States should ensure that their tax treaties provide for the elimination of double taxation without creating opportunities for tax avoidance strategies.

Potential application of anti-discrimination provisions in the OECD Model Tax Convention

447. The basic thrust of the recommendations set out in Part I of this report is to ensure that payments are treated consistently in the hands of the payer and the recipient and, in particular, to prevent a double deduction or deduction without a corresponding inclusion. These recommendations do not appear to raise any issue of discrimination based on nationality (Art. 24(1)). They also do not appear to treat permanent establishments differently from domestic enterprises (Art. 24(3), to provide different rules for the deduction of payments made to residents and non-residents (Art. 24(4)) or to treat domestic enterprises differently based on whether their capital is owned or controlled by residents or non-residents (Art. 24(5)).

448. Some of the domestic law recommendations to neutralise the effects of hybrid mismatch arrangements that are included in Part I may impact payments to non-residents more than they will impact payments to residents. This, however, is not relevant for the purposes of Article 24 as long as the distinction is based on the treatment of the payments in the hands of the payers and recipients. The fact that a mismatch in the tax treatment of an entity or payment is less likely in a purely domestic context (i.e. one would expect a country to be consistent in the way it characterises domestic payments and entities) cannot be interpreted as meaning that rules that are strictly based on the existence of such a mismatch are treating payments to non-residents, or to non-resident owned enterprises, differently from the way payments to residents, or resident-owned enterprises, are treated under domestic law.

449. The following excerpts from the Commentary on Article 24 are of particular relevance in that context:

(a) *As regards all the provisions of Art. 24:* "The non-discrimination provisions of the Article seek to balance the need to prevent unjustified discrimination with the need to take account of these legitimate distinctions. For that reason, the Article should not be unduly extended to cover so-called "indirect" discrimination." (paragraph 1)

> "Also, whilst the Article seeks to eliminate distinctions that are solely based on certain grounds, it is not intended to provide foreign nationals, non-residents, enterprises of other States or domestic enterprises owned or controlled by non-residents with a tax treatment that is better than that of nationals, residents or domestic enterprises owned or controlled by residents …" (paragraph 3)

(b) *As regards Art. 24(3)*: "That principle, therefore, is restricted to a comparison between the rules governing the taxation of the permanent establishment's own activities and those applicable to similar business activities carried on by an independent resident enterprise. It does not extend to rules that take account of the relationship between an enterprise and other enterprises (e.g. rules that allow consolidation, transfer of losses or tax-free transfers of property between companies under common ownership) since the latter rules do not focus on the taxation of an enterprise's own business activities similar to those of the permanent establishment but, instead, on the taxation of a resident enterprise as part of a group of associated enterprises." (paragraph 41)

(c) *As regards Art 24(4):* "This paragraph is designed to end a particular form of discrimination resulting from the fact that in certain countries the deduction of interest, royalties and other disbursements allowed without restriction when the recipient is resident, is restricted or even prohibited when he is a non-resident." (paragraph 73)

(d) *As regards Art. 24(5):* "Since the paragraph relates only to the taxation of resident enterprises and not to that of the persons owning or controlling their capital, it follows that it cannot be interpreted to extend the benefits of rules that take account of the relationship between a resident enterprise and other resident enterprises (e.g. rules that allow consolidation, transfer of losses or tax-free transfer of property between companies under common ownership)." (paragraph 77)

> "…it follows that withholding tax obligations that are imposed on a resident company with respect to dividends paid to non-resident shareholders but not with respect to dividends paid to resident shareholders cannot be considered to violate paragraph 5. In that case, the different treatment is not dependent on the fact that the capital of the company is owned or controlled by non-residents but, rather, on the fact that dividends paid to non-residents are taxed differently." (paragraph 78)

450. For these reasons, and subject to an analysis of the precise wording of the domestic rules that would be drafted to implement the recommendations, the recommendations set out in Part I of this report would not appear to raise concerns about a possible conflict with the provisions of Article 24 of the *OECD Model Tax Convention* (OECD, 2014).

Notes

1. "4. The provisions of paragraph 1 [of Article 23 A] shall not apply to income derived or capital owned by a resident of a Contracting State where the other Contracting State applies the provisions of this Convention to exempt such income or capital from tax or applies the provisions of paragraph 2 of Article 10 or 11 to such income."

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Annex A

List of Part I Recommendations

Recommendations

Recommendation 1	Hybrid Financial Instrument Rule
Recommendation 2	Specific Recommendations for the Tax Treatment of Financial Instruments
Recommendation 3	Disregarded Hybrid Payments Rule
Recommendation 4	Reverse Hybrid Rule
Recommendation 5	Specific Recommendations for The Tax Treatment of Reverse Hybrids
Recommendation 6	Deductible Hybrid Payments Rule
Recommendation 7	Dual Resident Payer Rule
Recommendation 8	Imported Mismatch Rule
Recommendation 9	Design Principles
Recommendation 10	Definition of Structured Arrangement
Recommendation 11	Definition of Related Persons, Control Group and Acting Together
Recommendation 12	Other Definitions

Recommendation 1

Hybrid financial instrument rule

1. Neutralise the mismatch to the extent the payment gives rise to a D/NI outcome

The following rule should apply to a payment under a financial instrument that results in a hybrid mismatch and to a substitute payment under an arrangement to transfer a financial instrument:

(a) The payer jurisdiction will deny a deduction for such payment to the extent it gives rise to a D/NI outcome.

(b) If the payer jurisdiction does not neutralise the mismatch then the payee jurisdiction will require such payment to be included in ordinary income to the extent the payment gives rise to a D/NI outcome.

(c) Differences in the timing of the recognition of payments will not be treated as giving rise to a D/NI outcome for a payment made under a financial instrument, provided the taxpayer can establish to the satisfaction of a tax authority that the payment will be included as ordinary income within a reasonable period of time.

2. Definition of financial instrument and substitute payment

For the purposes of this rule:

(a) A financial instrument means any arrangement that is taxed under the rules for taxing debt, equity or derivatives under the laws of both the payee and payer jurisdictions and includes a hybrid transfer.

(b) A hybrid transfer includes any arrangement to transfer a financial instrument entered into by a taxpayer with another person where:

(i) the taxpayer is the owner of the transferred asset and the rights of the counterparty in respect of that asset are treated as obligations of the taxpayer; and

(ii) under the laws of the counterparty jurisdiction, the counterparty is the owner of the transferred asset and the rights of the taxpayer in respect of that asset are treated as obligations of the counterparty.

Ownership of an asset for these purposes includes any rules that result in the taxpayer being taxed as the owner of the corresponding cash-flows from the asset.

(c) A jurisdiction should treat any arrangement where one person provides money to another in consideration for a financing or equity return as a financial instrument to the extent of such financing or equity return.

(d) Any payment under an arrangement that is not treated as a financial instrument under the laws of the counterparty jurisdiction shall be treated as giving rise to a mismatch only to the extent the payment constitutes a financing or equity return.

(e) A substitute payment is any payment, made under an arrangement to transfer a financial instrument, to the extent it includes, or is payment of an amount representing, a financing or equity return on the underlying financial instrument where the payment or return would:

Recommendation 1 (*continued*)

(i) not have been included in ordinary income of the payer;

(ii) have been included in ordinary income of the payee; or

(iii) have given rise to hybrid mismatch;

if it had been made directly under the financial instrument.

3. Rule only applies to a payment under a financial instrument that results in a hybrid mismatch

A payment under a financial instrument results in a hybrid mismatch where the mismatch can be attributed to the terms of the instrument. A payment cannot be attributed to the terms of the instrument where the mismatch is solely attributable to the status of the taxpayer or the circumstances in which the instrument is held.

4. Scope of the rule

This rule only applies to a payment made to a related person or where the payment is made under a structured arrangement and the taxpayer is party to that structured arrangement.

5. Exceptions to the rule

The primary response in in Recommendation 1.1(a) should not apply to a payment by an investment vehicle that is subject to special regulation and tax treatment under the laws of the establishment jurisdiction in circumstances where:

(a) The tax policy of the establishment jurisdiction is to preserve the deduction for the payment under the financial instrument to ensure that:

(i) the taxpayer is subject to no or minimal taxation on its investment income; and

(ii) that holders of financial instruments issued by the taxpayer are subject to tax on that payment as ordinary income on a current basis.

(b) The regulatory and tax framework in the establishment jurisdiction has the effect that the financial instruments issued by the investment vehicle will result in all or substantially all of the taxpayer's investment income being paid and distributed to the holders of those financial instruments within a reasonable period of time after that income was derived or received by the taxpayer.

(c) The tax policy of the establishment jurisdiction is that the full amount of the payment is:

(i) included in the ordinary income of any person that is a payee in the establishment jurisdiction; and

(ii) not excluded from the ordinary income of any person that is a payee under the laws of the payee jurisdiction under a treaty between the establishment jurisdiction and the payee jurisdiction.

(d) The payment is not made under a structured arrangement.

The defensive rule in Recommendation 1.1(b) will continue to apply to any payment made by such an investment vehicle.

Recommendation 2

Specific recommendations for the tax treatment of financial instruments

1. Denial of dividend exemption for deductible payments

In order to prevent D/NI outcomes from arising under a financial instrument, a dividend exemption that is provided for relief against economic double taxation should not be granted under domestic law to the extent the dividend payment is deductible by the payer. Equally, jurisdictions should consider adopting similar restrictions for other types of dividend relief granted to relieve economic double taxation on underlying profits.

2. Restriction of foreign tax credits under a hybrid transfer

In order to prevent duplication of tax credits under a hybrid transfer, any jurisdiction that grants relief for tax withheld at source on a payment made under a hybrid transfer should restrict the benefit of such relief in proportion to the net taxable income of the taxpayer under the arrangement.

3. Scope of the rule

There is no limitation as to the scope of these recommendations.

Recommendation 3

Disregarded hybrid payments rule

1. Neutralise the mismatch to the extent the payment gives rise to a D/NI outcome

The following rule should apply to a disregarded payment made by a hybrid payer that results in a hybrid mismatch:

(a) The payer jurisdiction will deny a deduction for such payment to the extent it gives rise to a D/NI outcome.

(b) If the payer jurisdiction does not neutralise the mismatch then the payee jurisdiction will require such payment to be included in ordinary income to the extent the payment gives rise to a D/NI outcome.

(c) No mismatch will arise to the extent that the deduction in the payer jurisdiction is set-off against income that is included in income under the laws of both the payee and the payer jurisdiction (i.e. dual inclusion income).

(d) Any deduction that exceeds the amount of dual inclusion income (the excess deduction) may be eligible to be set-off against dual inclusion income in another period.

2. Rule only applies to disregarded payments made by a hybrid payer

For the purpose of this rule:

(a) A disregarded payment is a payment that is deductible under the laws of the payer jurisdiction and is not recognised under the laws of the payee jurisdiction.

(b) A person will be a hybrid payer where the tax treatment of the payer under the laws of the payee jurisdiction causes the payment to be a disregarded payment.

3. Rule only applies to payments that result in a hybrid mismatch

A disregarded payment made by a hybrid payer results in a hybrid mismatch if, under the laws of the payer jurisdiction, the deduction may be set-off against income that is not dual inclusion income.

4. Scope of the rule

This rule only applies if the parties to the mismatch are in the same control group or where the payment is made under a structured arrangement and the taxpayer is a party to that structured arrangement.

Recommendation 4

Reverse hybrid rule

1. Neutralise the mismatch to the extent the payment gives rise to D/NI outcome

In respect of a payment made to a reverse hybrid that results in a hybrid mismatch the payer jurisdiction should apply a rule that will deny a deduction for such payment to the extent it gives rise to a D/NI outcome.

2. Rule only applies to payment made to a reverse hybrid

A reverse hybrid is any person that is treated as a separate entity by an investor and as transparent under the laws of the establishment jurisdiction.

3. Rule only applies to hybrid mismatches

A payment results in a hybrid mismatch if a mismatch would not have arisen had the accrued income been paid directly to the investor.

4. Scope of the rule

The recommendation only applies where the investor, the reverse hybrid and the payer are members of the same control group or if the payment is made under a structured arrangement and the payer is party to that structured arrangement.

Recommendation 5

Specific recommendations for the tax treatment of reverse hybrids

1. Improvements to CFC and other offshore investment regimes

Jurisdictions should introduce, or make changes to, their offshore investment regimes in order to prevent D/NI outcomes from arising in respect of payments to a reverse hybrid. Equally jurisdictions should consider introducing or making changes to their offshore investment regimes in relation to imported mismatch arrangements.

2. Limiting the tax transparency for non-resident investors

A reverse hybrid should be treated as a resident taxpayer in the establishment jurisdiction if the income of the reverse hybrid is not brought within the charge to taxation under the laws of the establishment jurisdiction and the accrued income of a non-resident investor in the same control group as the reverse hybrid is not brought within the charge to taxation under the laws of the investor jurisdiction.

3. Information reporting for intermediaries

Jurisdictions should introduce appropriate tax filing and information reporting requirements on persons established within their jurisdiction in order to assist both taxpayers and tax administrations to make a proper determination of the payments that have been attributed to that non-resident investor.

Recommendation 6

Deductible hybrid payments rule

1. Neutralise the mismatch to the extent the payment gives rise to a DD outcome

The following rule should apply to a hybrid payer that makes a payment that is deductible under the laws of the payer jurisdiction and that triggers a duplicate deduction in the parent jurisdiction that results in a hybrid mismatch:

(a) The parent jurisdiction will deny the duplicate deduction for such payment to the extent it gives rise to a DD outcome.

(b) If the parent jurisdiction does not neutralise the mismatch, the payer jurisdiction will deny the deduction for such payment to the extent it gives rise to a DD outcome.

(c) No mismatch will arise to the extent that a deduction is set-off against income that is included in income under the laws of both the parent and the payer jurisdictions (i.e. dual inclusion income).

(d) Any deduction that exceeds the amount of dual inclusion income (the excess deduction) may be eligible to be set-off against dual inclusion income in another period. In order to prevent stranded losses, the excess deduction may be allowed to the extent that the taxpayer can establish, to the satisfaction of the tax administration, that the excess deduction in the other jurisdiction cannot be set-off against any income of any person under the laws of the other jurisdiction that is not dual inclusion income.

2. Rule only applies to deductible payments made by a hybrid payer

A person will be treated as a hybrid payer in respect of a payment that is deductible under the laws of the payer jurisdiction where:

(a) the payer is not a resident of the payer jurisdiction and the payment triggers a duplicate deduction for that payer (or a related person) under the laws of the jurisdiction where the payer is resident (the parent jurisdiction); or

(b) the payer is resident in the payer jurisdiction and the payment triggers a duplicate deduction for an investor in that payer (or a related person) under the laws of the other jurisdiction (the parent jurisdiction).

3. Rule only applies to payments that result in a hybrid mismatch

A payment results in a hybrid mismatch where the deduction for the payment may be set-off, under the laws of the payer jurisdiction, against income that is not dual inclusion income.

4. Scope of the rule

The defensive rule only applies if the parties to the mismatch are in the same control group or where the mismatch arises under a structured arrangement and the taxpayer is party to that structured arrangement. There is no limitation on scope in respect of the recommended response.

Recommendation 7

Dual resident payer rule

1. Neutralise the mismatch to the extent the payment gives rise to a DD outcome

The following rule should apply to a dual resident that makes a payment that is deductible under the laws of both jurisdictions where the payer is resident and that DD outcome results in a hybrid mismatch:

(a) Each resident jurisdiction will deny a deduction for such payment to the extent it gives rise to a DD outcome.

(b) No mismatch will arise to the extent that the deduction is set-off against income that is included as income under the laws of both jurisdictions (i.e. dual inclusion income).

(c) Any deduction that exceeds the amount of dual inclusion income (the excess deduction) may be eligible to be set-off against dual inclusion income in another period. In order to prevent stranded losses, the excess deduction may be allowed to the extent that the taxpayer can establish, to the satisfaction of the tax administration, that the excess deduction cannot be set-off against any income under the laws of the other jurisdiction that is not dual inclusion income.

2. Rule only applies to deductible payments made by a dual resident

A taxpayer will be a dual resident if it is resident for tax purposes under the laws of two or more jurisdictions.

3. Rule only applies to payments that result in a hybrid mismatch

A deduction for a payment results in a hybrid mismatch where the deduction for the payment may be set-off, under the laws of the other jurisdiction, against income that is not dual inclusion income.

4. Scope of the rule

There is no limitation on the scope of the rule.

Recommendation 8

Imported mismatch rule

1. Deny the deduction to the extent the payment gives rise to an indirect D/NI outcome

The payer jurisdiction should apply a rule that denies a deduction for any imported mismatch payment to the extent the payee treats that payment as set-off against a hybrid deduction in the payee jurisdiction.

2. Definition of hybrid deduction

Hybrid deduction means a deduction resulting from:

(a) a payment under a financial instrument that results in a hybrid mismatch;

(b) a disregarded payment made by a hybrid payer that results in a hybrid mismatch;

(c) a payment made to a reverse hybrid that results in a hybrid mismatch; or

(d) a payment made by a hybrid payer or dual resident that triggers a duplicate deduction resulting in a hybrid mismatch;

and includes a deduction resulting from a payment made to any other person to the extent that person treats the payment as set-off against another hybrid deduction.

3. Imported mismatch payment

An imported mismatch payment is a deductible payment made to a payee that is not subject to hybrid mismatch rules.

4. Scope of the rule

The rule applies if the taxpayer is in the same control group as the parties to the imported mismatch arrangement or where the payment is made under a structured arrangement and the taxpayer is party to that structured arrangement.

Recommendation 9

Design principles

1. Design principles

The hybrid mismatch rules have been designed to maximise the following outcomes:

(a) neutralise the mismatch rather than reverse the tax benefit that arises under the laws of the jurisdiction;

(b) be comprehensive;

(c) apply automatically;

(d) avoid double taxation through rule co-ordination;

(e) minimise the disruption to existing domestic law;

(f) be clear and transparent in their operation;

(g) provide sufficient flexibility for the rule to be incorporated into the laws of each jurisdiction;

(h) be workable for taxpayers and keep compliance costs to a minimum; and

(i) minimise the administrative burden on tax authorities.

Jurisdictions that implement these recommendations into domestic law should do so in a manner intended to preserve these design principles.

2. Implementation and co-ordination

Jurisdictions should co-operate on measures to ensure these recommendations are implemented and applied consistently and effectively. These measures should include:

(a) the development of agreed guidance on the recommendations;

(b) co-ordination of the implementation of the recommendations (including timing);

(c) development of transitional rules (without any presumption as to grandfathering of existing arrangements);

(d) review of the effective and consistent implementation of the recommendations;

(e) exchange of information on the jurisdiction treatment of hybrid financial instruments and hybrid entities;

(f) endeavouring to make relevant information available to taxpayers (including reasonable endeavours by the OECD); and

(g) consideration of the interaction of the recommendations with other Actions under the BEPS Action Plan including Actions 3 and 4.

Recommendation 10

Definition of structured arrangement

1. General Definition

Structured arrangement is any arrangement where the hybrid mismatch is priced into the terms of the arrangement or the facts and circumstances (including the terms) of the arrangement indicate that it has been designed to produce a hybrid mismatch.

2. Specific examples of structured arrangements

Facts and circumstances that indicate that an arrangement has been designed to produce a hybrid mismatch include any of the following:

(a) an arrangement that is designed, or is part of a plan, to create a hybrid mismatch;

(b) an arrangement that incorporates a term, step or transaction used in order to create a hybrid mismatch;

(c) an arrangement that is marketed, in whole or in part, as a tax-advantaged product where some or all of the tax advantage derives from the hybrid mismatch;

(d) an arrangement that is primarily marketed to taxpayers in a jurisdiction where the hybrid mismatch arises;

(e) an arrangement that contains features that alter the terms under the arrangement, including the return, in the event that the hybrid mismatch is no longer available; or

(f) an arrangement that would produce a negative return absent the hybrid mismatch.

3. When taxpayer is not a party to a structured arrangement

A taxpayer will not be treated as a party to a structured arrangement if neither the taxpayer nor any member of the same control group could reasonably have been expected to be aware of the hybrid mismatch and did not share in the value of the tax benefit resulting from the hybrid mismatch.

Recommendation 11

Definitions of related persons, control group and acting together

1. General definition

For the purposes of these recommendations:

(a) Two persons are related if they are in the same control group or the first person has a 25% or greater investment in the second person or there is a third person that holds a 25% or greater investment in both.

(b) Two persons are in the same control group if:

(i) they are consolidated for accounting purposes;

(ii) the first person has an investment that provides that person with effective control of the second person or there is a third person that holds investments which provides that person with effective control over both persons;

(iii) the first person has a 50% or greater investment in the second person or there is a third person that holds a 50% or greater investment in both; or

(iv) they can be regarded as associated enterprises under Article 9.

(c) A person will be treated as holding a percentage investment in another person if that person holds directly or indirectly through an investment in other persons, a percentage of the voting rights of that person or of the value of any equity interest in that person.

2. Aggregation of interests

For the purposes of the related party rules a person who acts together with another person in respect of ownership or control of any voting rights or equity interests will be treated as owning or controlling all the voting rights and equity interests of that person.

3. Acting together

Two persons will be treated as acting together in respect of ownership or control of any voting rights or equity interests if:

(a) they are members of the same family;

(b) one person regularly acts in accordance with the wishes of the other person;

(c) they have entered into an arrangement that has material impact on the value or control of any such rights or interests; or

(d) the ownership or control of any such rights or interests are managed by the same person or group of persons.

If a manager of a collective investment vehicle can establish to the satisfaction of the tax authority, from the terms of any investment mandate, the nature of the investment and the circumstances that the hybrid mismatch was entered into, that the two funds were not acting together in respect of the investment then the interest held by those funds should not be aggregated for the purposes of the acting together test.

Recommendation 12

Other definitions

1. Definitions

For the purpose of these recommendations:

Accrued income	Accrued income, in relation to any payee and any investor, means income of the payee that has accrued for the benefit of that investor.
Arrangement	Arrangement refers to an agreement, contract, scheme, plan, or understanding, whether enforceable or not, including all steps and transactions by which it is carried into effect. An arrangement may be part of a wider arrangement, it may be a single arrangement, or it may be comprised of a number of arrangements.
Collective investment vehicle	Collective investment vehicle means a collective investment vehicle as defined in paragraph 4 of the *Granting of Treaty Benefits with Respect to the Income of Collective Investment Vehicles* (2010, OECD).
Constitution	Constitution, in relation to any person, means the rules governing the relationship between the person and its owners and includes articles of association or incorporation.
D/NI outcome	A payment gives rise to a D/NI outcome to the extent the payment is deductible under the laws of the payer jurisdiction but is not included in ordinary income by any person in the payee jurisdiction. A D/NI outcome is not generally impacted by questions of timing in the recognition of payments or differences in the way jurisdictions measure the value of that payment. In some circumstances however a timing mismatch will be considered permanent if the taxpayer cannot establish to the satisfaction of a tax authority that a payment will be brought into account within a reasonable period of time (see Recommendation 1.1(c)).
DD outcome	A payment gives rise to a DD outcome if the payment is deductible under the laws of more than one jurisdiction.
Deduction	Deduction (including deductible), in respect of a payment, means that, after a proper determination of the character and treatment of the payment under the laws of the payer jurisdiction, the payment is taken into account as a deduction or equivalent tax relief under the laws of that jurisdiction in calculating the taxpayer's net income.
Director	Director, in relation to any person, means any person who has the power under the constitution to manage and control that person and includes a trustee.
Distribution	Distribution, in relation to any person, means a payment of profits or gains by that person to any owner.

Recommendation 12 (*continued*)

Dual inclusion income	Dual inclusion income, in the case of both deductible payments and disregarded payments, refers to any item of income that is included as ordinary income under the laws of the jurisdictions where the mismatch has arisen. An item that is treated as income under the laws of both jurisdictions may, however, continue to qualify as dual inclusion income even if that income benefits from double taxation relief, such as a foreign tax credit (including underlying foreign tax credit) or a domestic dividend exemption, to the extent such relief ensures that income, which has been subject to tax at the full rate in one jurisdiction, is not subject to an additional layer of taxation under the laws of either jurisdiction.
Equity interest	Equity interest means any interest in any person that includes an entitlement to an equity return.
Equity return	Equity return means an entitlement to profits or eligibility to participate in distributions of any person and, in respect of any arrangement is a return on that arrangement that is economically equivalent to a distribution or a return of profits or where it is reasonable to assume, after consideration of the terms of the arrangement, that the return is calculated by reference to distributions or profits.
Establishment jurisdiction	Establishment jurisdiction, in relation to any person, means the jurisdiction where that person is incorporated or otherwise established.
Family	A person (A) is a member of the same family as another person (B) if B is: • the spouse or civil partner of A; • a 'relative' of A (brother, sister, ancestor or lineal descendant); • the spouse or civil partner of a relative of A; • a relative of A's spouse or civil partner; • the spouse or civil partner of a relative of A's spouse or civil partner; or • an adopted relative.
Financing return	Financing return, in respect of any arrangement is a return on that arrangement that is economically equivalent to interest or where it is reasonable to assume, after consideration of the terms of the arrangement, that the return is calculated by reference to the time value of money provided under the arrangement.
Hybrid mismatch	A hybrid mismatch is defined in paragraph 3 in Recommendations 1, 3, 4, 6 and 7 for the purposes of those recommendations.
Included in ordinary income	A payment will be treated as included in ordinary income to the extent that, after a proper determination of the character and treatment of the payment under the laws of the relevant jurisdiction, the payment has been incorporated as ordinary income into a calculation of the payee's income under the law of that jurisdiction.
Investor	Investor, in relation to any person, means any person directly or indirectly holding voting rights or equity interests in that person.
Investor jurisdiction	Investor jurisdiction is any jurisdiction where the investor is a taxpayer.
Mismatch	A mismatch is a DD outcome or a D/NI outcome and includes an expected mismatch.

Recommendation 12 (*continued*)

Money	Money includes money in any form, anything that is convertible into money and any provision that would be paid for at arm's length.
Offshore investment regime	An offshore investment regime includes controlled foreign company and foreign investment fund rules and any other rules that require the investor's accrued income to be included on a current basis under the laws of the investor's jurisdiction.
Ordinary income	Ordinary income means income that is subject to tax at the taxpayer's full marginal rate and does not benefit from any exemption, exclusion, credit or other tax relief applicable to particular categories of payments (such as indirect credits for underlying tax on income of the payer). Income is considered subject to tax at the taxpayer's full marginal rate notwithstanding that the tax on the inclusion is reduced by a credit or other tax relief granted by the payee jurisdiction for withholding tax or other taxes imposed by the payer jurisdiction on the payment itself.
Payee	Payee means any person who receives a payment under an arrangement including through a permanent establishment of the payee.
Payee jurisdiction	Payee jurisdiction is any jurisdiction where the payee is a taxpayer.
Payer	Payer means any person who makes a payment under an arrangement including through a permanent establishment of the payer.
Payer jurisdiction	Payer jurisdiction is any jurisdiction where the payer is a taxpayer.
Payment	Payment includes any amount capable of being paid including (but not limited to) a distribution, credit, debit, accrual of money but it does not extend to payments that are only deemed to be made for tax purposes and that do not involve the creation of economic rights between parties.
Person	Person includes any natural or legal person or unincorporated body of persons and a trust.
Taxpayer	Taxpayer, in respect of any jurisdiction, means any person who is subject to tax in that jurisdiction whether as a resident or by virtue of applicable source rules (such as maintaining a permanent establishment in that jurisdiction).
Trust	Trust includes any person who is a trustee of a trust acting in that capacity.
Voting rights	Voting rights means the right to participate in any decision-making concerning a distribution, a change to the constitution or the appointment of a director.

Annex B

Examples

List of examples

Hybrid financial instrument rule

Specific recommendations for the tax treatment of financial instruments

Disregarded hybrid payments rule

Reverse hybrid rule

Deductible hybrid payments rule

Dual-resident payer rule

Imported mismatch rule

Design principles

Definition of structured arrangements

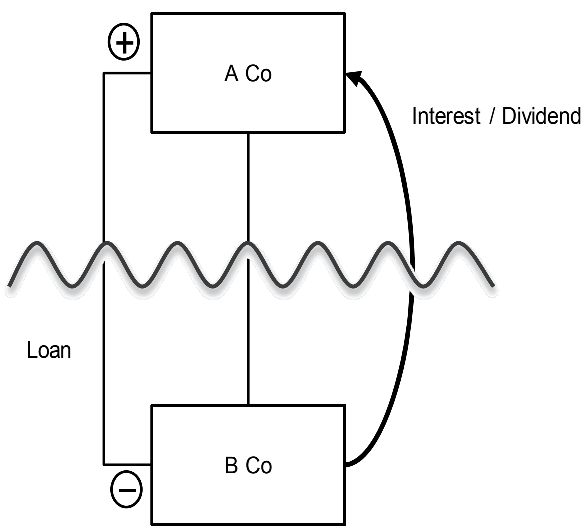
Definition of related persons, control group and acting together

Example 1.1

Interest payment under a debt/equity hybrid

Facts

1. In the example illustrated in the figure below, A Co (a company resident in Country A) owns all the shares in B Co (a company resident in Country B). A Co lends money to B Co. The loan carries a market rate of interest which is payable every six months in arrears. Payments of interest and principal under the loan are subordinated to the ordinary creditors of B Co and can be suspended in the event B Co fails to meet certain solvency requirements.



2. The loan is treated as a debt instrument under the laws of Country B but as an equity instrument (i.e. a share) under the laws of Country A and interest payments on the loan are treated as a deductible expense under Country B law but as dividends under Country A law. Country A exempts dividends paid by a foreign company if that shareholder has held more than 10% of the shares in the company in the 12 month period immediately prior to when the dividend is paid.

Question

3. Whether the interest payments fall within the scope of the hybrid financial instrument rule and, if so, to what extent an adjustment is required in accordance with that rule.

Answer

4. If Country A applies Recommendation 2.1 to deny A Co the benefit of tax exemption for a deductible dividend then no mismatch will arise for the purposes of the hybrid financial instrument rule.

5. If Country A does not apply Recommendation 2.1 then the payment of interest will give rise to a hybrid mismatch within the scope of the hybrid financial instrument rule and Country B should deny B Co a deduction for the interest paid to A Co. If Country B does not apply the recommended response, then Country A should treat the interest payments as ordinary income.

Analysis

Recommendation 2.1 will apply to deny A Co the benefit of the dividend exemption for the payment

6. Recommendation 2.1 states that a dividend exemption, which is granted by the payee jurisdiction to relieve double taxation, should not apply to payments that are deductible by the payer. As, in this case, the entire interest payment is deductible under Country B law, no part of the interest payment should be treated as eligible for exemption under Country A law.

7. If the dividend exemption in Country A does not extend to deductible dividends then no mismatch will arise for the purposes of the hybrid financial instrument rule. The determination of whether a payment gives rise to a D/NI outcome requires a proper consideration of the character of the payment and its tax treatment in both jurisdictions. This will include the effect of any rules in Country A, consistent with Recommendation 2.1, excluding deductible dividends from the benefit of a tax exemption.

If Country A does not apply Recommendation 2.1 then the payment will give rise to a hybrid mismatch that is within the scope of the hybrid financial instrument rule

8. Assuming that Country A has not implemented Recommendation 2.1, and the dividend exemption continues to apply in Country A, then the payment of interest will give rise to a D/NI outcome, which can be attributed to differences in the tax treatment of the subordinated loan under Country A and Country B law.

9. The subordinated loan meets the definition of a *financial instrument* under Recommendation 1 because it is characterised and taxed as a debt instrument in Country B and as an equity instrument in Country A.

10. A Co and B Co are also related parties (A Co owns 100% of B Co) so that the hybrid financial instrument falls within the scope of the hybrid financial instrument rule. Note that, because A Co and B Co are related parties, the circumstances in which the parties enter into the financial instrument does not affect whether the hybrid financial instrument rule is within the scope of Recommendation 1. If, for example, the subordinated loan was purchased by A Co from an unrelated party in an unconnected transaction, the mismatch in tax outcomes under the loan would still be treated as a hybrid mismatch between related parties for the purposes of Recommendation 1.

Primary recommendation – deny the deduction in the payer jurisdiction

11. Country B should deny the deduction to the extent the interest payment is not included in ordinary income under the laws of Country A. The adjustment is limited to neutralising the mismatch in tax outcomes. Recommendation 1 does not further require, for example, that Country B change the tax character of the payment in order to align it with the tax outcomes in the payee jurisdiction by treating it as a dividend for tax purposes.

Defensive rule – require income to be included in the payee jurisdiction

12. If Country B does not apply the recommended response, then the Country A should treat the deductible payment as ordinary income. As with the primary recommendation, the adjustment required under the defensive rule is limited to neutralising the mismatch in tax outcomes and does not require Country A to re-characterise the loan as debt or treat the payment as interest for tax purposes.

Example 1.2

Interest payment under a debt/equity hybrid eligible for partial exemption

Facts

1. The facts of this example are the same as **Example 1.1** except that Country A provides a partial tax exemption for foreign dividends paid by a controlled foreign entity. A table summarising the tax treatment of the instrument is set out below. In this table it is assumed that B Co has 100 of income for the period and makes a payment of 50 to A Co. A Co has no income for the period other than the payment under the subordinated loan. The corporate tax rate in both countries is 30%.

A Co			B Co		
	Tax	**Book**		**Tax**	**Book**
Income			Income		
Dividend received	5	50	Other income	100	100
Expenditure			Expenditure		
			Interest paid	(50)	(50)
Net return		**50**	**Net return**		**50**
Taxable income	**5**		**Taxable income**	**50**	
Tax to pay (30%)		(1.5)	Tax to pay (30%)		(15)
After-tax return		**48.5**	**After-tax return**		**35**

2. Under Country B law, the payment to A Co is treated as a deductible interest which means that B Co's taxable income is equal to its pre-tax net return. Under Country A law, however, the payment is treated as a dividend and A Co is entitled to a tax exemption for 90% of the payment received. The net effect of this difference in the characterisation of the instrument for tax purposes can be illustrated by comparing it to the tax treatment of an ordinary interest or dividend payment under the laws of Country A and B.

		Loan	Share	Hybrid
B Co	Income	100	100	100
	Expenditure	(50)	(50)	(50)
	Tax (at 30%)	(15)	(30)	(15)
	After-tax return	**35**	**20**	**35**
A Co	Income	50	50	50
	Expenditure	-	-	-
	Tax (at 30%)	(15)	(1.5)	(1.5)
	After-tax return	**35**	**48.5**	**48.5**
Combined after-tax return		**70**	**68.5**	**83.5**

3. This comparison shows the net tax benefit to the parties of making a payment under the subordinated loan is between 13.5 and 15 (depending on whether the final outcome is compared to a dividend or interest payment).

Question

4. Whether the tax treatment of the payments under the subordinated loan falls within the scope of the hybrid financial instrument rule and, if so, to what extent an adjustment is required under that rule?

Answer

5. The payment under the subordinated loan will give rise to a mismatch in tax outcomes unless Country A applies Recommendation 2.1 to prevent A Co claiming the benefit of a partial dividend exemption in respect of a deductible payment.

6. Country B should deny B Co a deduction for a portion of the interest payable under the subordinated loan equal to the amount that is fully exempt from taxation under Country A law. If Country B does not apply the recommended response, then Country A should treat the entire payment as ordinary income.

Analysis

If Country A does not apply Recommendation 2.1 then the payment will give rise to a hybrid mismatch

7. Assuming Country A has not applied Recommendation 2.1 to prevent A Co claiming the benefit of the partial exemption, the payment will give rise to a mismatch in tax outcomes. This mismatch is attributable to the terms of the instrument because it is attributable to a difference in the way the loan is characterised under Country A and Country B laws.

Primary recommendation – deny the deduction in the payer jurisdiction

8. The primary recommendation under the hybrid financial instrument rule is that Country B deny the deduction to the extent it gives rise to a D/NI outcome. The effect of the adjustment should be to align the tax treatment of the payments made under the instrument so that the amounts that are treated as a financing expense in the payer jurisdiction are limited to the amounts that are fully taxed in the payee jurisdiction. The adjustment should result in a proportionate outcome that minimises the risk of double taxation. This can be achieved by only denying a deduction for the portion of the interest payment that is effectively exempt from taxation in the payee jurisdiction. Because 10% of the payment made to A Co is taxed at A Co's full marginal rate, B Co may continue to deduct an equivalent portion of the interest payment under Country B law. A table setting out the amount of the required adjustment is set out below.

A Co			**B Co**		
	Tax	**Book**		**Tax**	**Book**
Income			Income		
Dividend received	5	50	Other income	100	100
Expenditure			Expenditure		
			Interest paid	(5)	(50)
Net return		**50**	**Net return**		**50**
Taxable income	**5**		**Taxable income**	**95**	
Tax to pay		(1.5)	Tax to pay		(28.5)
After-tax return		**48.5**	**After-tax return**		**21.5**

9. Under Country B law the deduction is denied to the extent the payment is treated as exempt in Country A. Because the exemption granted in Country A only extends to 90% of the payment made under the instrument, the hybrid financial instrument rule still allows B Co to deduct 10% of the payment made to A Co. The adjustment has the net effect of bringing a sufficient amount of income into tax, under the laws of the payer and payee jurisdictions, to ensure that all the income under the arrangement is subject to tax at the taxpayer's full marginal rate.

Defensive rule – require income to be included in the payee jurisdiction

10. If Country B does not apply the recommended response, then A Co should treat the entire amount of the deductible payment as ordinary income under Country A law. A table setting out the amount of the required adjustment is set out below.

A Co			B Co		
	Tax	Book		Tax	Book
Income			Income		
Dividend received	50	50	Other income	100	100
Expenditure			Expenditure		
			Interest paid	(50)	(50)
Net return		**50**	**Net return**		**50**
Taxable income	**50**		**Taxable income**	**50**	
Tax to pay		(15)	Tax to pay		(15)
After-tax return		**35**	**After-tax return**		**35**

11. Under Country A law the entire amount of the payment is treated as ordinary income and subject to tax at the taxpayer's full marginal rate. As with the adjustment made under the primary recommendation this has the net effect of bringing the total amount of the income under the arrangement into tax under the laws of either the payer or payee jurisdiction and, because the tax rates in Country A and B are the same, produces the same net tax outcome as an adjustment under the primary rule.

Example 1.3

Interest payment under a debt/equity hybrid that is subject to a reduced rate

Facts

1. The facts of this example are the same as **Example 1.1** except that amounts that are characterised as dividends under Country A law are subject to tax at a reduced rate. A table summarising the tax treatment of the interest payment under the laws of Country A and Country B is set out below.

2. In this table it is assumed that B Co has income of 100 for the period and makes a payment of 40 under the subordinated loan. A Co has no income for the period other than the payment under the loan. The corporate tax rate is 20% in Country B and 40% in Country A, however Country A taxes dividends at 10% of the normal corporate rate (i.e. 4%).

A Co				B Co		
	Tax		**Book**		**Tax**	**Book**
	4%	**40%**				
Income				Income		
Dividend received	40		40	Other income	100	100
Expenditure				Expenditure		
				Interest paid	(40)	(40)
Net return			**40**	**Net return**		**60**
Income taxable at full rate		**4**		**Taxable income**	**60**	
Tax to pay			(1.6)	Tax to pay		(12)
After-tax return			**38.4**	**After-tax return**		**48**

3. Under Country B law, the payment to A Co is treated as deductible interest, which means that B Co's taxable income and pre-tax net return are the same. Under Country A law, however, the payment is treated as a dividend. A Co is subject to a reduced rate of taxation on dividend income (4%), which leaves A Co with an after-tax return of 38.4. The net effect of this difference in the characterisation of the instrument for tax purposes can be illustrated by comparing the tax treatment of this payment to that of an ordinary interest or dividend payment under the laws of Country A and B.

		Loan	Share	Hybrid
B Co	Income	100	100	100
	Expenditure	(40)	(40)	(40)
	Tax (at 20%)	(12)	(20)	(12)
	After-tax return	48	40	48
A Co	Income	40	40	40
	Expenditure	-	-	-
	Tax (at 40%)	(16)	(1.6)	(1.6)
	After-tax return	**24**	**38.4**	**38.4**
	Combined after-tax return	**72**	**78.4**	**86.4**

4. This comparison shows the net tax benefit to the parties of making a payment under the subordinated loan is between 8 and 14.4 (depending on whether the final outcome is compared to a dividend or interest payment).

Question

5. Whether the tax treatment of the payments under the subordinated loan falls within the scope of the hybrid financial instrument rule and, if so, to what extent an adjustment is required under that rule?

Answer

6. No mismatch will arise for the purposes of the hybrid financial instrument rule (and therefore no adjustment will be required under that rule) if the reduced rate of taxation applicable to the payment under the subordinated loan is the same rate that is applied to ordinary income derived by A Co under all types of financial instruments.

7. Assuming, however, that the reduced rate in Country A is less than the general rate applied to other types of income under a financial instrument then, unless Country A applies Recommendation 2.1 to prevent A Co claiming the benefit of the reduced rate for dividends, the payment under the loan will give rise to a mismatch in tax outcomes. The mismatch will be a hybrid mismatch because it is attributable to the way the subordinated loan is characterised under Country A and Country B laws.

8. Country B should therefore deny B Co a deduction for a portion of the interest payable under the subordinated loan. The amount that remains eligible to be deducted should equal the amount of income that is effectively subject to tax at the full marginal rate in the payee jurisdiction. If Country B does not apply the recommended response, then Country A should treat the entire payment as ordinary income subject to tax at the full rate.

Analysis

A payment made under the financial instrument will not give rise to a mismatch if the payment is subject to tax at A Co's full marginal rate

9. Ordinary income means "income that is subject to tax at the taxpayer's full marginal rate and does not benefit from any exemption, exclusion, credit or other tax relief applicable to particular categories of payments." Accordingly, the payment under the subordinated loan will not give rise to a mismatch in tax treatment if the payment is subject to tax at A Co's full marginal rate.

10. In the context of the hybrid financial instrument rule, A Co's *full marginal rate* is the rate of tax A Co would be expected to pay on ordinary income derived under a financial instrument. A mismatch will not arise, for the purposes of the hybrid financial instrument rule, simply because Country A taxes income from financial instruments at a lower rate than other types of income.

11. If, therefore, the reduced rate of taxation applicable to the payment under the subordinated loan applies to all payments of ordinary income under a financial instrument, then no mismatch arises for the purposes of the hybrid financial instrument rule and no adjustment is required to be made to the tax treatment of the payment under Country A or B laws.

12. If, however, the reduced rate of 4% applies only to dividends then, assuming Country A has not applied Recommendation 2.1 to prevent A Co claiming the benefit of the reduced rate, the payment will give rise to a mismatch in tax outcomes that is attributable to the terms of the instrument.

Primary recommendation – deny the deduction in the payer jurisdiction

13. The primary recommendation under the hybrid financial instrument rule is that Country B deny the deduction to the extent it gives rise to a D/NI outcome. This can be achieved by denying a deduction for a portion of the interest payment up to the amount that is effectively exempt from taxation in the payee jurisdiction. Because of the reduced rate in Country A, only 10% of the payment made to A Co is effectively taxed at the full rate and B Co's deduction should be restricted to a corresponding amount. A table showing the amount of the required adjustment is set out below.

A Co	Tax 4%	Tax 40%	Book	B Co	Tax	Book
Income				Income		
Dividend received	40		40	Other income	100	100
Expenditure				Expenditure		
				Interest paid	(4)	(40)
Net return			**40**	**Net return**		**60**
Income taxable at full rate		**4**		**Taxable income**	**96**	
Tax to pay			(1.6)	Tax to pay		(19.2)
After-tax return			**38.4**	**After-tax return**		**40.8**

14. Country B should deny a deduction for 90% of the payment made under the instrument because the reduced rate of tax is only sufficient to cover 10% of the payment at normal corporate rates. This adjustment has the net effect of bringing a sufficient amount of income into tax, under the laws of the payer and payee jurisdictions, to ensure that all the income under the arrangement is subject to tax at the taxpayer's full marginal rate.

Defensive rule – require income to be included in the payee jurisdiction

15. If Country B does not apply the recommended response, then A Co should be required to treat the entire amount of the deductible payment as ordinary income under Country A law. A table setting out the amount of the required adjustment is set out below.

A Co	4% Tax	40% Tax	Book	B Co	Tax	Book
Income				Income		
Dividend received		40	40	Other income	100	100
Expenditure				Expenditure		
				Interest paid	(40)	(40)
Net return			**40**	**Net return**		**60**
Income subject to tax at effective rate of 40%		**40**		**Taxable income**	**60**	
Tax to pay			(16)	Tax to pay		(12)
After-tax return			**24**	**After-tax return**		**48**

16. Under Country A law the entire amount of the payment is treated as ordinary income and subject to tax at the taxpayer's full marginal rate (40%). The adjustment has the net effect of bringing a sufficient amount of income into tax, under the laws of the payer and payee jurisdictions, to ensure that all the income under the arrangement is subject to tax at the taxpayer's full marginal rate in each jurisdiction.

17. The differences between the total aggregate tax liability under the primary and secondary rule are explained by reference to different amounts of income brought into account in each jurisdiction under the rule and differences in tax rate between the payer and payee jurisdictions.

Example 1.4

Interest payment eligible for an underlying foreign tax credit

Facts

1. The facts of this example are the same as **Example 1.1** except that the tax relief granted by Country A is in the form of a tax credit for underlying foreign taxes paid by its subsidiary. The credit is granted in proportion to the amount of pre-tax retained earnings that are distributed to the shareholder by way of dividend. A table summarising the treatment of a payment under the laws of Country A and Country B is set out below. In this table it is assumed that B Co derives income of 100 for the period. B Co makes a payment of 40 to A Co under the subordinated loan. A Co has no other income for the period. The corporate tax rate in Country B is 20% and in Country A is 35%.

A Co			B Co		
	Tax	**Book**		**Tax**	**Book**
Income			Income		
Dividend received	40	40	Other income	100	100
Expenditure			Expenditure		
			Interest paid	(40)	(40)
Net return		**40**	**Net return**		**60**
Taxable income	**40**		**Taxable income**	**60**	
Tax (35%)	(14)				
Tax credit	4.8				
Tax to pay		(9.2)	Tax to pay (at 20%)		(12)
After-tax return		**30.8**	**After-tax return**		**48**

2. Under Country B law, the payment to A Co is treated as deductible interest which means that B Co's taxable income is equal to its net return. Under Country A law, however, the payment is treated as a dividend and A Co is entitled to a foreign tax credit for the underlying foreign tax paid on the dividend. The formula for determining the amount of the credit granted under Country A law for underlying foreign taxes can be expressed as follows:

$$\text{Total amount of tax paid by B Co} \times \frac{\text{Total amount of dividend from B Co}}{\text{B Co's retained earnings + taxes paid + B Co distributions}}$$

Assuming the B Co has no historical earnings and has not previously made any distributions, the simplified formula set out above produces an underlying foreign tax credit that is equal to 4.8 (= 12 x 40/100) leaving A Co with a total Country A tax to pay of 9.2.

3. Note that this formula for calculating foreign taxes has been simplified for the purpose of demonstrating the effect of the hybrid financial instrument rule in the context of a dividend that qualifies for a credit for underlying foreign taxes. In practice, the amount of underlying foreign tax paid on distributions of retained earnings can be more accurately calculated by determining the historical amount of tax paid on the subsidiary's *after-tax* retained earnings. The jurisdiction granting the credit will treat the dividend as grossed-up by the amount of the foreign tax credit attached to the dividend and may operate a tax credit pooling system that tracks the retained earnings of each subsidiary and the amount of tax that has been borne by those earnings and treats the foreign tax credits attached to previous dividends as reducing the available pool of foreign tax credits.

4. The net effect of the difference in the characterisation of the payment made under the instrument can be illustrated by comparing it to the tax treatment of an ordinary interest or dividend payment under the laws of Country A and B. This comparison shows the net tax benefit to the parties of making a payment under the subordinated loan is 4.8.

		Loan	Share	Hybrid
B Co	Income	100	100	100
	Expenditure	(40)	(40)	(40)
	Tax (at 20%)	(12)	(20)	(12)
	After-tax return	**48**	**40**	**48**
A Co	Income	40	40	40
	Expenditure			
	Tax (at 35%)	(14)	(6)	(9.2)
	After-tax return	**26**	**34**	**30.8**
Combined after-tax return		**74**	**74**	**78.8**

5. In theory, because a credit for underlying foreign taxes only imposes incremental tax on distributed profit, the aggregate tax burden borne by a dividend and an interest payment is the same regardless of the difference in tax rates between the payer and payee jurisdictions. Hence, in this simplified example, the total retained earnings of A Co and B Co are unaffected by whether the payment is characterised as a dividend or as interest. In practice, however, differences in the way the payer and payee jurisdictions calculate income for tax and foreign tax credit purposes and restrictions on the utilisation of tax credits in the payee jurisdiction will impact on the amount of tax paid on the dividend in the payee jurisdiction (and therefore on the equality of tax treatment between dividends

and interest) in much the same way as they will under a partial exemption or reduced rate system.

Question

6. Whether the tax treatment of the payments under the subordinated loan falls within the scope of the hybrid financial instrument rule and, if so, what adjustments are required under the rule?

Answer

7. If Country A applies Recommendation 2.1 to deny A Co the benefit of tax credit for a deductible dividend then no mismatch will arise for the purposes of the hybrid financial instrument rule.

8. If Country A does not apply Recommendation 2.1 then the payment under the subordinated loan will give rise to a mismatch in tax outcomes to the extent that the credit shelters the dividend from tax under the laws of Country A.

9. Country B should deny B Co a deduction for a portion of the interest payable under the subordinated loan. The amount that remains eligible to be deducted following the adjustment should equal the amount of income that will be effectively subject to tax at the full marginal rate in the payee jurisdiction after application of the tax credit.

10. If Country B does not apply the recommended response, then A Co should treat the entire payment as ordinary income under the secondary rule and deny A Co the benefit of any tax credit.

Analysis

Recommendation 2.1 will apply to deny A Co the benefit of the tax credit

11. Credits, such as those granted by Country A, which are designed to relieve the payee from economic double taxation of dividend income, fall within Recommendation 2.1. That Recommendation states that jurisdictions should consider denying the benefit of such double taxation relief in the case of payments that are deductible by the payer. Accordingly, no part of the interest payment should be treated as eligible for a credit for underlying taxes in the payee jurisdiction where that payment is deductible under the laws of the payer jurisdiction. If Country A maintains a pooling system for foreign tax credits then any credits that are denied under the application of the defensive rule should be left in the pool.

12. The determination of whether a payment gives rise to a D/NI outcome requires a proper consideration of the character of the payment and its tax treatment in both jurisdictions. This will include the effect of any rules in Country A, consistent with Recommendation 2.1, that exclude deductible dividends from the benefit of any double tax relief. Therefore, if Country A withdraws the benefit of the underlying foreign tax credit for the dividends paid by B Co, on the grounds that such dividend payments are deductible under Country B law, then no mismatch will arise for the purposes of the hybrid financial instrument rule.

A payment made under the financial instrument will give rise to a hybrid mismatch

13. On the assumption that Country A has not implemented the restrictions on double-tax relief that are called for under Recommendation 2.1, the payments of interest under the subordinated loan will give rise to a D/NI outcome as the payments are deductible under the laws of Country B and not included in ordinary income in the payee jurisdiction (because such payments benefit from a credit under Country A law). This mismatch will be a hybrid mismatch because the tax treatment in Country A that gives rise to the D/NI outcome is attributable to a difference in the characterisation of the loan under Country A and B laws.

Primary recommendation – deny the deduction in the payer jurisdiction

14. The primary recommendation under the hybrid financial instrument rule is that Country B deny the deduction for a payment to the extent it gives rise to a D/NI outcome. The effect of the adjustment should be to align the tax treatment of the payments made under the instrument so that amounts that are treated as a financing expense in the payer jurisdiction do not exceed the amounts that are taxed as ordinary income in the payee jurisdiction. The adjustment should result in an outcome that is proportionate and minimises the risk of double taxation.

15. This can be achieved by denying a deduction for the interest payment to the extent it is fully sheltered from tax under the laws of Country A. Of the payment made to A Co, 65.7% (i.e. 9.2/14) is taxed at the full rate of tax applicable to ordinary income in Country A and Country B should allow for a similar portion of the interest payment to be deducted. A table setting out the effect of this adjustment is set out below.

A Co			**B Co**		
	Tax	**Book**		**Tax**	**Book**
Income			Income		
Dividend received	40	40	Other income	100	100
Expenditure			Expenditure		
			Interest paid	(26.29)	(40)
Net return		**40**	**Net return**		**60**
Taxable income	**40**		**Taxable income**	**73.71**	
Tax (35%)	(14)				
Tax credit	4.8				
Tax to pay		(9.2)	Tax to pay (at 20%)		(14.74)
After-tax return		**30.8**	**After-tax return**		**45.26**

16. Under Country B law the deduction is denied to the extent the payment is not subject to tax at the payee's full marginal rate in the payee jurisdiction. A Co's tax liability on the payment is 9.20 which at the 35% tax rate indicates that 26.29 (i.e. 9.2/0.35) of the payment was taxable as ordinary income in Country A.

17. The adjustment has the net effect of bringing a sufficient amount of income into tax, under the laws of the payer and payee jurisdictions, to ensure that all the income under the arrangement is subject to tax at the taxpayer's full marginal rate. While the adjustment results in a lower overall effective tax rate for the arrangement than would have occurred under a normal dividend this is explained by reference to the different amounts of income brought into account, and differences in tax rate between, the payer and payee jurisdictions.

18. In this simplified example it is assumed that the effect of the increase in taxation in Country B, resulting from the application of the hybrid financial instrument rule, is not taken into account for the purposes of calculating the amount of the tax credit in Country A. This may be because Country A expressly prohibits the crediting of increased foreign taxes that arise due to the application of the hybrid financial instrument rule or because, in practice, the incremental tax increase does not have a material impact on the amount of the payment brought into taxation as ordinary income in Country A.

Defensive rule – require income to be included in the payee jurisdiction

19. If Country B does not apply the recommended response, then Country A should treat the entire amount of the deductible payment as ordinary income and deny A Co the benefit of the foreign tax credit. A table setting out the amount of the required adjustment is set out below.

A Co			B Co		
	Tax	**Book**		**Tax**	**Book**
Income			Income		
Dividend received	40	40	Other income	100	100
Expenditure			Expenditure		
			Interest paid	(40)	(40)
Net return		**40**	**Net return**		**60**
Taxable income	**40**		**Taxable income**	**60**	
Tax (35%)	(14)				
Tax credit	-				
Tax to pay		(14)	Tax to pay (at 20%)		(12)
After-tax return		**26**	**After-tax return**		**48**

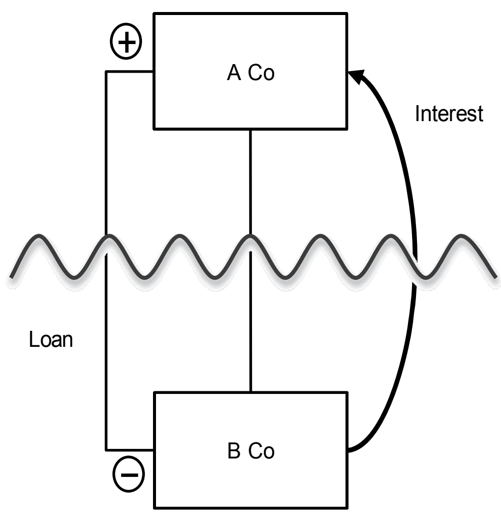
20. Under Country A law the entire amount of the payment is treated as ordinary income and subject to tax at the taxpayer's full marginal rate without a credit for underlying taxes. The adjustment has the net effect of bringing a sufficient amount of income into tax, under the laws of the payer and payee jurisdictions, to ensure that all the income under the arrangement is subject to tax at the taxpayer's full marginal rate. As for the adjustment under Recommendation 2.1, Country A should treat any credits that are denied under the application of the defensive rule as left in the pool and available for distribution at a future date.

Example 1.5

Interest payment to an exempt person

Facts

1. In this example the facts are the same as in **Example 1.1** except that both jurisdictions treat the subordinated loan as a debt instrument. A Co is a sovereign wealth fund established under Country A law that is exempt from tax on all income. A Co is therefore not taxable on the interest payment.



Question

2. Whether the tax treatment of the payments under the subordinated loan falls within the scope of the hybrid financial instrument rule and, if so, what adjustments are required under the rule?

Answer

3. The payment of interest under the loan gives rise to a mismatch in tax outcomes as it is deductible under Country B law but is not included in ordinary income under Country A law. This D/NI outcome will not, however, be treated as a *hybrid mismatch* unless it can be attributed to the terms of the instrument.

4. If the mismatch in tax outcomes would not have arisen had the interest been paid to a taxpayer of ordinary status, then the mismatch will be solely attributable to A Co's status as a tax exempt entity, and cannot be attributable to the terms of the instrument

itself. In such a case the mismatch in tax outcomes will not be caught by the hybrid financial instrument rule. If the terms of the instrument would have been sufficient, on their own, to bring about a mismatch in tax outcomes (i.e. the payment would not have been included in interest even if it had been made to an ordinary taxpayer) then the mismatch will be treated as a hybrid mismatch and subject to adjustment under the hybrid financial instrument rule.

5. While the application of the hybrid financial instrument rule could result in the denial of a deduction under Country B law, the application of the secondary rule in Country A will not result in any additional tax liability for A Co because A Co is not taxable on ordinary income.

Analysis

A payment made under the financial instrument may give rise to a hybrid mismatch

6. The mismatch in tax outcomes under the instrument will be treated as a *hybrid* mismatch when the outcome is attributable to the tax treatment of the instrument, rather than the tax treatment of the entity receiving the payment or the circumstances under which it is held. On the facts of this example the exemption is most likely to be attributable to A Co's special status as a tax exempt entity, however, if the terms of the instrument would have been sufficient, on their own, to bring about a D/NI outcome, then the mismatch should be treated as a "hybrid mismatch" for the purposes of these rules.

7. The guidance to Recommendation 1 notes that one way of testing for whether a mismatch is attributable to the terms of the instrument is to ask whether the same mismatch would have arisen between taxpayers of ordinary status. The test looks to what the tax treatment of the instrument would have been if both the payer and payee were ordinary resident taxpayers that computed their income and expenditure in accordance with the rules applicable to all taxpayers of the same type. If the payment of interest would not have been expected to be treated as ordinary income under this counterfactual then the mismatch should be treated as attributable to the terms of the instrument and potentially subject to adjustment under the hybrid financial instrument rule.

Primary recommendation – deny the deduction in the payer jurisdiction

8. In the event the mismatch is determined to be a hybrid mismatch, Country B should apply its hybrid mismatch rule to deny B Co a deduction for the payment made under the hybrid financial instrument to the extent of that mismatch. This deduction would be denied notwithstanding that the D/NI outcome would have arisen if the instrument had not been a hybrid financial instrument.

Defensive rule – require income to be included in the payee jurisdiction

9. While Country A should also treat the loan as a hybrid financial instrument the application of the defensive rule will not have any tax impact on A Co. Although, in theory A Co would be required to treat the interest payments as "ordinary income", this will not result in any additional tax liability for A Co because A Co is exempt from tax on all income.

Example 1.6

Interest payment to a person established in a no-tax jurisdiction

Facts

1. The facts of this example are the same as in **Example 1.1** except that Country A (the laws under which A Co is established) does not have a corporate tax system and A Co does not have a taxable presence in any other jurisdiction. A Co is therefore not liable to tax in any jurisdiction on payments of interest under the loan.

Question

2. Whether the interest payments under the loan fall within the scope of the hybrid financial instrument rule?

Answer

3. The interest payment does not give rise to a mismatch within the language or intended scope of the hybrid financial instrument rule.

Analysis

4. Recommendation 1 only applies to payments that give rise to a D/NI outcome. While the interest payment is deductible under the laws of Country B, a mismatch will only arise in respect of that payment if it is not included in income by a payee in a payee jurisdiction. In this case, however, the recipient of the interest payment is not a taxpayer in any jurisdiction and, accordingly, there is no payee jurisdiction where the payment can be included in income. The payment of interest under the loan therefore does not fall within the language or intended scope of the hybrid financial instrument rule.

Example 1.7

Interest payment to a taxpayer resident in a territorial tax regime

Facts

1. The facts of this example are the same as in **Example 1.1** except that Country A administers a pure territorial tax system and does not tax income unless it has a domestic source. Interest income paid by a non-resident is treated as foreign source income and is exempt from taxation unless the payment can be attributed to a PE maintained by B Co in Country A. As B Co has no PE in Country A, the interest is not subject to tax in the hands of A Co.

Question

2. Whether the interest payments under the loan fall within the scope of the hybrid financial instrument rule?

Answer

3. The mismatch is not attributable to the terms of the instrument but to the fact that A Co is exempt from tax on foreign source income of any description. The mismatch is thus not caught by the hybrid financial instrument rule.

Analysis

A payment made under the financial instrument gives rise to a mismatch

4. The payment of interest is deductible under the laws of the payer jurisdiction (Country B) but not included in income under the laws of the payee jurisdiction (Country A). Note that this outcome is to be contrasted with that under **Example 1.6** where the payment is made to an entity established in a no-tax jurisdiction. In that case the payment does not give rise to a mismatch in tax outcomes as the payment is not treated as received under the laws of any "payee jurisdiction". In this case Country A does maintain a corporate tax system and A Co is a taxpayer in that jurisdiction. There is therefore both payer and a payee jurisdictions that can be tested for the purposes of determining whether a D/NI outcome has arisen.

Mismatch is not a hybrid mismatch

5. Although the payment gives rise to a D/NI outcome the resulting mismatch is not a hybrid mismatch because it is not attributable to the terms of the instrument but to the fact that A Co is exempt on foreign source income of any description. There is no change that could be made to the terms of the instrument that would result in payments under the

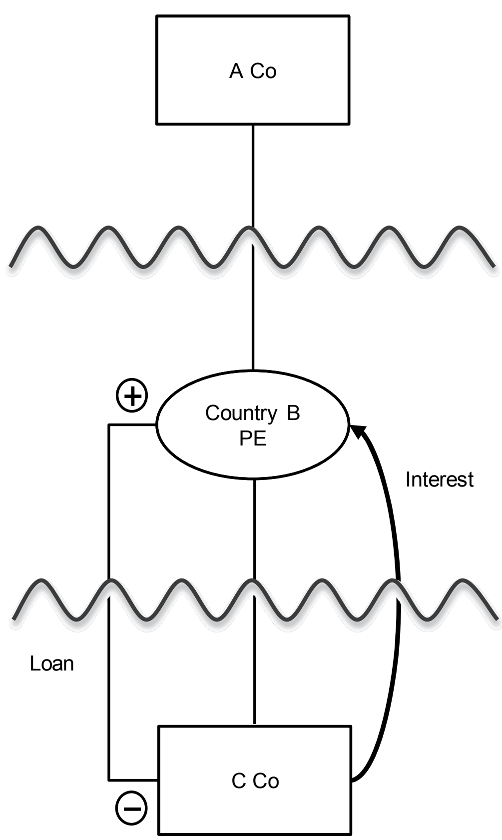
instrument becoming taxable. Note that this outcome is to be contrasted with **Example 1.1** where the payee jurisdiction exempts only dividend payments. In that case, it is both the source of the payment and the terms of the instrument that give rise to the dividend treatment (and hence the exemption) in the payee jurisdiction.

Example 1.8

Interest payment to a tax exempt PE

Facts

1. In the example illustrated below, A Co, a company resident in Country A lends money to C Co (a wholly-owned subsidiary) through a PE in Country B. Country A, B and C all treat the loan as a debt instrument for tax purposes. Payments of interest under the loan are deductible under Country C law but not included in income under Country A law. Country A provides an exemption for income derived through a foreign PE.



Question

2. In what circumstances will the payment of interest under the loan be treated as giving rise to a hybrid mismatch subject to adjustment under the hybrid financial instrument rule?

Answer

3. The payment of interest under the loan will only give rise to a D/NI outcome if the payment is not treated as ordinary income under both Country A and Country B laws. If a payment of deductible interest is not expected to be included in ordinary income under the laws of one of the payee jurisdictions (either Country A or B) then a tax administration may treat the payment as giving rise to a D/NI outcome unless the taxpayer can satisfy the tax authority that the payment has been included in ordinary income in the other jurisdiction.

4. A deductible payment that gives rise to a mismatch in tax outcomes will be treated as within the scope of the hybrid financial instrument rule if the mismatch can be attributed to the tax treatment of the instrument under the laws of either Country A or Country B. If, for example, the mismatch could be attributed to the fact that either jurisdiction treats the interest on the loan as an exempt dividend then the hybrid financial instrument rule would apply to the instrument. The arrangement should not be treated as falling within the scope of the hybrid financial instrument rule, however, if the mismatch would not have arisen in respect of a loan that had been entered into directly by a payee resident in either Country A or B.

5. If the interest payment falls within the scope of the hybrid financial instrument rule then the recommended response is to deny the deduction for that payment under Country C law. The application of the secondary rule in Country A will not, however, result in any additional tax liability if A Co is not taxable on ordinary income derived through a foreign PE.

Analysis

No mismatch arises if the interest payment is included in ordinary income under either Country A or Country B law

6. A D/NI outcome will only arise where a payment that is deductible under the laws of one jurisdiction (the payer jurisdiction) is not included in ordinary income under the laws of any other jurisdiction where the payment is treated as being received (the payee jurisdiction). In order for a jurisdiction to link the tax treatment of a payment in one jurisdiction with the tax consequences in another it is therefore necessary to identify the taxpayers and jurisdictions where the payment is made and received. In most cases the payee will be the legal entity with the right to receive the payment (in this case, A Co) and the payee jurisdiction will be the jurisdiction where that entity is resident (in this case, Country A). However where the payment is received through a tax transparent structure such as a PE, it will be necessary to look to the laws of the PE jurisdiction (in this case, Country B) to definitively establish whether a mismatch has arisen.

7. The facts of the example do not state whether the interest payment is treated as included in ordinary income under Country B law. Assuming, however, the tax treatment of the payment in Country B cannot be established, the deductible interest payments on the loan should be treated as giving rise to a D/NI outcome to the extent such payments are not included in ordinary income under the laws of Country A. It will be the taxpayer who has the burden of establishing, to the reasonable satisfaction of the tax administration, how the tax treatment in Country B impacts on the amount of the adjustment required under the rule. If the taxpayer can establish, to the satisfaction of its own tax administration, that the full amount of the interest payment is expected to be

included in ordinary income under the laws of another jurisdiction then the taxpayer should not be required to make an adjustment under the hybrid financial instrument rule.

Mismatch may be a hybrid mismatch

8. The mismatch will be treated as a hybrid mismatch to the extent it can be attributed to differences in the tax treatment of the instrument under the laws of the payer and payee jurisdictions. The test for hybridity, in the financial instrument context, looks to whether the terms of the instrument were sufficient to bring about the mismatch under the laws of the relevant jurisdictions. Thus, if the mismatch arose because either Country A or B treated the interest on the loan as an exempt dividend, then the hybrid financial instrument rule would apply.

9. A mismatch in outcomes will not be treated as a hybrid mismatch, however, if it is solely attributable to the circumstances in which the instrument is held. If, for example, the interest payment is exempt in Country A only because A Co has made the loan through the foreign PE then the resulting mismatch in tax outcomes will not be treated a hybrid mismatch for the purposes of the rule.

10. One way of testing whether the mismatch is attributable to the terms of the instrument, rather than the status of the taxpayer or the context in which the instrument is held, is to ask whether the mismatch would have arisen had the instrument been held directly by an ordinary taxpayer that computed its income and expenditure under the ordinary rules applicable to taxpayers of the same type. If a mismatch would still have arisen in these circumstances then the mismatch should be treated as a hybrid mismatch within the scope of the rule.

Application of the hybrid financial instrument rule under Country C law

11. If Country C determines that the loan is caught by the rule, then Country C should apply the primary recommendation and deny C Co a deduction for the interest to the extent of that mismatch.

12. C Co may be able to establish, however, that, notwithstanding the hybrid mismatch between Country A and C, the payment has, in fact, been included in income under the laws of a third jurisdiction (Country B). If the taxpayer can reasonably satisfy the tax administration that the interest payments are in fact included in income under Country B law, then, in fact, no D/NI outcome arises and the hybrid financial instrument rule should not apply.

Application of the hybrid financial instrument rule under Country B law

13. If Country C does not apply the recommended response, Country B may treat the interest payment as ordinary income under the secondary rule.

Application of the hybrid financial instrument rule under Country A law

14. In no event will the hybrid financial instrument rule in Country A result in any additional tax liability for A Co. This is either because:

(a) the mismatch will not be attributable the terms of the instrument but to the special tax treatment granted under Country A law for income derived through a foreign PE (in which case the instrument is not a hybrid financial instrument under Country A law); or

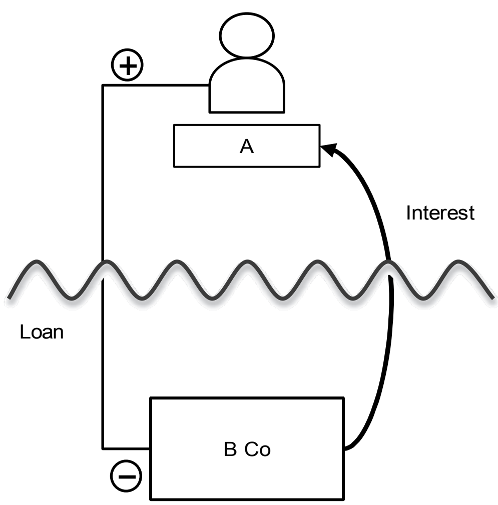
(b) the instrument will be treated as a hybrid financial instrument but the response under the hybrid financial instrument rule (treating the payment as ordinary income) will not result in any increase in tax liability for A Co as all ordinary income derived through a foreign PE is exempt from income under Country A law.

Example 1.9

Interest payment to a person holding instrument through tax-exempt account

Facts

1. In the example illustrated in the figure below, A is an individual resident in Country A and B Co is a company resident in Country B. Individual A subscribes for a bond issued by B Co that pays regular interest.



2. The bond is treated as a debt instrument under the laws of both Country A and B. B Co is entitled to a deduction for the interest payments and these payments would usually be treated as ordinary income in Country A. In this case, however, the bond is held by A through a tax exempt personal savings account that entitles A to an exemption on any income and gains in respect of assets held in the account. The saving account is available only to individuals and there are limits on the amount and type of assets that can be put into the account.

Question

3. Whether the arrangement falls within the scope of the hybrid financial instrument rule?

Answer

4. The instrument does not fall within the scope of the hybrid financial instrument rule because the mismatch is attributable to the circumstances in which the bond is held and cannot be attributed to the terms of the instrument.

Analysis

There is no payment made under the financial instrument that gives rise to a hybrid mismatch

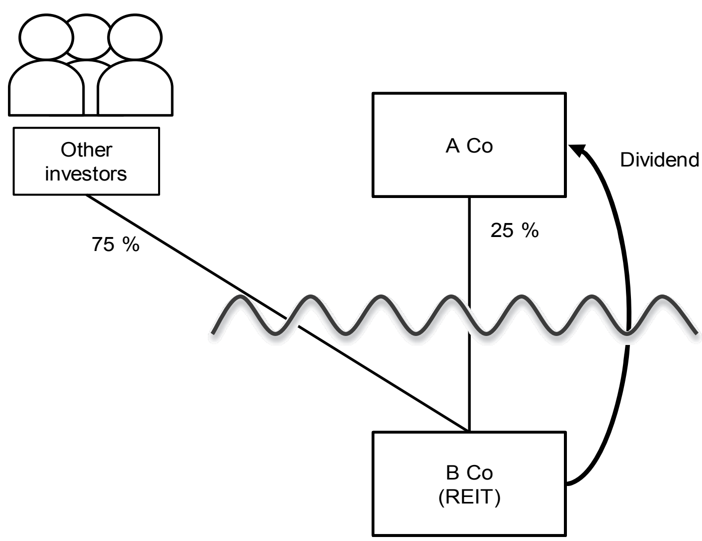
5. The hybrid financial instrument rule only applies where the mismatch can be attributed to terms of the instrument. In this example B Co's interest payments result in D/NI outcome, however this mismatch is caused by the fact that A holds the instrument through a savings account that, under Country A law, entitles A to an exemption in respect of the interest payment on the bond. The mismatch would not have arisen if the bond was held directly by A, rather than through the savings account. Because the mismatch is attributable to the context in which the instrument is held rather than the nature of the instrument itself, it falls outside the intended scope of the hybrid financial instrument rule.

Example 1.10

Deductible dividends paid by a special purpose entity

Facts

1. In the example illustrated in the figure below, A Co (a company resident in Country A) owns 25% of the shares in B Co. B Co is a Real Estate Investment Trust (REIT) that earns most of its income from real estate investments. B Co pays a dividend to A Co. The dividend is not required to be included in ordinary income under Country A law.



2. Under the laws of Country B, a REIT is granted a special tax status, which is only available to entities that invest in certain classes of assets and that derive certain kinds of income. Entities that meet the criteria to become a REIT and have elected to take advantage of this special tax status are entitled to a deduction for the dividends they pay their investors. This dividend deduction is intended to ensure that there is only one level of taxation (at the shareholder level) in respect of the investments made by the REIT.

3. The REIT will generally be required to meet certain distribution requirements (intended to ensure that all the income of the REIT is distributed to investors within a reasonable period of time) and there may also be restrictions on the type of persons that can invest in the REIT and the amount of shares of the REIT that the investor can hold.

Question

4. Whether the dividend payment falls within the scope of the hybrid financial instrument rule?

Answer

5. The deductibility of the dividend turns on B Co's special tax status as REIT not on the terms of the instrument. Therefore the dividend does not fall within the scope of the hybrid financial instrument rule.

Analysis

Recommendation 2.1 will apply to the dividend

6. Recommendation 2.1 states that a dividend exemption, which is granted by the payee jurisdiction to relieve double taxation, should not apply to payments that are deductible by the payer. As, in this case, the entire interest payment is deductible by B Co, no part of the interest payment should be treated as eligible for exemption under Country A law. Recommendation 2.1 should apply notwithstanding the payment will not be treated as subject to adjustment under the hybrid financial instrument rule (see below).

Deductible dividend does not give rise to a hybrid mismatch as deduction attributable to special status of REIT

7. The payment of a deductible dividend will not give rise to a hybrid mismatch under Recommendation 1 provided the deduction is attributable to the tax status of the REIT rather than the ordinary tax treatment of dividends under the laws of that jurisdiction.

8. The guidance to Recommendation 1 notes that one way of testing for whether a mismatch is attributable to the terms of the instrument is to ask whether the same mismatch would have arisen between taxpayers of ordinary status. If dividend payments are not ordinarily deductible under Country B law, then the mismatch that arises in this case should be treated as attributable to the particular status of the payer rather than the tax treatment of the instrument.

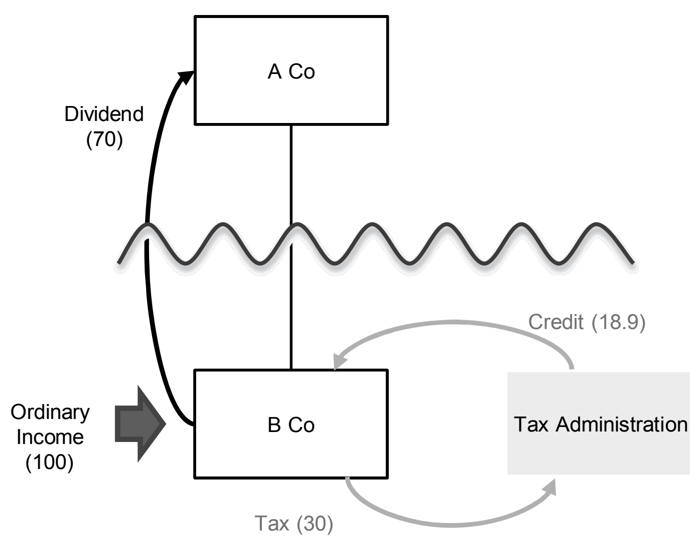
Example 1.11

Tax relief equivalent to a deduction

Facts

1. In this example A Co, a company resident in Country A owns all the shares of B Co a company resident in Country B. B Co derives operating income which is subject to corporation tax under the laws of Country B. B Co pays a dividend to A Co. A Co is not subject to tax on the dividend under the laws of Country B (as A Co is not a Country B taxpayer) and Country A provides for an exemption for dividends paid by a foreign company. A Co is therefore not subject to tax on the dividend under either Country A or Country B law.

2. Under Country B law, the payment of a dividend triggers a tax credit equal to 90% of the corporate tax paid on the distributed income. This refund may be in the form of a credit against B Co's tax liability or may be paid as an additional amount directly to the shareholder. The figure below illustrates the tax consequences where Country B provides B Co with a tax credit for dividends paid.

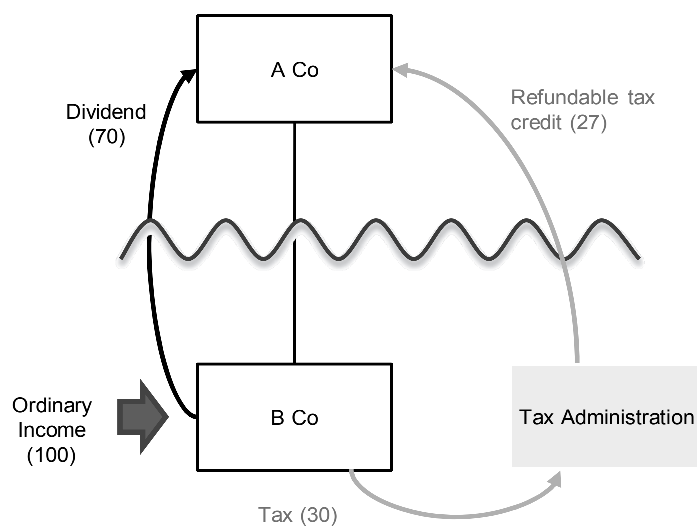


3. As illustrated in the figure above, B Co derives 100 of operating income which is subject to tax at a 30% corporate rate and that the remaining income is distributed as a dividend. Payment of the dividend, however, allows B Co to claim a tax credit equal to 90% of the corporate tax rate on the dividend. The table below sets out the net tax consequences for both A Co and B Co where Country B law provides for a tax credit in respect of dividends paid.

A Co			B Co		
	Tax	**Book**		**Tax**	**Book**
Income			Income		
			Ordinary income	100	100
Dividend received		70			
Expenditure			Expenditure		
			Dividend paid		(70)
Net return		**70**	**Net return**		**30**
Taxable income	**0**		**Taxable income**	**100**	
Tax on net income		0	Tax on net income (30%)	(30)	
			Credit	18.9	
			Tax to pay		(11.1)
After-tax return		**70**	**After-tax return**		**18.9**

4. As can be seen from the above table the net effect of the tax credit granted under Country B law is that B Co pays 30% tax on the undistributed income (0.3 x 30 = 9) and 3% tax on the amount that has been distributed (0.03 x 70 = 2.1).

5. The figure and table below illustrate the tax consequences that apply where Country B provides A Co with a refundable credit in respect of the dividend paid by B Co.



6. As in the fact pattern illustrated in the first page of this example, B Co derives 100 of operating income which is subject to tax at a 30% corporate rate with the remainder of the income distributed to A Co as a dividend. In this case, however, Country B provides A Co with a refundable tax credit in respect of the dividend paid. As A Co is not subject to tax on the dividend under the laws of Country B, it is entitled to claim a full refund for the unutilised credit. The formula for calculating the amount of the refundable credit that can be attached to the dividend is as follows:

$$0.9 \text{ x tax rate in Country B} \quad \text{x} \quad (\text{amount of distribution x } \frac{1}{1 - \text{tax rate in Country B}})$$

7. Applying this formula to the distribution, A Co is entitled to a credit equal to (0.27 x (70 x 1/0.7) = 27. The table below illustrates the net tax consequences for both A Co and B Co where Country B law provides shareholders with a refund of 90% of the corporate tax paid on a dividend distribution.

A Co			**B Co**		
	Tax	**Book**		**Tax**	**Book**
Income			Income		
Dividend received	-	70	Ordinary income	100	100
Refundable Tax Credit	-	27			
			Expenditure		
			Dividend paid		(70)
Net return		**97**	**Net return**		**30**
Taxable income	**0**		**Taxable income**	**100**	
Tax on net income		0	Tax on net income		(30)
After-tax return		**97**	**After-tax return**		**0**

8. This refundable credit mechanism ensures that the net amount of Country B tax paid on B Co's distributed income is 3% (i.e. 10% of the normal corporate rate). Because the dividend is not subject to tax in Country A the net effect of this credit is that only 3% of the income under the arrangement is subject to tax under either Country A or B law.

Question

9. Whether the dividend falls within the scope of the hybrid financial instrument rule and, if so, to what extent an adjustment is required to be made in accordance with the rule.

Answer

10. In either case, the dividend gives rise to tax relief that is equivalent to a deduction under Country B law and the dividend payment should, therefore, be treated as falling within the scope of the hybrid financial instrument rule.

11. When making an adjustment under Country A law, A Co should take into account the fact that only 10% of the amount distributed has been subject to tax as ordinary income due to the tax relief granted under Country B law.

Analysis

Tax credit or refund treated as equivalent tax relief under Country B law

12. A payment will be treated as deductible under the laws of the payer jurisdiction if it is applied, or can be applied, to reduce a taxpayer's net income. While B Co's dividend payment cannot be deducted directly from B Co's income, the concept of "deductible", for the purposes of the hybrid mismatch rules, also extends to payments that trigger other types of "equivalent tax relief". The tax credit or refund granted to B Co or its shareholder is equivalent to granting B Co a deduction for a dividend payment because it has the same net effect of reducing the overall amount of tax payable on B Co's net operating income.

13. The laws of some countries permit domestic companies to attach imputation or franking credits to dividends that have been paid out of tax-paid income. Taxpayers in the same jurisdiction can then apply this credit against the resulting tax liability on the dividend in order to protect themselves from economic double taxation. In such a case, however, the recognition of the credit is premised on the dividend being treated as taxable income in that jurisdiction. In this example the dividend is not subject to tax under the laws of Country B, so that allowing B Co or its shareholder to take the benefit of the credit in these circumstances has the effect, not of avoiding double taxation, but of cancelling the corporation tax previously paid on the underlying income.

Mismatch in tax outcomes arises under a financial instrument

14. The dividend gives rise to a D/NI outcome that is attributable to the terms of the instrument. In contrast to **Example 1.10**, where the difference in tax treatment is a result of the special tax status of the payer, the refund or credit is part of the ordinary rules governing the tax treatment of dividends in Country B and, accordingly, the mismatch is one that would arise between taxpayers of ordinary status.

Adjustment required

15. When determining the amount of adjustment required under the hybrid financial instrument rule under Country A law, Country A should take into account all amounts received (including the amount of any refunds paid directly to A Co) and should adjust the amount of income eligible to benefit from the dividend exemption consistently with the principles set out in **Example 1.2** to **1.4** so that the amount of the payment that remains eligible for tax relief in Country A should equal the amount of income that is effectively subject to tax at the full marginal rate in Country B.

16. In this case 10% of the payment remains subject to tax at the full corporate rate under Country B law and therefore 90% of the payment should be treated as ordinary income under Country A law. The table below sets out the adjustment required where Country B law provides B Co with a tax credit for dividends paid.

17. For the purposes of this calculation it is assumed that the corporate tax rate in Country A is 30%. A Co is required to treat 90% of the dividend paid as taxable income which results in a 18.9 tax liability.

A Co			B Co		
	Tax	**Book**		**Tax**	**Book**
Income			Income		
			Ordinary income	100	100
Dividend received	63	70			
Expenditure			Expenditure		
			Dividend paid		(70)
Net return		**70**	**Net return**		**30**
Taxable income	**63**		**Taxable income**	**100**	
Tax on net income	(18.9)		Tax on net income	(30)	
			Tax credit	18.9	
Tax to pay		(18.9)	Tax to pay		(11.1)
After-tax return		**51.1**	**After-tax return**		**18.9**

18. The table below sets out the adjustment for A Co where Country B law permits B Co to attach a refundable tax credit to the dividend paid to A Co.

A Co			B Co		
	Tax	**Book**		**Tax**	**Book**
Income			Income		
Dividend received	90	70	Ordinary income	100	100
Refundable Tax Credit	-	27			
Expenditure			Expenditure		
			Dividend paid		(70)
Net return		**97**	**Net return**		**30**
Taxable income	**90**		**Taxable income**	**100**	
Tax to pay		(27)	Tax to pay		(30)
After-tax return		**70**	**After-tax return**		**0**

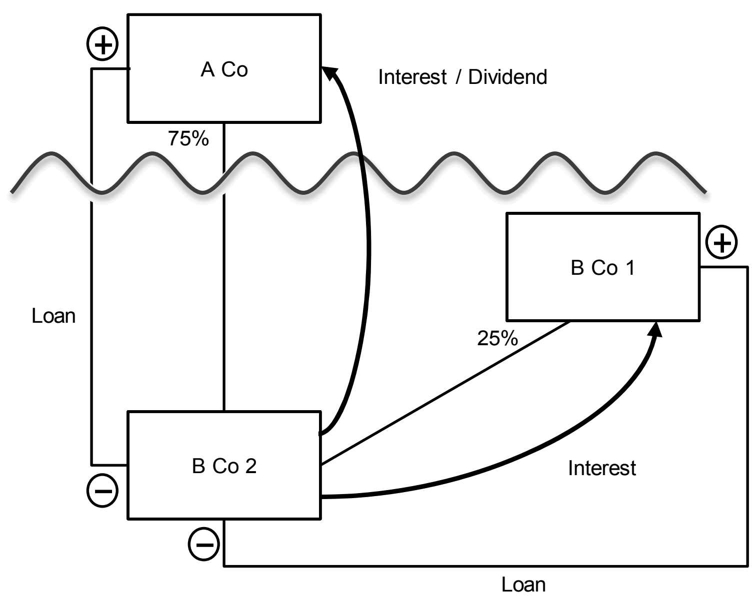
Example 1.12

Debt issued in proportion to shares re-characterised as equity

Facts

1. In the example illustrated in the figure below, B Co 2 is a company resident in Country B whose shares are held by B Co 1 (another entity resident in Country B) and A Co (an entity resident in Country A). A Co owns 75% of the ordinary shares in B Co 2 with B Co 1 owning the remaining 25%.

2. B Co 2 is in need of 2 000 of additional financing. Both of its shareholders agreed to debt finance B Co 2 in proportion to their shareholding, i.e. A Co and B Co 1 subscribed 1 500 and 500 respectively for a loan that pays regular interest at a fixed rate.



3. Country B treats the loan in accordance with its form and allows B Co 2 a deduction for the interest payments in accordance with the normal rules applicable to debt financing in Country B. B Co 2 is allowed a deduction for these interest payments and B Co 1 includes those payments in its ordinary income.

4. The laws of Country A, however, re-characterise a debt instrument as equity (i.e. shares) when the debt is issued by a company to its shareholder for an amount that is calculated by reference to the shareholder's equity in the issuer. Accordingly, the loan held by A Co is treated as a share in Country A and the interest payments on the loan are treated as an exempt dividend.

Question

5. Whether the mismatch in tax outcomes that arises in respect of the interest payments from B Co 2 to A Co, fall within the scope of the hybrid financial instrument rule?

Answer

6. The interest payment will give rise to a mismatch unless Country A denies the benefit of the dividend exemption for the deductible interest payments in accordance with Recommendation 2.1.

7. The fact that the debt is issued to each holder in proportion to their equity in the company is a commercially significant element of the debt financing transaction that impacts on the tax treatment of the payments made under it. These circumstances in which the debt was issued should therefore be considered to be part of the terms of the instrument and the resulting mismatch should be treated as a hybrid mismatch within the scope of the rule.

Analysis

Recommendation 2.1 will apply to deny A Co the benefit of the dividend exemption for the payment

8. The loan is treated as a share under the domestic laws of Country A and interest payments on the loan are treated as exempt dividends. Recommendation 2.1 states that, in order to prevent D/NI outcomes arising under a debt / equity hybrid, countries should deny the benefit of a dividend exemption for deductible payments. Accordingly, in this case, A Co should tax the interest payments from B Co 2 as ordinary income.

If Country A does not apply Recommendation 2.1 then the payment will give rise to a hybrid mismatch that is within the scope of the hybrid financial instrument rule

9. If Country A does not implement Recommendation 2.1 into its domestic law, the hybrid financial instrument rule will apply.

10. Recommendation 1 only applies to *a financial instrument* entered into with a *related party*. The loan meets the definition of financial instrument as it is treated as a debt instrument in Country B and as an equity instrument in Country A. A Co and B Co 2 are related parties as A Co holds 75% of the shares in B Co 2.

A payment made under the loan will give rise to a hybrid mismatch

11. The interest paid by B Co 2 to A Co is deductible under Country B law and treated as an exempt dividend in the hands of A Co. The interest payments therefore give rise to a mismatch. This mismatch will be treated as a hybrid mismatch if the difference in tax outcomes is attributable to the *terms of the instrument*. The terms of the instrument should be construed broadly, going beyond the rights and obligations of the loan and the relationship between the parties to include the circumstances in which the instrument is issued or held if those circumstances are commercially or economically significant to the

relationship between the parties and affect the tax treatment of the payments made under the instrument.

12. The cause of the mismatch in this example is the fact that debt has been issued to shareholders in proportion to their equity. The issue of debt in proportion to equity is commercially and economically different from the issue of debt to a third party, or to shareholders in different proportions, and is likely to impact on the commercial terms of that debt. Therefore the circumstances in which the debt was issued should be treated as part of the terms of the instrument and the resulting mismatch as a hybrid mismatch.

Application of the primary and secondary response

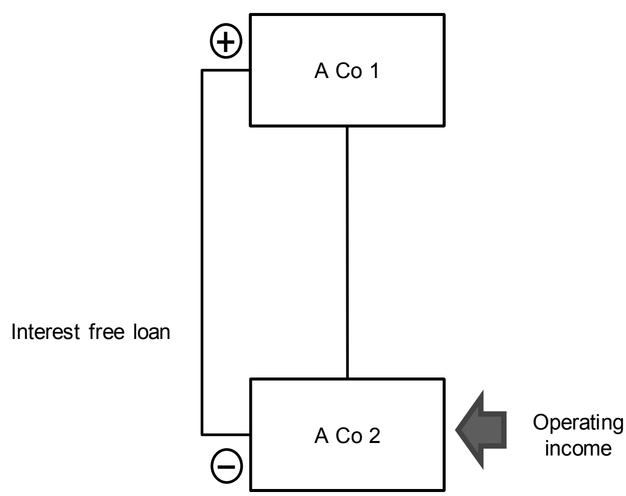
13. Country B should deny the interest deduction to the extent that it is not included in the ordinary income of A Co. If Country B does not apply the recommended response, Country A should treat the interest payments received by A Co as ordinary income.

Example 1.13

Accrual of deemed discount on interest free loan

Facts

1. In the example illustrated in the figure below, A Co 1 (a company resident in Country A) establishes a subsidiary in the same jurisdiction (A Co 2). A Co 1 provides A Co 2 with a total capital of 40, 12.5% of which is provided in the form of share capital and the rest by way interest free loan. The loan is repayable in full at the end of five years.



2. The loan is treated as a debt instrument under the laws of Country A. However, due to the particular tax accounting treatment adopted by A Co 2 in respect of interest free loans made by another group member, A Co 2 is required to split the loan into two separate components for accounting purposes: a non-interest bearing loan, which A Co 2 is treated as having issued to A Co 1 at a discount, and a deemed equity contribution equal to the amount of that discount. The amount that A Co 2 treats as received for the interest free loan is based on an arm's length valuation. The table below sets out a simplified illustration of how the loan and deemed equity contribution might be reflected on A Co 2's balance sheet.

Year 0	A Co 2 – Assets, Liabilities and Equity		
	Assets	**40**	
	Fixed assets		40
	Liabilities	**20**	
	Shareholder loan		20
	Equity	**20**	
	Share capital		5
	Other equity		15

3. In this case A Co 2 has treated the interest free loan of 35 as an equity contribution of 15 and a loan of 20. In each accounting period A Co 2 will be required to accrue a portion of the deemed discount on the loan as an expense for accounting purposes and to treat this expense as funded out of A Co 1's deemed equity contribution. The table below provides a simplified illustration of how A Co 2 might account for the accrued liability under the shareholder loan as at the end of Year 1:

Year 1	A Co 2 – Assets. Liabilities and Equity			A Co 2 - Income		
					Book / Tax	**Cash**
	Assets	**45**		Income		
	Current assets (cash)		5	Operating Income	5	5
	Fixed assets		40			
	Liabilities	**23**		Expenses		
	Shareholder loan		23	Accrued liability on shareholder loan	(3)	
	Equity	**22**		**Net return**	**2**	
	Share capital		5			
	Other equity		17			

4. In this case A Co 2 treats the deemed discount as accruing on a straight-line basis so that, at the end of Year 1 the shareholder loan is recorded on the balance sheet as 23 (an increase of 3). Country A law permits this deemed increase in liabilities to be treated as a current expense in Year 1 so that, while A Co has operating income of 5 in that year its accounts show a net return (and increase in equity) of only 2. Applying the same accounting treatment in each of the following years will permit the entire discount to be expensed over the life of the loan so that, at maturity, the shareholder loan will be recorded on the company's balance sheet at its face amount.

5. A Co 1 adopts a different tax accounting treatment from A Co 2 and does not split the interest-free loan into equity and debt components. Accordingly the accrued liability recorded in A Co 2's accounts in each year is not recognised by A Co 1. On repayment of the loan the entire amount paid by A Co 2 is simply treated as a non-taxable return of loan principal.

Question

6. Whether the arrangement falls within the scope of the hybrid financial instrument rule?

Answer

7. Country A should deny A Co 2 a deduction under the hybrid financial instrument rule as the amount which is expensed by A Co 2 in each accounting period gives rise to a D/NI outcome and this mismatch in tax outcomes is attributable to different approaches taken to the accounting and tax treatment of the instrument by the payer and payee under the laws of the same jurisdiction

Analysis

The accrued obligation under the loan should be treated as a payment

8. A payment includes an amount that is *capable of being paid* and includes any future or contingent obligation to make a payment. The definition specifically excludes, however, *payments that are only deemed to be made for tax purposes and that do not involve the creation of economic rights between the parties*. As described in Chapter 1 of the report, this exception for deemed payments is only intended to exclude regimes, such as those that grant deemed interest deductions for equity capital, where the tax deduction is not linked to any payment obligation of the issuer. In this example, A Co 2's deduction in each accounting period is in respect of its repayment obligation under the loan. Although the deduction granted to A Co 2 in each accounting period does not correspond to any increase in A Co 2's liabilities during that period, it does arise in respect of a repayment obligation and it therefore falls within the definition of a payment for the purposes of the rule.

Payment gives rise to a hybrid mismatch

9. The D/NI outcome that arises in this case is the result of A Co 2's entitlement to a deduction in each accounting period for the annual increase in loan liabilities recorded on its balance sheet. This deduction is not matched by a corresponding income inclusion for A Co 1 because A Co 1 does not treat the loan as having been split into equity and debt components. The ability of A Co 1 and A Co 2 to apply different accounting (and, by extension, tax) treatments to the same instrument means that the mismatch is attributable to differences in the tax treatment of the instrument under the laws of the same jurisdiction.

10. Note that a mismatch could still arise, on the facts of this example, if A Co 1 adopted the same accounting treatment as A Co 2 but attributed a lower value to the equity portion of the loan. In such a case the entitlement to a deduction in each accounting period for the annual increase in loan liabilities would not be matched by an inclusion of the same amount in Country A. While differences in the value attributed to a payment under the laws of the payer and payee jurisdictions will not generally give rise to a D/NI outcome, in this case, the valuation of the respective components of an instrument has a direct impact on the character of the payments made under it (see further the analysis in **Example 1.16**)

11. The particular accounting treatment taken by A Co 2 only applies to interest-free loans from a group member. The accounting treatment (and, by extension the mismatch in tax outcomes) would not have arisen if the loan had been entered into between unrelated taxpayers of ordinary status. The "terms of the instrument" should be given a broad meaning and may include any aspect of the relationship between the parties. The fact that a loan is from a group member should therefore be treated as part of the terms of the loan notwithstanding that there may be no legal requirement for the loan to be held intra-group.

Example 1.14

Deemed interest on interest-free loan

Facts

12. The facts of this Example are the same as Example 1.13 except that the interest free loan is made to a foreign subsidiary (B Co) and the laws of Country B allow B Co to claim a deduction for tax purposes as if it had paid interest on the loan at a market rate.

13. The laws of Country A treat the loan as a debt instrument or equity instrument and there is no corresponding adjustment in Country A. On repayment of the loan the entire amount is treated as a non-taxable return of loan principal or return of capital.

Question

14. Whether the arrangement falls within the scope of the hybrid financial instrument rule?

Answer

15. The arrangement does not fall within the scope of the hybrid financial instrument rule because there is no payment under the loan that gives rise to a deduction for tax purposes in Country B.

Analysis

There is no payment made under the financial instrument that gives rise to a hybrid mismatch

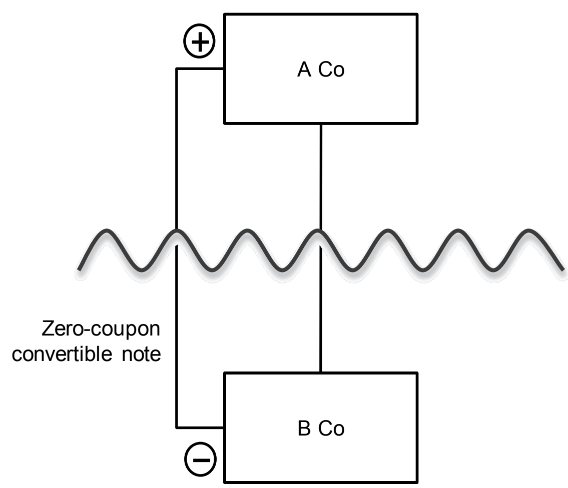
16. Recommendation 1 only applies to D/NI outcomes that arise in respect of payments. The definition specifically excludes payments that are only deemed to be made for tax purposes and that do not involve the creation of economic rights between the parties. In this example B Co's deduction in each accounting period arises in respect of an amount that is not capable of being paid. Accordingly there is no payment under the financial instrument that gives rise to a D/NI outcome.

Example 1.15

Differences in value attributable to share premium paid under mandatory convertible note

Facts

1. In the example illustrated in the figure below, A Co (a company resident in Country A) owns all the shares in B Co (a company resident in Country B). A Co subscribes for a five year zero-coupon convertible note with a principal amount of 100.



2. The zero-coupon note automatically converts into shares of B Co at the maturity date. The equity premium that arises on the conversion of the note is treated as deductible by B Co and is included in ordinary income by A Co. The value of the equity premium is calculated by Country A to be 15, while Country B values the equity premium at 30.

Question

3. Whether any portion of the deduction for the equity premium under Country B law gives rise to a hybrid mismatch within the scope of the hybrid financial instrument rule?

Answer

4. No adjustment is required under the hybrid financial instrument rule as the difference in valuation of the equity premium does not give rise to a hybrid mismatch.

Analysis

No mismatch in respect of differences in the valuation of a payment

5. The mismatch in tax outcomes in this case is not a mismatch within the meaning of the hybrid financial instrument rule. This is because the difference in outcome is merely attributable to the differences in the valuation of a payment and it does not relate to any difference in characterisation of the payment between the two countries.

Example 1.16

Differences in valuation of discount on issue of optional convertible note

Facts

1. The facts of this example are the same as those in **Example 1.15** except that zero-coupon note can be converted into shares of B Co at the option of A Co. Both Country B and Country A laws bifurcate the instrument for tax purposes. Country B treats A Co as having paid 80 for a zero-coupon note and 20 in exchange for the share option. Accordingly the note is treated as issued at a discount and B Co is entitled to accrue the amount of that discount as a deduction for tax purposes over the term of the loan. Country A adopts the same tax treatment but treats A Co as having paid 90 for the note and 10 for the share option.

Question

2. Whether the adjustment under Country B law for the deductible costs attributable to the convertible note gives rise to a hybrid mismatch within the scope of the hybrid financial instrument rule?

Answer

3. The difference in valuation has a direct impact on the characterisation of the payments made under the instrument and therefore gives rise to a hybrid mismatch.

Analysis

The accrued obligation under the loan should be treated as a payment

4. A payment includes an amount that is *capable of being paid* and includes any future or contingent obligation to make a payment. In this example, B Co's deduction in each accounting period is in respect of its contingent repayment obligation under the loan. Although the deduction does not correspond to any increase in A Co 2's liabilities during that period, it does arise in respect of a repayment obligation and it therefore falls within the definition of a payment for the purposes of the rule (see analysis in **Example 1.13**)

The difference in the valuation of the option component results in a difference in the character of the underlying payments

5. In order for the deductible payment to give rise to a D/NI outcome there must be a difference in the way the payment is measured and characterised under the laws of the payer and payee jurisdictions. If the amount of the payment is characterised and calculated in the same way under the laws of both jurisdictions, then differences in the

value attributed to that amount under the laws of the payer and payee jurisdictions will not give rise to a D/NI outcome. Differences in tax outcomes that are solely attributable to differences in the value ascribed to a payment (including through the application of transfer pricing) do not fall within the scope of the hybrid mismatch rule (see **Example 1.15**).

6. In certain cases, however, particularly in the case of more complex financial instruments that are treated as incorporating both financing and equity returns, the way the separate components of the instrument are measured, and therefore the character of the payments under local law, may be dependent on the value attributed to each of those components. In such a case, where the valuation of the components of a financial instrument has a direct impact on the characterisation of the payments made under it, differences in valuation may give rise to a mismatch.

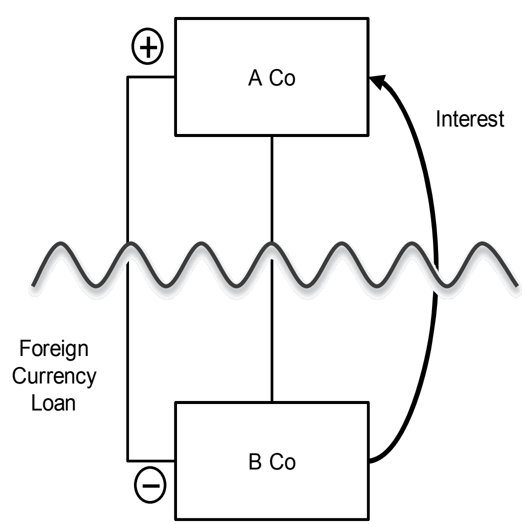
7. In this case both the issuer and the holder treat a convertible note as being issued at discount representing its equity value. The higher valuation given to the equity value of the note in the issuer's jurisdiction, results in the issuer recognising a larger accrued discount, which, in turn, results in greater portion of the payments being treated as deductible in the issuer jurisdiction. In this case, the way in which the component elements of the note are valued has a direct impact on the way the payments under the instrument are characterised for tax purposes and, accordingly, the difference in valuation should be treated as giving rise to a mismatch in tax outcomes.

Example 1.17

No mismatch with respect to measurement of foreign exchange differences

Facts

1. In the example illustrated in the figure below, A Co (a company resident in Country A) owns all the shares in B Co (a company resident in Country B). A Co provides B Co with an ordinary loan. Interest on the loan is payable every year in arrears at a market rate and the principal on the loan is payable at maturity. The loan is treated as a debt instrument under the laws of both Country A and B and the countries take a consistent position on the characterisation of the payments made under the loan. The interest payable on the loan is deductible in Country B and included in ordinary income under the laws of Country A.



2. The interest and principal under the loan are payable in Currency A. The value of Currency B falls in relation to Currency A while the loan is still outstanding so that payments of interest and principal under the loan become more expensive in Currency B terms. Under the Country B law, B Co is entitled to a deduction for this increased cost. There is no similar adjustment required under Country A law.

Question

3. Whether the adjustment under Country B law for the increase in costs attributable to the fall in the value of Currency B gives rise to a hybrid mismatch within the scope of the hybrid financial instrument rule?

Answer

4. While the fall in the value of Currency B gives rise to a deduction under Country B law that is not reflected by a corresponding inclusion in Country A, this difference does not give rise to a D/NI outcome provided the proportion of the interest and principal payable under the loan is the same under the laws of both jurisdictions. Gains and losses that result from converting foreign exchange into local or functional currency are attributable to the way jurisdictions measure the value of money rather than the value of the payment itself.

Analysis

The foreign currency adjustment does not give rise to a mismatch

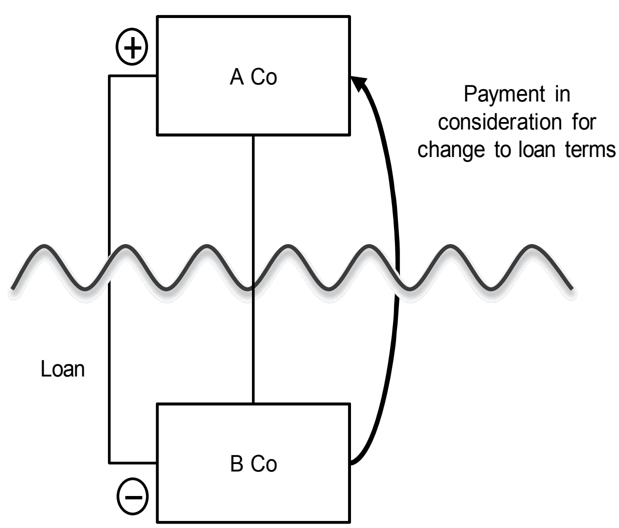
5. In this case both Country A and B characterise the payments in the same way (as either principal or interest) and take the same view as to the proportion of interest and principal payable under the loan. The difference in tax treatment in this case does not arise because the tax systems of the two countries characterise the payments in different ways or arrive at a different value for the payments made under the loan. Rather, once the character and amount have been determined, the laws of one jurisdiction require the value of the payment to be translated into local currency. This type of currency translation difference, which is a difference in the way jurisdictions measure the value of money (rather than the underlying character or amount of a payment), should not be treated as giving rise to a mismatch.

Example 1.18

Payment in consideration for an agreement to modify the terms of a debt instrument

Facts

1. In the example illustrated in the figure below B Co is a company resident in Country B. B Co borrows money from its immediate parent A Co, a company resident in Country A. The loan has a 5 year term and pays a high fixed rate of interest. B Co makes a one-off arms-length payment to A Co in consideration for A Co agreeing to lower the interest rate on the loan. The effect of this adjustment is to reduce the value of the loan as recorded in A Co's accounts.



Question

2. Whether the payment in consideration for the agreement to change to the terms of the loan falls within the scope of the hybrid financial instrument rule?

Answer

3. B Co's payment should be treated as a payment made under the loan itself. The payment will give rise to a hybrid mismatch to the extent it is treated as deductible under the laws of Country B and is not included in ordinary income under Country A law. Although A Co's surrender or discharge of rights under the loan may be thought of as a

transfer of value, it should not be considered a payment under the loan within the scope of the hybrid financial instrument rule.

Analysis

The amount paid in consideration for agreeing to a change in the terms of the loan is a payment under a financial instrument

4. The determination of whether a payment is made *under a financial instrument* can usually be made by looking to the terms of the instrument and considering whether that payment is either required under the instrument or is in consideration for the release from a requirement under the instrument. In this case the payment is made in consideration for agreeing to a release from the obligation to make certain payments under the loan and should therefore be treated as a payment under the instrument.

The payment will give rise to a hybrid mismatch if it is not treated as ordinary income under Country A law

5. The payment under a financial instrument will give rise to a mismatch in tax outcomes if it is deductible under the laws of Country B and not treated as ordinary income under the laws of Country A. The example does not state whether A Co treats the one-off payment as ordinary income. If, however, Country A law does not require a taxpayer to bring this type of payment into ordinary income, the mismatch in tax outcomes should be treated as a hybrid mismatch because it arises due to differences in the way Country A and Country B laws characterise such payments for tax purposes.

6. It may be the case that A Co is not required to bring the payment into account as ordinary income until the end of the loan term. If this is the case the reasonableness of the timing difference would need to be tested in accordance with Recommendation 1.1(c).

Release of obligations under the loan is not a payment

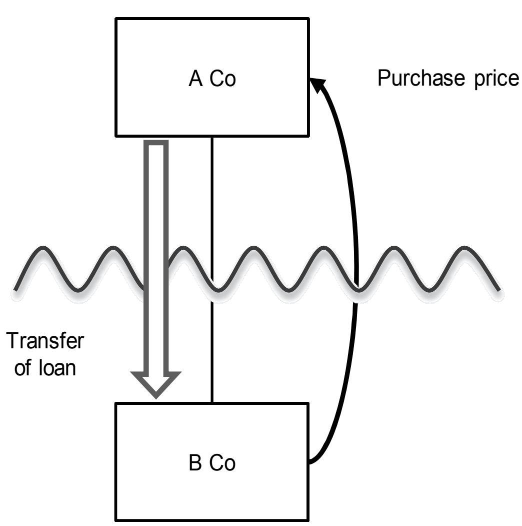
7. A Co's agreement to surrender or modify rights under the loan may be thought of as a transfer of value to B Co but it should not be treated as a payment under the loan itself. Any deduction that A Co may claim for the reduction in the value of the loan due to such surrender or discharge does not, therefore, fall within the scope of the hybrid financial instrument rule. Accordingly, the deduction that may be granted under Country A law for the reduction in the value of the loan is not a payment under the loan and does not fall within the scope of the hybrid financial instrument rule.

Example 1.19

Payment in consideration for the cancellation of a financial instrument

Facts

1. This example illustrated in the figure below is the same as **Example 1.18** except that B Co buys the subordinated loan at premium to the amount that would have been payable on maturity. This acquisition results in a deemed cancellation of the loan. B Co treats the premium as deductible expenditure while A Co treats it as a gain on the disposal of the loan.



Question

2. Whether the consideration paid to acquire the loan falls within the scope of the hybrid financial instrument rule and, if so, to what extent an adjustment is required to be made in accordance with that rule.

Answer

3. The consideration for the transfer of the loan should be treated as made under a financial instrument because the transfer has the effect of discharging B Co’s obligations under the loan. Unless Country A law treats the amount paid as ordinary income, the hybrid financial instrument will apply to neutralise the effect of the resulting mismatch.

Analysis

The consideration for the transfer is deemed to be a payment under a financial instrument

4. A payment made by a person to acquire an existing financial instrument will not generally be treated as a payment made under that instrument. Where, however, the payment is consideration for discharging, in whole or part, the issuer's obligations under the instrument, the payment should be treated as caught by the rule. In this case, B Co's acquisition of the loan from A Co has the effect of cancelling B Co's obligations under the instrument and, accordingly, the consideration paid for the transfer of the loan should be treated as a payment made under the instrument itself.

The payment will give rise to a hybrid mismatch

5. As the payment of a premium is deductible under the laws of Country B, the payment will give rise to a mismatch unless it is required to be included as ordinary income under Country A law. If Country A law dealing with the taxation of these types of instruments requires any gain on the disposal of such a loan to be brought into account as ordinary income for tax purposes, then the payment should not give rise to a mismatch. If, however, the gain is excluded or exempt from tax, or A Co is taxable on the proceeds of disposal solely due to its particular tax status or the context in which the instrument is held (for example, A Co holds the loan as trading asset), then the payment should be treated as giving rise to a mismatch. The mismatch that arises will be a hybrid mismatch as it is due to differences in the way in which the laws of Country A and Country B characterise redemption payments under a financial instrument.

Primary recommendation – deny the deduction in the payer jurisdiction

6. Country B should deny a deduction for the premium paid to A Co for the release of its obligations under the loan. If Country B does not apply the recommended response, then Country A should treat the premium as ordinary income.

Example 1.20

Release from a debt obligation not a payment

Facts

1. This example illustrated in the figure below is the same as **Example 1.19** except that B Co gets into financial difficulties and is unable to make payments of interest and principal on the loan. A Co agrees to forgive the loan and releases B Co from the obligation to make any further payments of principal and accrued interest. The amount of debt forgiven is treated as deductible under Country A law but is not treated as income by B Co.

Question

2. Whether the D/NI outcome, which arises with respect to the restructuring of the loan, falls within the scope of the hybrid financial instrument rule?

Answer

3. Although the forgiveness of debt is a transfer of value from A Co to B Co, it is not a payment under a financial instrument. Accordingly A Co's deduction does not fall within the scope of the hybrid financial instrument rule.

Analysis

4. The hybrid financial instrument rule applies only to payments made under a financial instrument. A payment will be treated as made *under a financial instrument* if it is made in discharge, satisfaction or release of an obligation under that financial instrument. The discharge, satisfaction or release of the obligation itself should not be treated as a payment even though such release may give rise to a transfer of value between the parties.

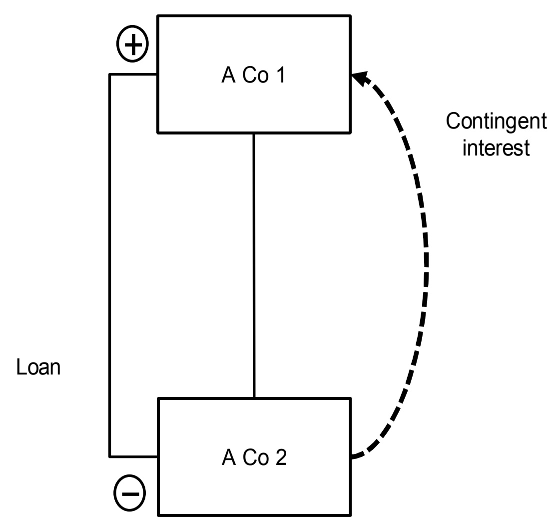
5. Accordingly the deduction granted under Country A law is in respect of the release of an obligation under a financial instrument, not a payment under it, and does not fall within the scope of the hybrid financial instrument rule.

Example 1.21

Mismatch resulting from accrual of contingent interest liability

Facts

1. In the example illustrated in the figure below, A Co 1 owns all the shares in A Co 2. Both companies are resident in Country A. A Co 1 provides A Co 2 with a subordinated loan. The terms of the loan provide for interest that is payable at maturity or, if earlier, at the discretion of A Co 2. The loan has a long maturity date (50 years) and A Co 1 may waive its entitlement to interest at any time prior to payment.



2. The loan is treated as debt under the laws of Country A but A Co 1 and A Co 2 adopt different accounting policies in respect of the loan. The effect of this difference in accounting treatment is that interest payments on the loan are treated as deductible by A Co 2 in the year the interest accrues but will only be treated as income by A Co 1 when (and if) such interest is actually paid. Furthermore, if A Co 1 waives its entitlement to accrued interest at any point prior to payment, this waiver will be treated by A Co 2 as a deemed equity contribution to A Co 2 and will therefore not trigger a recapture of interest deductions previously claimed.

Question

3. Will the accrued but unpaid interest give rise to a hybrid mismatch under the hybrid financial instrument rule?

Answer

4. The terms of the loan are such that the taxpayer will be unable establish, to the satisfaction of the tax authority, that the payment will be made, or can be expected to be made, within a reasonable period of time. Accordingly the fact that the accrued interest is deductible for A Co 2 but not included in income by A Co 1 should be treated as giving rise to a mismatch for tax purposes. This mismatch in tax outcomes arises due to different ways in which A Co 1 and A Co 2 account for the payments of interest under the loan. Accordingly the deduction for the contingent interest will be treated as giving rise to a hybrid mismatch under the hybrid financial instrument rule.

Analysis

The accrued interest is a payment under a financial instrument

5. Recommendation 1 only applies to payments made under a financial instrument. The definition of payment under the hybrid mismatch rules includes an accrual of an amount even if it is in respect of a contingent obligation.

Taxpayer unable to establish that the payment can reasonably be expected to be included in income

6. The accounting treatment adopted by A Co 2 allows A Co 2 to recognise the interest as a deductible expense (i.e. as having been paid) in the year it accrues, however the conditions under which A Co 2 is entitled to claim a deduction are not sufficient to bring the interest into ordinary income in the hands of A Co 1. The mere fact that interest is deductible by one party when it accrues, but will not be included in ordinary income by the recipient until it is actually paid, does not necessarily mean that it will be treated as giving rise to a mismatch in tax outcomes. In this case, however, the maturity date and payment terms of the instrument, together with the fact that the loan is held intra-group, indicate that the parties have placed little commercial significance on the payment of the accrued interest under the loan.

7. Even if the loan had a significantly shorter maturity date, A Co 1 still has the power to waive its entitlement to interest at any time before the interest is actually paid without such waiver giving rise to any adverse tax or economic consequences for A Co 1 or A Co 2.

8. Accordingly the taxpayers in this example will be unable to satisfy its tax administration at the time the loan is issued that it is reasonable to expect that the amounts treated as a deductible payment by A Co 2 will be included as ordinary income under the accounting method adopted by A Co 1. The mismatch in tax outcomes that arises under the loan should therefore be treated as falling within the scope of the hybrid financial instrument rule.

Mismatch in tax outcomes will be a hybrid mismatch

9. The ability of A Co 1 and A Co 2 to apply different accounting (and, by extension, tax) treatments to the same instrument means that the mismatch is attributable to differences in the tax treatment of the instrument under the laws of the same jurisdiction.

Primary response

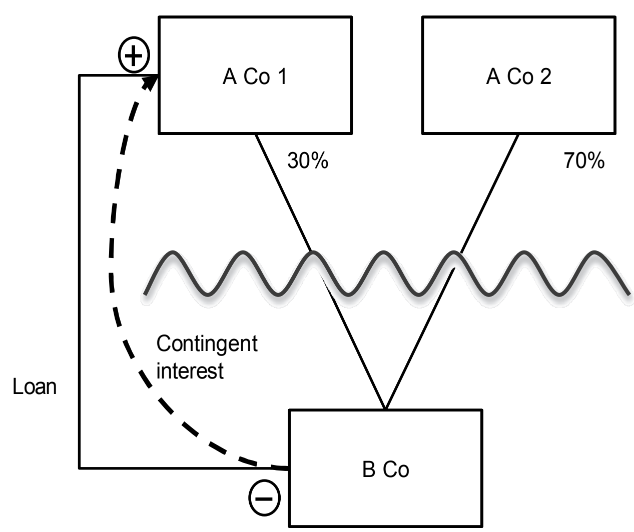
10. Country A should deny A Co 2 a deduction for the accrued interest on the loan. If Country A introduces a rule that defers A Co 2's entitlement to a deduction until the interest is actually paid then that may have the effect of bringing such interest payments within the operation of the safe harbour described in the guidance to Recommendation 1.1 and the primary response will no longer apply.

Example 1.22

No mismatch resulting from accrual of contingent interest liability

Facts

1. In the example illustrated in the figure below, A Co 1 owns 30% of the shares in B Co (a company established and tax resident in Country B). The rest of the shares are owned by A Co 2 (an unrelated company). B Co makes an investment in an infrastructure asset that is not expected to produce returns for a number of years. As part of the funding for this arrangement, A Co 1 provides B Co with a subordinated loan.



2. Interest accrues on the loan at a fixed rate. The terms of the loan, however, provide that interest will only be paid at the end of the term of the loan (15 years) or at the discretion of B Co and only if certain solvency requirements are met. Furthermore there is a 'dividend-blocker' on the shares issued by B Co that prevents B Co from making any distributions to its shareholders while there is accrued but unpaid interest on the loan.

3. The loan is treated as debt under the laws of both countries, however, due to differences in the way interest is accounted for tax purposes by the two countries, the interest is treated as deductible by B Co in the year it accrues but will only be treated as income by A Co 1 when it is actually paid.

Question

4. Will the accrued but unpaid interest give rise to a hybrid mismatch under the hybrid financial instrument rule?

Answer

5. The fact that the accrued interest can reasonably be expected to be paid and that the payment terms are reasonable in the circumstances should mean that the tax administration will not treat the accrued interest as giving rise to a hybrid mismatch.

Analysis

It can reasonably be expected that the payment will be made within a reasonable period of time

6. The hybrid financial instrument rule is not intended to pick up differences in the timing of recognition of payments under a financial instrument. A mismatch in tax outcomes will be treated as simply giving rise to a timing difference (outside the scope of the hybrid financial instrument rule) if the taxpayer can establish, to the satisfaction of the tax administration, that it is reasonable to expect payment to be made (i.e. included in ordinary income) within a reasonable period of time.

7. In this case, interest payments are not required to be made until maturity and only if the borrower meets certain solvency requirements. Although the period of maturity is long (15 years) the facts of this example, including the fact that the interests of the debt and equity holders are not aligned, suggest that, in practice, the parties have placed real commercial significance on the requirement to make payments under the loan and that they expect, at the time the arrangement is entered into, that the outstanding principal and interest under the loan will be paid.

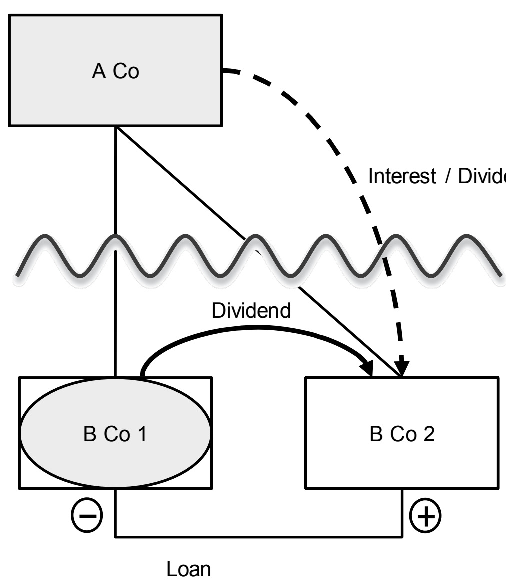
8. The time period for the payment of interest will be treated as reasonable if it is what might be expected to be agreed between unrelated parties acting at arm's length. This determination should take into account such factors as the terms of the instrument, the circumstances in which it is held and the commercial objectives of the parties, including the nature of the accrual and any contingencies or other commercial factors affecting payment. In this case: the nature of the underlying investment (infrastructure); the competing and potentially divergent interests of the parties (bearing in mind that the holder is only a minority equity holder) and the contractual protections for the payee, such as the dividend blocker on the shares, are all factors indicative of an arrangement on arm's length terms.

Example 1.23

Payment by a hybrid entity under a hybrid financial instrument

Facts

1. In the example illustrated in the figure below B Co 1, a company resident in Country B, is a wholly-owned subsidiary of A Co, a company resident in Country A. B Co 1 is disregarded for the purposes of Country A law. B Co 1 borrows money from B Co 2 another wholly-owned subsidiary resident in the same jurisdiction.



2. Country B treats the loan as an equity instrument. Accordingly it does not allow B Co 1 a deduction for the payment and treats the payment as an exempt dividend in the hands of B Co 2. The loan is, however, treated as a debt instrument under Country A law and, because B Co 1 is a disregarded entity, the interest payable on the loan is treated as deductible by A Co under the laws of Country A.

Question

3. Whether the interest payment is subject to adjustment under the hybrid financial instrument rule and, if so, what adjustments are required under the rule?

Answer

4. The interest payment is caught by the hybrid financial instrument rule.

5. Country A should deny A Co the deduction for the interest payable under the loan. If Country A does not apply the recommended response then Country B should treat the interest payments on the loan as ordinary income.

Analysis

The arrangement is a financial instrument

6. The loan meets the definition of a *financial instrument* because it is treated as an equity instrument under the laws of Country B and a debt instrument under the laws of Country A.

The payment gives rise to a hybrid mismatch

7. A D/NI outcome arises where a payment that is deductible under the laws of one jurisdiction (Country A) is not included in ordinary income under the laws of any other jurisdiction where the payment is treated as being received (Country B). The mismatch is a hybrid mismatch as it is attributable to differences in the tax treatment of the loan under the laws of the payee and payer jurisdictions.

Primary recommendation – deny the deduction in the payer jurisdiction

8. The primary recommendation under the hybrid financial instrument rule is that Country A deny the deduction to the extent it gives rise to a D/NI outcome.

Defensive rule – require income to be included in the payee jurisdiction

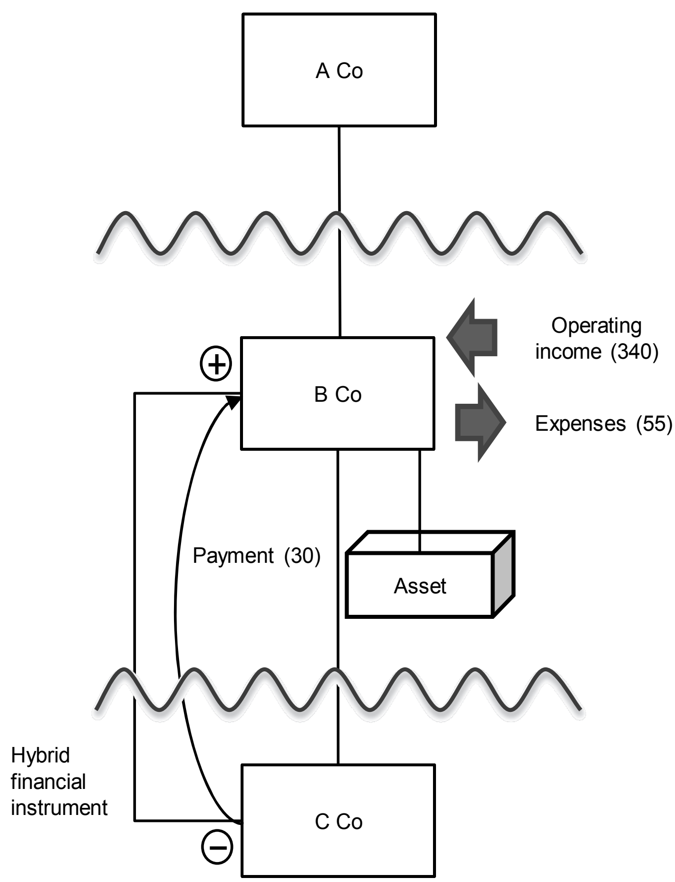
9. If Country A does not apply the recommended response, then Country B should treat the deductible payment as ordinary income in the hands of B Co 2, under the laws of Country B.

Example 1.24

Payment included in ordinary income under a CFC regime

Facts

1. In the example illustrated in the figure below, C Co is a company resident in Country C and a member of the ABC Group. C Co makes a payment of 30 under a hybrid financial instrument to B Co, another group company resident in Country B. In addition to receiving this payment from C Co, B Co also derives income from other sources and incurs expenses, including interest on a loan from Bank.



2. A Co, the parent of the group, resident in Country A, is subject to a CFC regime in Country A that attributes certain types of passive income derived by controlled foreign entities to resident shareholders in proportion to their shareholding in that entity. Countries A and C have introduced the recommendations set out in this report.

3. A simplified table below illustrates the net tax positions of A Co and B Co in the period the payment under the hybrid financial instrument was made.

B Co			A Co		
	Tax	**Book**		**Tax**	**Book**
Income			Income		
Active income	280	280	CFC income	80.4	
Passive income (including rents, interest and royalties)	60	60	Foreign tax credit	27.6	
Payment under hybrid financial instrument	-	30			
Expenditure			Expenditure		
Interest expense	(10)	(10)			
Depreciation	(15)	-			
Employment expenses	(45)	(45)			
Net return		315	**Net return**		0
Taxable income	**270**		**Taxable income**	**108**	
			Tax (at 30%)	(32.4)	
			Tax credit	27.6	
Tax to pay (at 40%)		(108)	Tax to pay		(4.8)
After-tax return		**207**	**After-tax return**		**(4.8)**

4. B Co derives 340 of taxable income for the period (including 60 of passive income such as rents, royalties and interest). The payment of 30 under the hybrid financial instrument is excluded from the calculation of B Co's income under Country B law. B Co incurs 70 of expenses (including tax depreciation) giving it taxable income of 270 which is taxable at the ordinary corporate rate of 40%.

5. A Co's only income for the same period is the income of B Co that is attributed under Country A's CFC regime. As set out in the table above, an amount of 80.4 is brought into account for tax purposes as ordinary income and subject to tax at the full corporate rate (30%) together with a credit of 27.6 for underlying taxes paid in Country B.

Question

6. How should the inclusion of CFC income under Country A law impact on the application of the hybrid financial instrument rule in Country C?

Answer

7. A taxpayer seeking to rely on a CFC inclusion in the parent jurisdiction, in order to avoid an adjustment under the hybrid financial instrument rule, should only be able to do so in circumstances where it can satisfy the tax administration that the payment will be

fully included under the laws of the relevant jurisdiction and subject to tax at the full rate. In this case the taxpayer will be required to establish that:

(a) the payment under the hybrid financial instrument is of a type that is required to be brought into account as ordinary income under the CFC rules in Country A (and does not benefit from any exemption under those rules, such as an active income or de-minimis exemption); and

(b) the payment is or will be brought into account as ordinary income on A Co's return under the quantification and timing rules of the CFC regime in Country A.

8. The facts of this example state that the parent of the group (A Co) is subject to a CFC regime that attributes certain types of passive income derived by controlled foreign entities to resident shareholders, The example does not, however, provide any further detail on whether, and to what extent, the payment under the hybrid financial instrument has been brought into account under the rules of that CFC regime. Accordingly, there is insufficient information, on the facts of this example, for a tax administration to conclude that relief should be provided from any adjustment under the hybrid financial instrument rule.

9. If the taxpayer can demonstrate, by reference to both the laws of Country A and the tax returns filed under Country A law that the payment is or will be included under the laws of the CFC regime in that jurisdiction then a jurisdiction in the position of Country C seeking to avoid the risk of economic double taxation under the hybrid financial instrument rule should consider whether relief should be granted from the application of the hybrid financial instrument rule in light of the CFC inclusion in Country A. Relief from the application of the hybrid financial instrument rule should only be granted, however, to the extent that the payment has not been treated as reduced or offset by any deduction incurred in the payee jurisdiction (Country B) and does not carry an entitlement to any credit or other relief under the laws of the parent jurisdiction (Country A).

10. Finally, in order for an amount that is included in ordinary income under the laws of Country A to be eligible for relief from the operation of the hybrid financial instrument rule in Country C, the taxpayer may need to establish that the income has not been set-off against a hybrid deduction under the laws of Country A. In this case the requirement will be satisfied because Country A has implemented the recommendations set out in this report.

Analysis

Inclusion of income under a CFC regime may give rise to economic double taxation

11. Recommendation 1.1 states that jurisdictions should consider how to address the mismatch in tax outcomes under the hybrid financial instrument rule in cases where the payment under a hybrid financial instrument has been included in ordinary income by the shareholder under a CFC regime and whether any relief should be granted from the operation of that rule in cases where denying a deduction for a payment that is included in income under a CFC regime may give rise to the risk of economic double taxation.

12. A CFC regime often focuses on certain categories of income derived by a foreign entity that are required to be attributed to a shareholder in a CFC. These categories, however, will often be defined by reference to the local tax law of the shareholder's

jurisdiction and will not necessarily correspond to the same categories, timing and quantification rules of the payer and payee jurisdictions. Before a payment can be treated as included in ordinary income under a CFC or other offshore inclusion regime, the taxpayer must be able to show that the payment under the hybrid financial instrument, which has given rise to the D/NI outcome, falls within a category of payments that is required to be brought into account as income of the shareholder under a CFC regime and does not qualify for any exception (such as a de-minimis exception or an exemption for active income).

13. On the face of the tax calculations above there is nothing that shows the relationship between the excluded payment received by B Co under the hybrid financial instrument and the amount included in CFC income under Country A law. In fact, the simplified accounts shown above provide no evidence that the amount of CFC income recognised by A Co is attributable to the payment made under the hybrid financial instrument. In this case, the taxpayer would therefore need to adduce additional evidence both to satisfy the tax administration that the CFC regime actually required the payment under the hybrid financial instrument to be included as CFC income and when and to what extent the payment would be recognised as CFC income in the hands of the shareholder. If, for example, all the income of a CFC from a particular period is attributed to a shareholder on the final day of the CFC's accounting period, then the shareholder would need to satisfy the tax administration that it holds or will be holding those shares on the attribution date.

Payment only treated as included to the extent it has not been reduced or offset by any deduction

14. CFC regimes typically require the net income of a CFC from particular sources or activities to be brought into account and subject to tax at the shareholder level. In this case B Co has a number of deductions that are offset against its net income. The example gives no information on whether or to what extent those deductions are also taken into account for the purposes of calculating A Co's attributed income from a CFC.

15. If Country A's CFC regime treats the amount of the payment under the hybrid financial instrument as reduced by deductible expenditure incurred by B Co then only the net amount of CFC income attributable to the payment should be treated as having been brought into account as ordinary income under the laws of the Country A.

16. For example, the CFC regime of Country A may require the full amount of passive income derived by B Co and the payment under the hybrid financial instrument to be brought into account as CFC income under Country A law (i.e. 60 + 30 = 90) but it may permit a deduction to be taken against such CFC income for a proportionate amount of B Co's expenses, other than depreciation (i.e. a deduction equal to 55 x 55/315 = 9.6) resulting in a net CFC inclusion of 80.4 (plus foreign tax credits). In this case a jurisdiction may take the view that the portion of the payment under the hybrid financial instrument actually included in income is 26.8 (= 30 – (30/90 x 9.6).

Payment only treated as included to the extent it has not been sheltered by any credit for underlying taxes

17. Country A's CFC regime further treats attributed income as carrying a right to underlying foreign tax credits. In this case the payment that is attributed CFC income

under the laws of Country A should not be treated as included in ordinary income under Country A law to the extent the payment is sheltered by such tax credits.

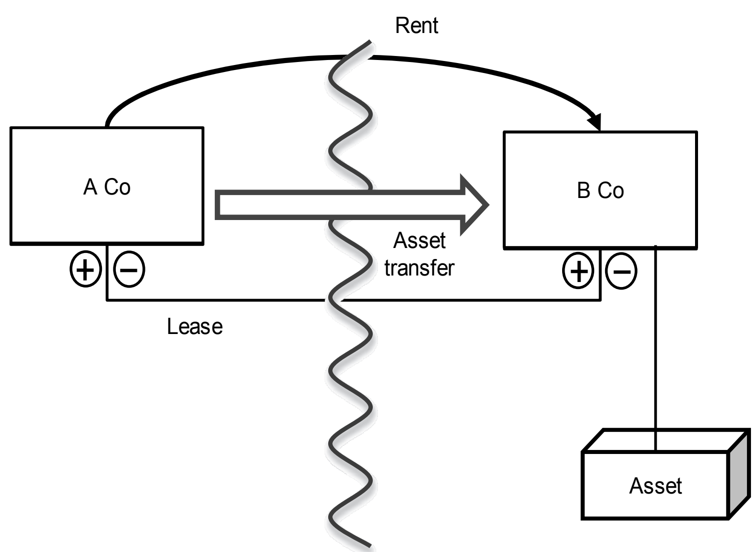
18. For example, the CFC regime of Country A may allow A Co to claim an underlying tax credit in proportion to the effective rate of tax on the (adjusted) income of B Co (i.e. a tax credit equal to 80.4 x (108 / 315) = 27.5). The effect of this tax credit is to shelter 85% of the tax liability on the amount of income included under the CFC regime of Country A. Applying this percentage to the amount of the payment under the hybrid financial instrument that is actually included under Country A law (26.8) a tax authority may conclude that the total amount of the payment under the hybrid financial instrument that has been included in income under this example is ((1 – 0.85) x 26.8 = 4).

Example 1.25

Payment under a lease only subject to adjustment to extent of financing return

Facts

1. The arrangement illustrated in the figure below involves a company resident in Country A (A Co) which obtains financing from a related company resident in Country B (B Co). To secure the financing A Co transfers a piece of equipment to B Co. B Co then leases that equipment back to A Co on terms that give A Co both the right and obligation to acquire the equipment for an agreed value at the end of the lease.



2. Country B treats the arrangement as a finance lease, pursuant to which, A Co is treated as the owner of asset and the arrangement between the parties is treated as a loan, with the payments of rental under the lease treated as payments of interest and principal on the loan.

3. Country A treats the arrangement in accordance with its form (i.e. as an ordinary lease) and the payments on the lease as deductible payments of rent. The effect of this arrangement is that a certain portion of the rental payments give rise to a D/NI outcome because they are deductible for the purposes of Country A law but are not included in ordinary income for the purposes of Country B law (because they are characterised as periodic payments of purchase price or repayments of principal).

Question

4. Is the arrangement subject to adjustment under the hybrid financial instrument rule and, if so, to what extent?

Answer

5. Under Country A law the hybrid financial instrument rule does not apply because the arrangement is not a hybrid transfer and is not otherwise treated as a financial instrument under local law.

6. The arrangement is treated as a debt instrument in Country B and B Co will therefore be required to apply the hybrid financial instrument rule to the payments under the lease. However, only the financing return is subject to adjustment under the rule. In this case the financing return is fully taxable under Country B law, so B Co should not be required to make any adjustment under the hybrid financial instrument rule.

Analysis

Whether arrangement is a financial instrument to be determined by reference to its domestic tax treatment

7. Jurisdictions are expected to use their own domestic tax concepts and terminology to define the arrangements covered by the hybrid financial instrument rule. This local law definition should generally include any financing arrangement, such a finance lease, where one party (B Co) provides money (including money's worth) to another in consideration for a financing return. On the facts of any particular case, however, the question of whether an arrangement is a financial instrument (and, therefore, potentially subject to adjustment under the hybrid financial instrument rule) should be answered solely by reference to the domestic tax treatment of that arrangement.

Rule does not apply under laws of Country A

8. In this case Country A treats the arrangement as an agreement for the supply of services (i.e. lease) and the arrangement is not taxed under the rules for taxing debt, equity or derivatives. As the agreement is not a hybrid transfer and does not give rise to a substitute payment (as it does not involve the transfer of a financial instrument) the payments under the lease will not be subject to adjustment under the hybrid financial instrument rule in Country A.

No adjustment required under laws of Country B

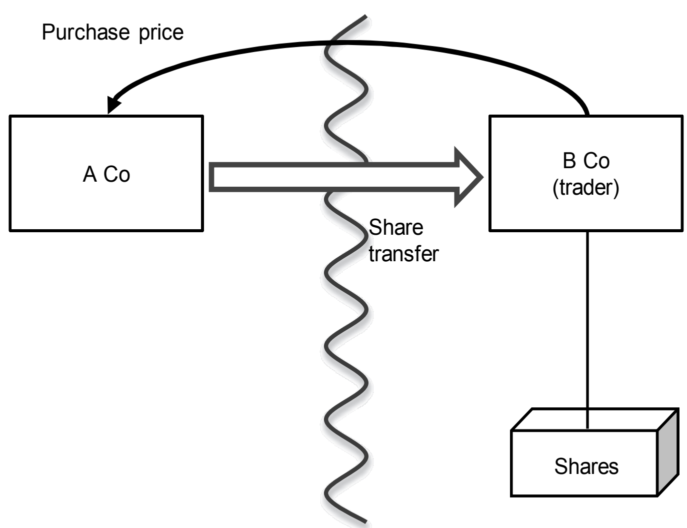
9. The hybrid financial instrument rule is only intended to capture mismatches that arise in respect the equity or financing return paid under a financial instrument. Accordingly, in this case, where the counterparty does not treat the payments under the arrangement as payments under a financial instrument, the hybrid financial instrument rule should only apply to the extent of the equity or financing return. Payments under the arrangement that are treated under Country B law as purchase price or repayment of principal should, therefore, not be subject to adjustment under the rule. In this case the financing return on the lease will be fully taxable in Country B under ordinary law, so the hybrid financial instrument rule will generally not result in any net adjustment for B Co.

Example 1.26

Consideration for the purchase of a trading asset

Facts

1. In the example illustrated in the figure below, A Co (a company resident in Country A) transfers shares to B Co. B Co pays fair market value for the shares. The share transfer occurs on the same day as the payment. B Co acquires the shares as part of its activities as a trader and will be able to include the purchase price as expenditure when calculating any taxable gain/loss on the disposal of the shares.



Question

2. Does the payment give rise to a D/NI outcome under the hybrid financial instrument rule?

Answer

3. The asset sale agreement is not a financial instrument as it does not provide for a financing or equity return. The payment under the asset transfer agreement is not a substitute payment as it does not include, or contain an amount representing, a financing or equity return. Accordingly the transaction does not fall within the scope of the hybrid financial instrument rule.

Analysis

The asset transfer agreement is not a financial instrument

4. The hybrid financial instrument rule is not intended to apply to asset transfers unless the transfer is a hybrid transfer or incorporates a substitute payment.

5. This asset transfer agreement does not fall within the definition of a financial instrument. It does not produce a return that is economically equivalent to interest, as the exchange of value occurs on the same day, and does not provide any party with an entitlement to an equity return (other than the return to B Co from holding the transferred asset).

6. The asset transfer agreement is not a hybrid transfer (and therefore does not fall within the extended definition of a hybrid financial instrument) as it does not give rise to a situation where both parties are treated as holding the transferred shares at the same time. Furthermore, even if the asset transfer was treated as a hybrid transfer, the purchase price deduction claimed by the trader in this case should not be treated as falling within the scope of the hybrid financial instrument rule as such a deduction is not the product of differences between jurisdictions in the tax treatment of asset transfer agreement but rather because the underlying asset is held by A Co and B Co in different capacities (i.e. by A Co as a capital asset and by B Co as a trading asset).

Purchase price does not include a substitute payment

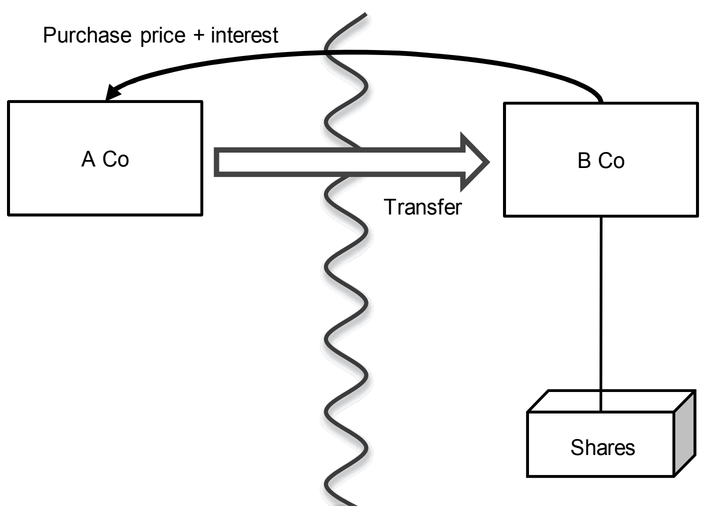
7. Because the purchase price contains no element of an equity or financing return it should not be treated as a substitute payment under an asset transfer agreement.

Example 1.27

Interest component of purchase price

Facts

1. The example illustrated in the figure below is the same as **Example 1.26** except that the agreement provides that consideration payable under the share sale agreement will be deferred for one year. The purchase price of the shares is their fair market value on the date of the agreement plus an adjustment equivalent to a market-rate of interest on the unpaid purchase price. Country B allows B Co to treat the interest portion of the purchase price as giving rise to a separate deductible expense for tax purposes while, under Country A law, the entire purchase price (including the interest component) is treated as consideration for the transfer of the asset.



Question

2. To what extent does the hybrid financial instrument rule apply to adjust the ordinary tax consequences for A Co and B Co in respect of the purchase price?

Answer

3. The asset sale agreement is treated under Country B law as giving rise to a deductible financing expense. Country B law should therefore treat the payment as within the scope of the hybrid financial instrument rule. Country A law does not treat the payment as ordinary income under a financial instrument. The interest payment thus gives rise to a mismatch which is attributable to the different ways in which the asset transfer

agreement is characterised under the laws of Country A and Country B. Therefore B Co should be denied a deduction for the adjustment under the hybrid financial instrument rule.

4. Unless the asset transfer falls within the definition of a hybrid transfer, the hybrid financial instrument rule will not apply in Country A as Country A law does not treat the arrangement between the parties as a financial instrument.

5. The payment of interest under the asset sale agreement is not a substitute payment as the interest payment does not represent a financing or equity return on the underlying shares.

Analysis

The contract is not subject to the hybrid financial instrument rule in Country A unless it constitutes a hybrid transfer

6. While jurisdictions are encouraged to ensure that the hybrid financial instrument rules apply to any arrangement that produces a financing or equity return, the rules are not intended to standardise the categories of financial instrument or to harmonise their tax treatment and, in the present case, where the financing component of the arrangement is actually embedded into the calculation of the purchase price for an asset transfer agreement, it should be left to Country A law to determine whether the consideration paid under the share sale agreement should be taxed as a payment under a financial instrument.

7. The arrangement between the parties is treated as an asset transfer agreement under Country A law and the interest portion of the purchase price is not separately taxed under the rules for taxing debt, equity or derivatives. Accordingly the hybrid financial instrument rule will not apply in Country A.

8. The payment under the arrangement would be deemed to be a financial instrument under Country A law, however, if the way the transaction is structured results in both A Co and B Co being treated as the owner of the transferred shares at the same time. In such a case the payment of the interest component under the asset transfer agreement would be required to be treated, under Country A law as a deductible payment under a financial instrument that would give rise to a hybrid mismatch for tax purposes.

The substitute payment rule does not apply in Country A

9. The substitute payments rules in Recommendation 1.2(e) neutralise any D/NI outcome in respect of certain payments made under an asset transfer agreement. The rule only applies, however, to a taxpayer that transfers a financial instrument for a consideration that includes an amount representing a financing or equity return on the underlying instrument. In this case the interest paid under the asset transfer agreement has not been calculated by reference to the return on the underlying asset. Accordingly the interest payment does not fall within the scope of the substitute payments rule.

The interest component of the purchase price is subject to the hybrid financial instrument rule in Country B

10. B Co does not treat the interest portion of the purchase price as subsumed within the sale consideration but rather treats it as a separate and deductible financing cost. As such, the payment falls to be taxed under the rules for taxing debt or financial derivatives

in Country B and should therefore be treated as falling within the scope of the hybrid financial instrument rule.

11. The interest payment gives rise to a D/NI outcome because the payment has no independent significance under Country A law and is simply treated as a component of the purchase price paid for the shares. This mismatch in tax outcomes is attributable to the differences in the tax treatment of the share sale agreement under Country A and Country B laws and is therefore a hybrid mismatch subject to adjustment under the hybrid financial instrument rule in Country B.

12. In a case where the counterparty to the arrangement does not treat the adjustment as a payment under a financial instrument, the amount of the adjustment should be limited to the portion that is treated, under Country B law, as giving rise to a financing or equity return.

Example 1.28

Interest paid by a trading entity

Facts

1. This Example is the same as **Example 1.27** except that B Co acquires the asset as part of its activities as a trader and is entitled to include the purchase price as expenditure when calculating its (taxable) return on the asset.

Question

2. To what extent does the hybrid financial instrument rule apply to adjust the ordinary tax consequences for A Co and B Co in respect of the purchase price?

Answer

3. The adjustments required under the hybrid financial instrument rule are the same as set out in **Example 1.27**, however, denying a deduction for the interest component of the purchase price paid by B Co (i.e. the deduction that is attributable to the terms of the instrument) should not affect B Co's ability to take the full amount payable under the asset transfer agreement into account when calculating any taxable gain or loss on the acquisition and disposal of the asset.

Analysis

The interest component of the purchase price is a payment that is subject to the hybrid financial instrument rule in Country B

4. As described in further detail in the analysis part of **Example 1.27**, Country B law treats the payment as a separate and deductible financing cost and, as such, the payment should be treated as falling within the scope of the hybrid financial instrument rule to the extent it gives rise to a D/NI outcome.

The adjustment under Country B law should not affect the ability of B Co to claim a deduction for the expenditure incurred in acquiring a trading asset

5. A taxpayer's net return from trading or dealing in securities in the ordinary course of business will often be subject to tax as ordinary income. The income, expenses, profits, gains and losses from buying, holding and selling those securities will be included in, or deducted from, taxable income, as the case may be, regardless of what the ordinary rules would otherwise be for taxing payments under those instruments or how those amounts are accounted for on the balance sheet or income statement. The hybrid financial instrument rule should not prevent the trader from being able to claim a deduction for an

expense incurred in respect of the acquisition of a trading asset in the ordinary course of its business provided the taxpayer is fully taxable on the net return from those trading activities.

6. In general, therefore, the deduction that a trader is entitled to claim for the cost of acquiring an asset in the ordinary course of its trade should not be affected by the application the hybrid financial instrument rule. The deduction claimed by the trading entity will not be attributable to the terms of instrument under which payment is made but rather because the trader's particular status entitles it to bring all expenditure into account for tax purposes.

7. Even in cases where the trader would ordinarily rely on the particular tax character of the payment to determine its tax consequences (such as in respect of the payment of interest) the trader should be able to continue to deduct that payment, notwithstanding the operation of the hybrid financial instrument rule, provided that deduction is consistent with the taxpayer's status as a trader. Therefore, in the present case, the denial of the interest deduction under the hybrid financial instrument rules should not affect the ability of a trader to claim a deduction for the consideration paid to acquire the financial instrument.

Example 1.29

Interest paid to a trading entity

Facts

1. The facts of this example are the same as **Example 1.27** except that A Co sells the asset as part of its activities as a trader and is required to bring the entire amount of the payment into account as ordinary income when calculating its (taxable) return on the asset.

Question

2. To what extent does the hybrid financial instrument rule apply to adjust the ordinary tax consequences for A Co and B Co in respect of the purchase price?

Answer

3. The adjustments required under the hybrid financial instrument rule are the same as set out in **Example 1.27**. The fact that A Co may treat the amount of interest paid under the asset sale agreement as taxable gain should not affect the amount of the adjustment required under Country B law.

Analysis

The interest component of the purchase price is a deductible payment under a hybrid financial instrument

4. As described in further detail in the Analysis of **Example 1.27**, Country B law treats the interest portion of the payment as a separate and deductible financing cost and, as such, it should be treated as a deductible payment under a financial instrument for the purposes of Country B law.

The interest component of the purchase price is not included in ordinary income under Country A law

5. The interest component of the purchase price should not be treated as payment under a financial instrument that has given rise to ordinary income under the laws of Country A, even though A Co may be required to bring all or a portion of the consideration for the disposal of that asset into account as ordinary income for tax purposes.

6. In determining whether a payment under a financial instrument has given rise to a mismatch in tax outcomes the hybrid financial instrument rule looks only to the expected

tax treatment of the payment under the laws of the counterparty jurisdiction rather than its actual tax treatment in the hands of the counterparty. The fact that A Co is a trader and may include by the payment in ordinary income as proceeds from the disposal of trading assets will not impact on the determination of whether the terms of the instrument and the payments made under it are expected to give rise to a D/NI outcome.

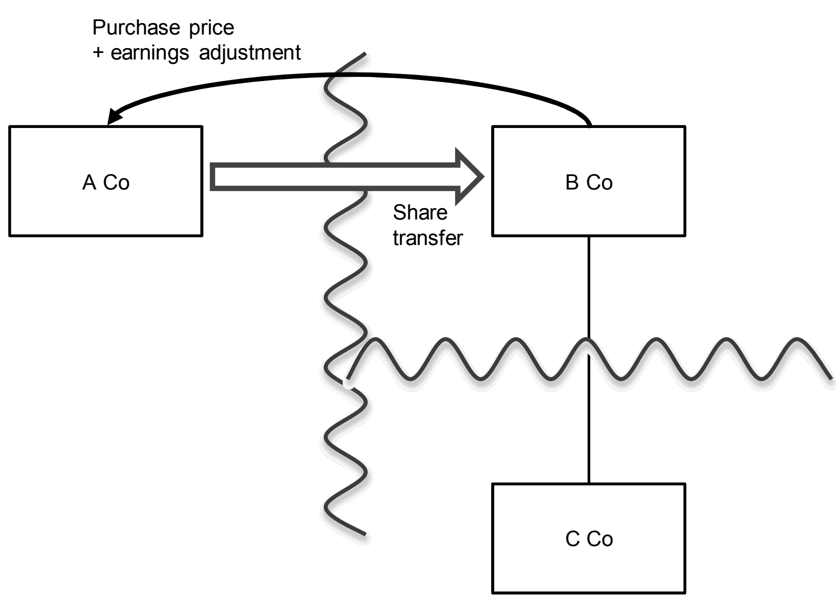
Example 1.30

Purchase price adjustment for retained earnings

Facts

1. In the example illustrated in the figure below, A Co (a company resident in Country A) transfers shares in C Co, a wholly-owned subsidiary resident in Country C, to B Co, a company resident in Country B, under a share sale agreement. B Co pays fair market value for the shares. While the share transfer occurs on the same day as the payment the sale takes place part-way through C Co's accounting period.

2. A Co is entitled to an adjustment to the purchase price. The amount of the adjustment will be calculated by reference to the operating income of C Co at the end of the accounting period. This adjustment is treated as a deductible expense under Country B law while A Co treats the payment as consideration from the disposal of a capital asset and subject to tax at preferential rates.



Question

3. Does the adjustment payment fall within the scope of the hybrid financial instrument rule?

Answer

4. The hybrid financial instrument rule should be applied in Country B to deny a deduction for the payment if the payment is made under a structured arrangement.

5. While the hybrid financial instrument rule will not generally apply in Country A (because A Co does not treat the payment as made under a financial instrument) the payment constitutes the payment of an equity return on the transferred shares that could be subject to adjustment under the substitute payment rules.

Analysis

Whether the asset transfer agreement should be treated as a financial instrument should be determined under local law

6. The share sale contract could fall within the definition of financial instrument for the purposes of the hybrid financial instrument rule because it provides A Co with an equity based return. The report encourages countries to take reasonable endeavours to ensure that the hybrid mismatch rules apply to instruments that produce a financing or equity return in order to ensure consistency in the application of the rules. The intention of the rules, however, is not to achieve harmonization in the way financial instruments are treated for tax purposes and, in hard cases, it should be left to local laws to determine the dividing line between financing instrument and other types of arrangement provided this is consistent with the overall intent of the rules.

Application of the hybrid financial instrument rule in Country B

7. Country B law does not treat the adjustment to the purchase price as subsumed within the consideration for the share sale but rather treats it as a separate deductible expense. The adjustment payment is in respect of an equity return under a financial instrument and should therefore be treated as a payment under a financial instrument under Country B law.

8. The adjustment payment gives rise to a D/NI outcome because the payment has no independent significance under Country A law and is simply treated as a component of the purchase price. The payment should be treated as giving rise to a D/NI outcome regardless of whether A Co is required to treat consideration from a share sale as ordinary income (see the analysis in **Example 1.29**). This mismatch in tax outcomes is attributable to the differences in the tax treatment of the share sale agreement under Country A and Country B laws and is therefore a hybrid mismatch subject to adjustment under the hybrid financial instrument rule in Country B.

9. Where, as in this case, one country treats the arrangement as a financial instrument and the other does not, the adjustment made by the country applying the rule should be limited to the portion of the payment that is treated as giving rise to the equity return.

Application of the substitute payment rule in Country A

10. A Co does not treat the payment as made under a financial instrument (because the entire amount payable is treated under Country A law as consideration for the sale of shares).

11. If the hybrid financial instrument rule does not apply in Country B to neutralise the mismatch in tax outcomes the payment may still, however, be caught by the substitute payments rule in Recommendation 1.2(e). Under this rule, a taxpayer that sells a financial instrument for a consideration that includes an amount representing an equity return on the underlying instrument (a substitute payment), is required to include such payment in income if the substitute payment is deductible under the laws of the counterparty jurisdiction and the underlying equity return would have been taxable if it had been paid directly under the financial instrument. Therefore, in this example, if A Co would have treated a dividend from C Co as ordinary income, the payment would be treated as a substitute payment and subject to adjustment under those rules.

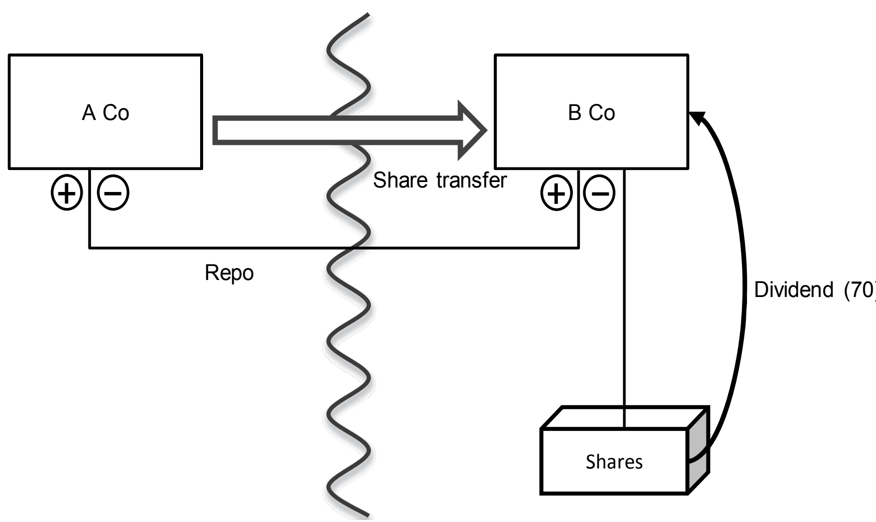
Example 1.31

Loan structured as a share repo

Facts

1. In the example illustrated in the figure below, A Co, a company resident in Country A, wishes to borrow money from B Co, an unrelated lender resident in Country B. B Co suggests structuring the loan as a sale and repurchase transaction (repo) in order to provide B Co with security for the loan and to secure a B Co with a lower tax cost (and therefore a lower financing cost for the parties) under the arrangement.

2. Under the repo, A Co transfers shares to B Co under an arrangement whereby A Co (or an affiliate) will acquire those shares at a future date for an agreed price that represents a financing return minus any distributions received on the B Co shares during the term of the repo.



3. This type of financing arrangement can be described as a "net paying repo". This is because B Co (the lender under the arrangement and the temporary holder of the shares during the term of the repo) does not pay the dividends that it receives on the underlying shares across to A Co (the economic owner of the shares). Rather those dividends are retained by B Co as part of its overall return under the financing arrangement.

4. In this example it is assumed that Country B taxes the arrangement in accordance with its form. B Co is taxed as if it were the beneficial owner of the dividends that are paid on the underlying shares and is entitled to claim the benefit of exemption in respect of such dividends under Country B law. Country A taxes the arrangement in accordance with its economic substance. For Country A tax purposes, the repo is treated as a loan to

A Co that is secured against the transferred shares. A Co is regarded as the owner of the shares under Country A law with the corresponding entitlement to dividends that are paid on those shares during the life of the repo. Under Country A's tax system, A Co is taxed on the dividend, grossed up for underlying (deemed-paid) tax on the profits out of which the dividend is paid and credit is given for that underlying tax. Because, however, this repo is a net paying repo, where the lender retains the dividend as part of the agreed return on the loan, A Co is also treated as incurring a deductible financing expense equal to the amount of the dividend retained by B Co.

5. Assume that the amount B Co initially pays for the shares is 2 000. The term of the repo is one year and the agreed financing return is 3.5%. A Co would therefore normally be obliged to buy back the shares for 2 070. In this case, however, B Co receives and retains a dividend of 70 on the shares which means that the repurchase price of the shares is 2 000 (although the net cost of the repo for A Co is 70). Below is a table setting out the tax position of A Co and B Co under this structure.

A Co			B Co		
	Tax	**Book**		**Tax**	**Book**
Income			Income		
Dividend	70	70	Dividend	0	70
Gross up for deemed tax paid	30	0			
Expenditure			Expenditure		
Expenditure under repo	(70)	(70)			
Net return		**0**	**Net return**		**70**
Taxable income	**30**		**Taxable income**	**0**	
Tax (30%) on net income	(9)				
Tax credit	30				
Tax benefit		21	Tax to pay		0
After-tax return		**21**	**After-tax return**		**70**

6. As illustrated in the table above, B Co receives a dividend of 70 which is treated as tax exempt under Country B law. The dividend exactly matches B Co's contractual entitlement to the return under the repo. B Co acquires the shares and disposes of them at the same price and accordingly has no gain that might otherwise be subject to tax in Country B.

7. A Co also includes this dividend in its own income tax calculation together with an indirect foreign tax credit of 30. A Co is entitled however, to deduct the net expenditure under the repo (including the dividend retained by B Co). This deduction may be because the laws of Country A characterise the repo as a loan (i.e. a financial instrument) and treat the amount of the dividend that is paid to, and retained by, B Co as interest under that loan or because Country A law treats the net return from these types of arrangements (i.e. share repos) as giving rise to an allowable loss or taxable gain, so that, given the nature of the arrangement between the parties, the amount of the dividend that

is paid to, and retained by, B Co will be taken into account as deduction in calculating A Co's taxable income.

8. While, from A Co's perspective, the arrangement may give rise to an outcome that is not materially different from an ordinary loan, the arrangement generates a tax benefit for B Co in that, A Co's financing costs are paid for by a dividend of 70 that is not included in ordinary income by B Co due to the operation of the dividend exemption in Country B.

Question

9. Whether the arrangement falls within the scope of the hybrid financial instrument rule and, if so, to what extent an adjustment is required to be made in accordance with that rule.

Answer

10. The repo is a hybrid transfer and the payment of the dividend on the underlying shares gives rise to a D/NI outcome as between the parties to the repo. Country A treats the dividend paid on the transferred shares as a deductible expense under the repo while Country B treats the same payment as a return on the underlying shares (and, accordingly, as exempt from taxation). This resulting mismatch is a hybrid mismatch because it is attributable to the difference in the way Country A and B characterise and treat the payments made under the repo.

11. Although A Co and B Co are not related parties, the arrangement was designed to produce the mismatch in tax outcomes and therefore falls within the scope of the hybrid financial instrument rule. Accordingly Country A should deny a deduction for the financing costs under the arrangement. In the event that Country A does not apply the recommended response under the hybrid financial instrument rule, the financing return should be included in ordinary income under the laws of Country B.

Analysis

Recommendation 2.1 does not apply to the arrangement.

12. It may be the case that Country B has implemented rules, consistent with Recommendation 2.1 that would remove the benefit of a dividend exemption in cases where the payment is deductible for tax purposes. In this case, however, Recommendation 2.1 will not generally apply, as this rule only looks to the tax treatment of the payment under the laws of the issuer's jurisdiction and whether the issuer was entitled to a deduction for such payment. Because the dividend is not deductible for the issuer but for A Co (the counterparty to the repo) changes to domestic law recommended in Recommendation 2.1 would not generally restrict B Co's entitlement to an exemption on the dividend.

The arrangement is a financial instrument under Country A law

13. Country A either characterises the dividend that is paid to B Co under the terms of the repo as interest on a loan or otherwise allows taxpayers to bring into account the net expenditure under this type of arrangement as a deduction in calculating A Co's

taxable income. Accordingly the repo should be treated as falling within the hybrid financial instrument rule under Country A law.

The arrangement is a hybrid transfer under Country B law

14. The repo is a hybrid transfer because:

(a) under the laws of Country B, B Co is the owner of the shares and A Co's rights in those shares are treated as B Co's obligation to sell the shares back to A Co; and

(b) under the laws of Country A, A Co is the owner of the shares while B Co's rights in those shares are treated as a security interest under a loan.

Therefore, even if the repo is characterised as simple asset transfer agreement under the laws of Country B, the payments that are made under the repo must be treated as made under a financial instrument for purposes of the hybrid financial instrument rule in Country B and will be subject to an adjustment to the extent they give rise to a mismatch in tax outcomes that is attributable to the terms of the instrument.

The payment under the repo gives rise to a hybrid mismatch

15. The hybrid financial instrument rule applies when a deductible payment under a financial instrument is not included in ordinary income under the laws of the payee jurisdiction and the mismatch in tax outcomes is attributable to the terms of the instrument.

16. In this case, the repo transaction is treated as a financial instrument under Country A law. The payment that gives rise to the D/NI outcome is the dividend on the transferred shares that is retained by B Co under the repo. This dividend is treated as a deductible expense of A Co and is not included in ordinary income under the laws of Country B. This difference in tax outcomes is attributable to differences between Country A and B laws in the tax treatment of the repo.

17. Although, under local law, B Co would ordinarily have treated the payment that gives rise to the D/NI outcome as a separate payment on the underlying shares (and not a payment under the repo itself), because, in this case, the asset transfer arrangement constitutes a hybrid transfer, B Co is required to take into account the way that payment is characterised under the laws of Country A.

A mismatch would still arise even if dividend was treated as ordinary income under Country A law

18. On the facts of this example, the dividend on the underlying shares is treated under Country A law as carrying a right to credit for underlying taxes paid by the issuer and is therefore not included in ordinary income when it is treated as received by A Co. As with other types of financial instrument, however, the hybrid transfer rules do not take into account whether the funds A Co obtains under the repo have been invested in assets that generate ordinary income. The adjustment that is required to be made under the hybrid financial instrument rule will therefore not be affected by whether A Co treats the dividend on the transferred shares as ordinary income.

The arrangement is structured

19. The facts state that one of the reasons for structuring the loan as a repo is to secure a lower tax cost for the parties under the arrangement. The facts of the

arrangement indicate that it has been designed to produce a mismatch. In this case, where the parties to the repo are unrelated, the parties will have agreed a lower financing rate than they would have agreed if the return on the repo had been taxable in Country B.

Adjustment under Country A law

20. The primary recommendation under the hybrid financial instrument rule is that Country A should deny A Co a deduction for the financing expenses under the repo to the extent such expenses are not included in ordinary income.

Adjustment under Country B law

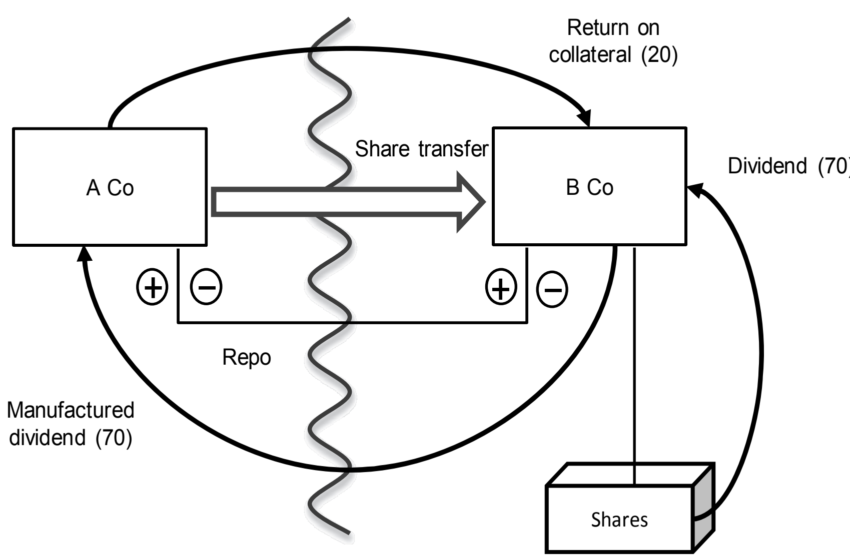
21. While Country B does not treat the repo as a financial instrument for domestic law purposes, the arrangement will, nevertheless, fall within the scope of the hybrid financial instrument rule under Country B law because it is a hybrid transfer. If the mismatch in tax outcomes is not neutralised by Country A denying a deduction for the financing expense under the repo then this amount should be treated as included in income under Country B law.

Example 1.32

Share lending arrangement

Facts

1. The figure below illustrates a share lending arrangement. A share loan is similar to the repo (described in **Example 1.31**) in that shares are transferred to a temporary holder (the borrower) under an arrangement to return those shares at a later date so that the transferor (the lender) continues to be exposed to the full risk and return of holding the shares through the obligations owed by the counterparty under the asset transfer agreement. The difference between a repo and a share lending arrangement is that the original transfer of the shares is not for a defined amount of consideration. Instead the borrower's obligation is to transfer the same or identical securities back to the lender at a later date.



2. The lender of shares will wish to protect itself from the risk of a default by the borrower so, in most commercial share-lending transactions, the lender will require the borrower to post collateral of value at least equal to the value of the borrowed shares. Often this collateral is in the form of investment grade debt securities. Commercial securities lending arrangements will provide for the borrower to receive a return on the posted collateral and for the lender to be paid a fee which may be taken out of the income on the collateral.

3. Under both share lending and repo transactions it is possible – or even intended – that a payment of interest or dividend will arise during the course of the stock loan or repo. If the shares are not returned to the lender before a dividend is paid on the shares,

the lender will generally demand a "manufactured payment" from the borrower equivalent to what would otherwise have been payable on the underlying shares. This situation can be contrasted with that of a net-paying repo, described in **Example 1.31**, where the re-purchase price is defined in the agreement and is reduced by any dividend or interest payments paid to and retained by the temporary holder of the securities.

4. A common reason for undertaking a securities lending transaction is that the borrower has agreed to sell the shares 'short' (i.e. shares the borrower does not have) and needs to deliver these shares to the purchaser. The borrower anticipates that the shares will be able to be acquired back at a later date for a lower price and can then be transferred back to the lender realising a gain reflecting the difference between the sales proceeds and the subsequent market purchase price, as reduced by any cost of the share lending arrangement. In this example, B Co borrows shares under a share loan from A Co (a member of the same control group) intending to sell the shares 'short'. In this case, however, the subsequent disposal of the shares does not take place and B Co ends up holding the shares over a dividend payment date. B Co is therefore required to make a manufactured dividend payment to A Co equal to the amount of the dividend received on the underlying shares. A simplified illustration of the tax consequences of such an arrangement is set out below:

A Co			B Co		
	Tax	**Book**		**Tax**	**Book**
Income			Income		
Fee paid by B Co	5	5	Interest paid by A Co	25	25
Interest on collateral	25	25	Dividend on borrowed shares	-	70
Exempt dividend	-	70			
Expenditure			Expenditure		
			Fee paid to A Co	(5)	(5)
Interest paid to B Co	(25)	(25)	Manufactured dividend	(70)	(70)
Net return		**75**	**Net return**		**20**
Taxable income	**5**		**Taxable income**	**(50)**	

5. During the terms of the loan A Co earns interest on the collateral posted by B Co. A Co pays both the collateral and the interest earned on this collateral back to B Co at the end of the transaction minus a fee. B Co retains the borrowed shares over a dividend payment date and makes a manufactured payment of that dividend to A Co. B Co is entitled to claim the benefit of an exemption on the underlying dividend but is entitled to treat the manufactured dividend as a deductible expense. This deduction may be because the laws of Country B specifically grant a deduction for manufactured dividends or because Country B law treats the net return from these types of arrangements (i.e. share loans) as giving rise to an allowable loss or taxable gain, so that, given the nature of the arrangement between the parties, the amount paid to A Co under the share loan will be taken into account as deduction in calculating A Co's taxable income.

6. Country A law disregards the transfer of the shares under the arrangement and treats A Co as if it continued to hold the shares during the term of the share loan. The manufactured dividend payment is treated as if it were an exempt dividend on the

underlying share so that A Co has no net tax to pay under the arrangement (other than on the stock-lending fee it receives from B Co).

7. The net effect of this arrangement is that B Co has incurred a net deductible expense of 70 for the payment of the manufactured dividend which is not included in ordinary income by A Co. The total income under the arrangement (including the dividend received and the interest earned on the collateral) is 95, however, for tax purposes, the transaction generates a net loss of 50 for B Co and A Co is only taxable on the share lending fee.

Question

8. Whether the arrangement falls within the scope of the hybrid financial instrument rule and, if so, to what extent an adjustment is required to be made in accordance with that rule.

Answer

9. The share loan is a hybrid transfer and the payment of the manufactured dividend under the share loan gives rise to a D/NI outcome. The payments under the repo give rise to a deduction in Country B that is attributable to the terms of the arrangement between the parties, while Country A treats the same payment as a return on the underlying shares (and, accordingly, as exempt from taxation). Therefore the mismatch in tax outcomes should be treated as a hybrid mismatch because it is attributable to differences in the way Country A and B characterise and treat the payments under a share loan.

10. Furthermore, on the facts of this example the manufactured payment will be a substitute payment so that the manufactured payment will be brought within the scope of the hybrid financial instrument rule even in a case where the deduction claimed by B Co is not attributable to the tax treatment of payments on the share loan but to the acquisition and disposal of the underlying shares.

11. A Co and B Co are related parties and the arrangement therefore falls within the scope of the hybrid financial instrument rule. Accordingly Country B should deny a deduction for the financing costs under the arrangement regardless of the basis for the deduction claimed by B Co. In the event that Country B does not apply the recommended response under the hybrid financial instrument rule, the financing return should be included in ordinary income under the laws of Country A.

Analysis

Recommendation 2.1 does not apply to the arrangement

12. It may be the case that Country A has implemented rules, consistent with Recommendation 2.1 that would remove the benefit of a dividend exemption in cases where the payment is deductible for tax purposes. In this case, however, Recommendation 2.1 will not generally apply, as this rule only looks to the tax treatment of the payment under the laws of the issuer's jurisdiction and whether the issuer was entitled to a deduction for such payment. In this case the dividend is not deductible for the issuer but for B Co (the counterparty to the repo) and, accordingly, the changes to domestic law recommended in Recommendation 2.1 would not generally restrict A Co's entitlement to an exemption on the dividend.

The arrangement is a financial instrument under Country B law

13. The deduction that B Co claims for the manufactured dividend does not result from a trading loss on the borrowed shares (contrast the facts in **Example 1.34**), rather, the deduction is attributable to the tax treatment of payments under a share loan. A taxpayer in Country B will be entitled to deduct the manufactured dividend regardless of its particular status or the way it deals with the underlying shares. In such a case, where Country B specifically grants taxpayers a deduction for manufactured dividend payments, Country B should treat such amounts as paid under a financial instrument and potentially subject to adjustment under the hybrid financial instrument rule.

The arrangement is a hybrid transfer that should be treated as a financial instrument under Country A law

14. While Country A ignores the existence of the share loan and does not treat it as a financial instrument for domestic law purposes, the arrangement will, nevertheless, fall within the scope of the hybrid financial instrument rule because it is an asset transfer agreement where:

(a) under the laws of Country A, A Co is treated as the owner of the shares with B Co's rights in the shares being treated as a loan made by A Co; and

(b) under the laws of Country B, B Co is the owner of the shares under the transfer and A Co's rights in those shares are treated as B Co's obligation to transfer the shares back to A Co.

The share loan is therefore a hybrid transfer within the scope of the hybrid financial instrument rule notwithstanding that the arrangement is not treated as a financial instrument under Country A law.

The payment under the share loan gives rise to a hybrid mismatch

15. The hybrid financial instrument rule applies when a deductible payment under a financial instrument is not included in ordinary income under the laws of the payee jurisdiction and the mismatch in tax outcomes is attributable to the terms of the instrument.

16. In this case, the share lending transaction is treated as a financial instrument under Country B law. The payment that gives rise to the D/NI outcome is the manufactured dividend which is treated as a deductible expense by B Co and is not included in ordinary income under the laws of Country A. This difference in tax outcomes is attributable to differences between Country A and B laws in the tax treatment of the share loan.

17. Although under local law, A Co would ordinarily have treated the manufactured dividend payment that gives rise to the D/NI outcome as a separate payment on the underlying shares (and not a payment under the share loan itself), because, in this case, the asset transfer arrangement constitutes a hybrid transfer, A Co is required to take into account the way that payment is characterised under the laws of Country B.

A mismatch would still arise even if dividend was treated as ordinary income under Country B law

18. On the facts of this example, the dividend on the underlying shares is treated as exempt under Country B law. As with other types of financial instrument, however, the

hybrid transfer rules are not affected by whether the funding provided under the share loan has been invested in assets that generate an ordinary income return. The adjustment that is required to be made under the hybrid financial instrument rule will therefore not be dependent on the tax treatment of the dividend under the laws of Country A. This principle is illustrated in **Example 1.33**.

Tax treatment of B Co in the event payment of manufactured dividend gives rise to a trading loss

19. The adjustment that is required to be made under the hybrid financial instrument rule is generally confined to adjusting those tax consequences that are attributable to the tax treatment of the instrument itself. The adjustment is not intended to impact on tax outcomes that are solely attributable to the status of the taxpayer or the context in which the instrument is held. Thus, as set out in further detail in **Example 1.34**, the denial of the deduction in Country B under the hybrid financial instrument rule should not generally impact on the position of a financial trader in relation to the taxation of any net gain or loss in respect of its share trading business.

20. Note, however, in this case, that manufactured dividend is a substitute payment that falls within the scope of Recommendation 1.2(e) as it is a payment of an amount representing an equity return on the underlying shares. The substitute payment rules apply to any type of D/NI outcome regardless of whether such outcome is attributable to the terms of the instrument, the tax status of the parties or the context in which the asset is held. Unlike the rules applying to hybrid mismatches under a financial instrument, the substitute payment rules are only triggered, however, where differences between the tax treatment of the substitute payment and the underlying return on the instrument have the potential to undermine the integrity of the hybrid financial instrument rule. In particular, a substitute payment that gives rise to a D/NI outcome will be subject to adjustment where the underlying financing or equity return on the transferred asset is treated as exempt or excluded from income in the hands of the transferee. On these facts, therefore, where the underlying dividend paid to B Co is tax exempt, the payment of the manufactured dividend will be treated as giving rise to a mismatch in tax outcomes regardless of the basis for the deduction claimed under Country B law.

Adjustment under Country B law

21. The primary recommendation under the hybrid financial instrument rule is that Country B should deny a deduction for the manufactured dividend to the extent the dividend is not included in ordinary income under Country A law.

Adjustment under Country A law

22. While Country A does not treat the repo as a financial instrument for domestic law purposes, the arrangement will, nevertheless, fall within the scope of the hybrid financial instrument rule under Country A law, either because it is a hybrid transfer or because the dividend is a substitute payment. If the mismatch in tax outcomes is not neutralised by Country B denying a deduction for the manufactured dividend under the share loan then this amount should be treated as included in income under Country A law.

Example 1.33

Share lending arrangement where transferee taxable on underlying dividend

Facts

1. In this example the facts are the same as in **Example 1.32** except that the dividend paid on the underlying shares is treated as taxable under Country B law. A simplified illustration of the tax consequences of such an arrangement is set out below.

A Co			B Co		
	Tax	Book		Tax	Book
Income			Income		
Fee paid by B Co	5	5	Interest paid by A Co	25	25
Interest on collateral	25	25	Dividend on borrowed shares	70	70
Exempt dividend	-	70			
Expenditure			Expenditure		
			Fee paid to A Co	(5)	(5)
Interest paid to B Co	(25)	(25)	Manufactured dividend	(70)	(70)
Net return		**75**	**Net return**		**20**
Taxable income	**5**		**Taxable income**	**20**	

2. As in **Example 1.32**, Country A law disregards the transfer of the shares under the arrangement and treats A Co as if it continued to hold the shares during the term of the share loan. The manufactured dividend payment is treated as if it were an exempt dividend on the underlying shares so that A Co has no net tax to pay under the arrangement (other than on the stock-lending fee).

3. Under Country B law, B Co is treated as deriving a taxable dividend on the borrowed shares and is entitled to a deduction for the manufactured dividend it pays to A Co. B Co is also taxable on the interest paid on the collateral and thus has a net return equal to its taxable income.

4. The net effect of this arrangement, both from a tax and economic standpoint, and after taking into account the tax treatment of the underlying dividend received by B Co, is that both parties are left in the same position as if the transaction had not been entered into (save that A Co derives a stock-lending fee).

Question

5. Whether the share lending arrangement falls within the scope of the hybrid financial instrument rule?

Answer

6. The share loan is a hybrid transfer and the payment of the manufactured dividend under the share loan gives rise to a D/NI outcome. Country B treats the manufactured dividend as a separate deductible expense while Country A treats the same payment as a return on the underlying shares (and, accordingly, as exempt from taxation). Therefore the mismatch in tax outcomes should be treated as a hybrid mismatch because it is attributable to differences in the way Country A and B characterise and treat the payments made under the hybrid transfer.

7. As with other types of financial instrument, the hybrid transfer rules do not take into account whether the funds obtained under the transfer have been invested in assets that generate a taxable or exempt return. The adjustment that the transferor is required to make in respect of payment under a repo or stock loan is not be affected by the fact that B Co is taxable on the underlying dividend.

8. No adjustment will be required, however, under the hybrid financial instrument rule in Country B, if B Co is a trader that acquires the shares as part of a share dealing business, provided B Co will be subject to tax on the net return from the acquisition, holding and disposal of that asset. Although the manufactured dividend is a substitute payment that gives rise to a D/NI outcome, no adjustment will be required under the substitute payment rule as B Co is taxable on the dividend it receives on the underlying shares and A Co would not ordinarily have been required to include that dividend in income.

9. In this case, the arrangement is unlikely to be a structured arrangement (as both parties are left in the same after-tax position as if the transaction had not been entered into). Therefore the hybrid financial instrument rule will generally only apply where A Co and B Co are related parties.

Analysis

The payment under the share loan gives rise to a hybrid mismatch

10. As discussed further in **Example 1.32**, the share lending arrangement is treated as a financial instrument under Country B law and a hybrid transfer under Country A law and the payment of a manufactured dividend gives rise to a D/NI outcome that is attributable to the terms of the instrument. Accordingly the analysis that applies to this arrangement is the same as set out in **Example 1.32** and the payment should be treated as subject to adjustment under the hybrid financial instrument rule.

11. Although, on the facts of this case, the transaction does not generate a tax advantage for either A Co or B Co, this is because B Co retained the borrowed shares and derived a taxable return on the underlying dividend. The underlying policy of Recommendation 1 is to align the tax treatment of the payments made under a financing or equity instrument so that amounts that are not fully taxed in the payee jurisdiction are not treated as a deductible expense in the payer jurisdiction. The operation of the hybrid financial instrument rule looks only to the expected tax treatment of the payments under the instrument and does not take into account whether the income funding the expenditure under the arrangement is subject to tax in the payer jurisdiction. B Co is no different position from what it would have been had it borrowed money from A Co under an ordinary hybrid financial instrument and invested the borrowed funds in an asset that generates a taxable return.

Tax treatment of B Co in the event payment of manufactured dividend gives rise to a trading loss

12. The adjustment that is required to be made under the hybrid financial instrument rule is, however, generally confined to adjusting those tax consequences that are attributable to the tax treatment of the instrument itself. The adjustment is not intended to impact on tax outcomes that are solely attributable to the status of the taxpayer or the context in which the instrument is held. Thus, as set out in further detail in **Example 1.34**, the denial of the deduction in Country B under the hybrid financial instrument rule should not generally impact on the position of a financial trader in relation to the taxation of any net gain or loss in respect of its share trading business

13. Furthermore the manufactured dividend is not a substitute payment that falls within the scope of Recommendation 1.2(e) as the dividend on the underlying shares is both taxable as ordinary income under Country B law and treated as exempt under Country A law. Therefore, if B Co is a trader that acquires the shares as part of its trade, it should be permitted to take the manufactured dividend into account as a deduction when calculating its net income.

Example 1.34

Share lending arrangement where manufactured dividend gives rise to a trading loss

Facts

1. This example has the same facts as **Example 1.33** except that B Co is a share trader that, under Country B law, is required to include the net return from its trading activities in income. B Co borrows shares from A Co (a member of the same control group) in order to sell them 'short'. During the term of the share loan B Co is required to make a manufactured dividend payment to A Co. B Co then acquires the same shares on the market and returns them to A Co to satisfy its obligations under the share lending arrangement.

2. As noted in **Example 1.32**, a common reason for undertaking a securities lending transaction is that the borrower has agreed to sell the shares 'short' (i.e. shares the borrower does not have) and needs to deliver these shares to the purchaser. The borrower anticipates that the shares will be able to be acquired back at a later date for a lower price and can then be transferred back to the lender realising a gain reflecting the difference between the sales proceeds and the subsequent market purchase price, as reduced by any cost of the share lending arrangement. In this example B Co may have expected the value of the shares to fall, first once the shares become "ex-dividend" and subsequently still further reflecting its "bearish" view on the shares, in the event the value of the shares does not fall and B Co ends up repurchasing the shares for an amount equal to the original proceeds from the short sale. A simplified illustration of the tax consequences of such an arrangement is set out below:

A Co			B Co		
	Tax	Book		Tax	Book
Income			Income		
Fee paid by B Co	5	5	Interest paid by A Co	25	25
Interest on collateral	25	25			
Exempt dividend	-	70			
Expenditure			Expenditure		
			Fee paid to A Co	(5)	(5)
Interest paid to B Co	(25)	(25)	Net expenditure under share loan	(70)	(70)
Net return		**75**	**Net return**		**65**
Taxable income	**5**		**Taxable income**	**(50)**	

3. In this case, B Co borrows the shares from A Co and sells them to an unrelated party for their market value of 1 000. B Co eventually acquires these shares back, in this case, at the same price (1 000) and returns them to A Co to close-out the transaction. B Co incorporates the cost of the manufactured dividend into the calculation of its overall taxable gain or loss on the share trade as follows:

	B Co
Proceeds from the on-market sale of borrowed shares	1 000
Additional amount paid to A Co in respect of manufactured dividend	(70)
Cost of re-acquiring shares on-market	(1 000)
Total return on trade	(70)

4. B Co has made a total loss on the share trade of 70 which, when added to the income derived on the posted collateral, gives B Co a loss for the period. A Co treats the manufactured dividend as an exempt return on the underlying share.

Question

5. Whether the share lending arrangement falls within the scope of the hybrid financial instrument rule?

Answer

6. Although the share loan is treated as a hybrid transfer, the adjustment to be made under the hybrid financial instrument rule should not affect B Co's deduction for the manufactured dividend to the extent Country B law requires that payment to be taken into account in calculating B Co's (taxable) return on the overall trade.

7. The manufactured dividend will, however, constitute a substitute payment subject to adjustment under Recommendation 1.2(e), if Country B law would not have treated B Co as subject to tax at the full rate on the underlying dividend.

Analysis

Manufactured dividend gives rise to a trading loss and is not treated as a deductible payment under a financial instrument

8. The hybrid financial instrument rule is not generally intended to impact on a country's domestic rules for taxing the gain or loss on the acquisition and disposal of property. Similarly, a trading entity should be entitled to take into account all the amounts paid or received in respect of the acquisition, holding or disposal of a trading asset for the purposes of calculating its net income from its trading activities even where such amounts are paid or received under a financial instrument such as a share loan.

9. The policy basis for the deduction claimed by B Co in this case is not the fact that the payment constitutes a financing expense but rather the fact that all the expenditure needs to be taken into account in order to calculate the overall return on the trade. The deduction is thus, not attributable to the terms of the instrument, but rather to the

taxpayer's particular tax treatment and the nature of the underlying asset that is the subject matter of the trade.

10. The hybrid financial instrument rule should not operate to restrict the ability of the trading entity to claim a deduction in respect of a payment under a financial instrument provided the payment is made as part of that trading activity and the taxpayer will be fully taxable on the net return from that trading activity. The precise mechanism by which the trader obtains the benefit of the deduction should not affect the trader's entitlement to claim such deduction provided the net return from the acquisition, holding and disposal of the shares will be subject to tax as ordinary income.

Manufactured dividend could be a substitute payment subject to adjustment under Recommendation 1

11. The manufactured dividend is a payment of an equity return under an asset transfer agreement that gives rise to a D/NI outcome and may therefore fall within the scope of the substitute payment rules. While, in this case, Recommendation 1.2(e)(ii) will not apply (as the example indicates that Country A law would treat the underlying dividend as exempt) the rule could still apply if the laws of Country B would otherwise have treated the dividend on the underlying shares as exempt or eligible for some other type of tax relief. The fact that B Co does not actually receive a dividend on the underlying shares does not impact on the application of the substitute payment rules which look to the expected tax outcome under the arrangement based on the character of the arrangement and the payments made under it rather than the actual outcome under the trade.

Example 1.35

Share lending arrangement where neither party treats the arrangement as a financial instrument

Facts

1. These facts are the same as in **Example 1.34** except that both jurisdictions respect the legal form of the transaction (as a sale and repurchase of securities) so that neither jurisdiction treats the share loan as a financial instrument for tax purposes. A simplified illustration of the tax consequences of such an arrangement is set out below:

A Co			B Co		
	Tax	**Book**		**Tax**	**Book**
Income			Income		
Fee paid by B Co	5	5	Interest paid by A Co	25	25
Interest on collateral	25	25			
Gain on share loan	0	70			
Expenditure			Expenditure		
			Fee paid to A Co	(5)	(5)
Interest paid to B Co	(25)	(25)	Loss on share loan	(70)	(70)
Net return		**75**	**Net return**		**65**
Taxable income	**5**		**Taxable income**	**(50)**	

2. As in **Example 1.34**, B Co borrows the shares from A Co and sells them 'short' to an unrelated party for their market value of 1 000. During the period of the share loan, B Co is required to pay a manufactured dividend to A Co. B Co eventually buys back the shares for the same price and returns them to A Co to close-out the transaction. During the terms of the loan A Co earns interest on the collateral. It pays both the collateral and the interest on that collateral back to B Co at the end of the transaction minus a fee.

3. Rather than treating the manufactured dividend as a separate deductible item, both A Co and B Co treat it as an adjustment to the cost of acquiring the shares. The total return from the share lending transaction for A Co and B Co can be calculated as follows:

	A Co	B Co
Market value of shares lent	1 000	(1 000)
Proceeds from the on market sale of borrowed shares		1 000
Additional amount paid to A Co in respect of manufactured dividend	70	(70)
Cost of re-acquiring shares on-market		(1 000)
Market value of shares returned	(1 000)	1 000
Total return on trade	70	(70)

4. B Co's loss on the share trade is deductible under Country B law while the gain on the share trade is treated as an excluded return under Country A law

Question

5. Does the hybrid financial instrument rule apply to neutralise the mismatch in tax outcomes under this arrangement?

Answer

6. Recommendation 1.2(e) will apply to neutralise the mismatch in tax outcomes if A Co would have been required to treat the dividend paid on the underlying shares as ordinary income or B Co would have been exempt on the underlying dividend.

Analysis

Manufactured payment is not treated as a payment under a financial instrument

7. Both Country A and B treat the share loan as a genuine sale so that the payment is not treated, under either Country A or Country B law, as a payment that is subject to the local law rules for taxing debt, equity or derivatives. Furthermore the asset transfer is not treated as a hybrid transfer subject to adjustment under the hybrid financial instrument rule. Accordingly, neither Country A nor Country B will apply the hybrid financial instrument rule to adjust the tax treatment of the payment.

Adjustment required to extent there is a mismatch in the tax treatment of the dividend and the manufactured dividend.

8. An asset transfer arrangement such as this will give rise to tax policy concerns where the transfer results in the parties obtaining a better tax outcome, in aggregate, than they would have obtained had the transferor received a direct payment of the underlying financing or equity return.

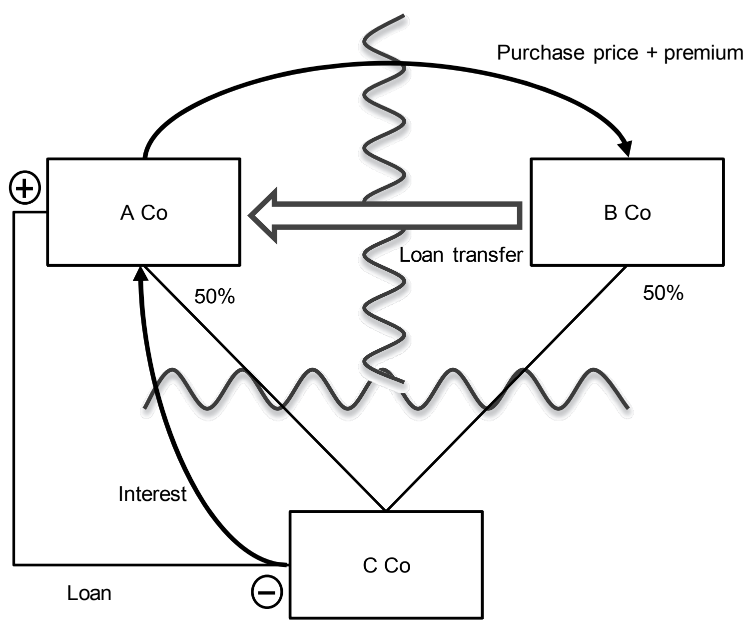
9. If the asset transfer agreement effectively allows A Co to substitute what would otherwise have been a taxable dividend on the shares for a non-taxable gain, or if B Co would have been entitled to an exemption on the underlying dividend then Recommendation 1.2(e) will apply to adjust the D/NI outcome between the parties to prevent these type of arrangements undermining the integrity of the hybrid financial instrument rule.

Example 1.36

Deduction for premium paid to acquire a bond with accrued interest

Facts

1. In the example illustrated in the figure below, A Co (a company resident in Country A) and B Co (a company resident in Country B) each own 50% of the ordinary shares in C Co (a company resident in Country C). C Co issues a bond to B Co. The bond is treated as a debt instrument under the laws of Country C, but as an equity instrument (i.e. a share) under the laws of Country B. Interest payments on the loan are deductible in Country C but treated as exempt dividends under Country B law. B Co subsequently transfers the bond to A Co.



2. The bond is issued for its principal amount of 20 million and has an interest rate of 12% which is paid in two equal instalments throughout the year. A Co acquires the bond from B Co part-way through an interest period under an ordinary contract of sale. A Co pays a premium of 0.8 million to acquire the bond which represents the accrued but unpaid interest on the bond. Under Country A law the bond premium can be deducted against interest income whereas, under Country B law, the premium is treated as an excluded capital gain. A table setting out the tax treatment of A Co, B Co and C Co in respect of the sale and purchase of the bond is set out below:

	A Co		B Co		C Co	
	Interest coupon	1.2	Interest coupon	-	Interest coupon	(1.2)
	Bond premium	(0.8)	Bond premium	-		
Net taxable income		**0.4**		**0**		**(1.2)**

3. As illustrated in the table above, the interest payment of 1.2 million gives rise to a deduction for C Co and income for A Co. A Co is, however, entitled to a deduction of 0.8 million for the premium paid on the bond. B Co does not receive any interest on the bond and treats the premium paid for the bond by A Co as an (exempt) gain on the disposal of an asset. In aggregate the arrangement gives rise to a deduction (for C Co) of 1.2 million and net income (for A Co) of 0.4 million.

Question

4. Does the hybrid financial instrument rule operate to neutralise the mismatch in tax outcomes under this arrangement.

Answer

5. The premium paid for the bond is a substitute payment within the meaning of Recommendation 1.2(e). Accordingly, if the bond transfer agreement was entered into as part of a structured transaction, the hybrid financial instrument rule should apply to adjust the tax treatment of the consideration paid for the bond to the extent necessary to neutralise the mismatch in tax outcomes.

Analysis

The bond is a financial instrument but a payment of interest under the bond does not give rise to a hybrid mismatch.

6. While the payment of interest on the bond gives rise to a deduction within the scope of the hybrid financial instrument rule, the full amount of that payment is included in ordinary income under Country A law. Therefore the payment of interest under the bond does not give rise to a mismatch in tax outcomes.

7. While the purchase price premium is deductible under Country A law and not included in ordinary income under Country B law, this payment is not a payment under the bond but rather a payment to acquire the bond and such a payment will only give rise a mismatch in tax outcomes under the hybrid financial instrument rule if the contract to acquire the bond is treated as a financial instrument or a hybrid transfer.

The contract to acquire the bond is not a financial instrument

8. In this case, the asset transfer is described as an ordinary contract of sale so that neither Country A nor Country B law tax the premium paid for the bond as a separate financing return. The contract to acquire the bond is therefore not a financial instrument that falls within the language or intent of Recommendation 1.

The premium is a substitute payment

9. Although neither party to the arrangement treats the sale contract as a financial instrument, the consideration for the sale of the bond includes an amount representing a financing or equity return on the underlying financial instrument that falls within the Recommendation 1.2(e). In this case the premium represents the accrued financing return on the underlying instrument. If that financing return had been paid directly to the transferor it would have given rise to a hybrid mismatch under Recommendation 1. Accordingly the payment of the premium should be treated as giving rise to a mismatch that is subject to adjustment under the hybrid financial instrument rule.

Adjustment required if the arrangement is a structured arrangement

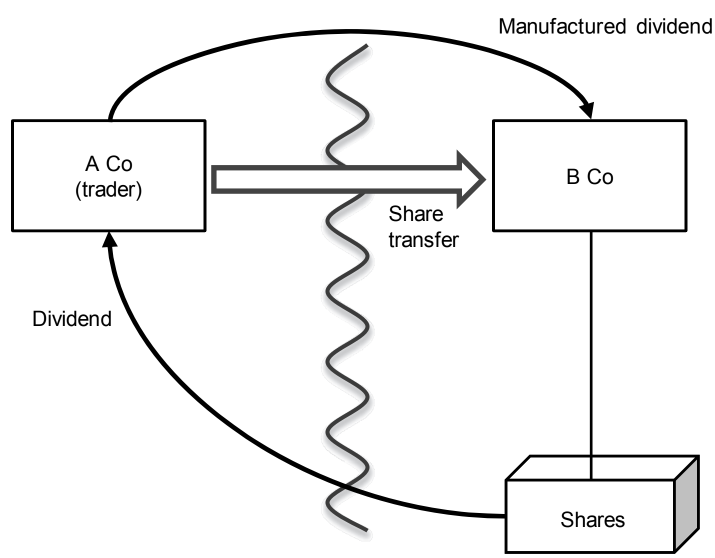
10. The hybrid financial instrument rule applies to arrangements entered into with a related person or where the payment is made under a structured arrangement and the taxpayer is party to that structured arrangement. In this case the fact that A Co and B Co both own shares in C Co does not make them related parties for the purposes of the Recommendation 10. The arrangement will be a structured arrangement, however, if the facts and circumstances, including the joint shareholding in C Co, indicate that the arrangement was designed to produce the mismatch in tax outcomes.

Example 1.37

Manufactured dividend on a failed share trade

Facts

1. The figure below illustrates a situation where a trading entity (A Co) has acquired or borrowed shares from an unrelated third party and on-sells these shares to B Co. The transferred shares carry an entitlement to a declared but unpaid dividend (i.e. the shares are sold to B Co cum-dividend). Because of a processing error, however, the shares are delivered after the dividend record date is set, so that the dividend is, in fact, paid to A Co. On the date the (non-deductible) dividend is actually paid A Co receives the dividend (even though it holds no shares) and pays the dividend across to B Co to whom it had agreed to sell the shares cum-dividend, but delivered the shares ex-dividend.



2. Under Country A law, A Co would be treated as the owner of the shares at the time the dividend is paid and, in the case of a taxpayer of normal status, a dividend exemption would apply. A Co is, however, a financial trader and accordingly the dividend is incorporated into the calculation of A Co's overall (taxable) return on the acquisition, holding and disposal of the shares. The dividend is therefore treated as ordinary income of A Co and the manufactured dividend is treated as a deductible trading expense. Under Country B law, B Co is also treated as the owner of the shares and treats the manufactured dividend as an exempt dividend on the underlying shares. The manufactured payment thus gives rise to a D/NI outcome.

Question

3. Does the payment of the manufactured dividend fall within the scope of the hybrid financial instrument rule?

Answer

4. Although the asset transfer agreement is a hybrid transfer, the manufactured dividend does not fall within the scope of the hybrid financial instrument rule because the D/NI outcome is solely attributable to the different tax status of the counterparties, in particular, because B Co is a financial trader, and all of its gains, receipts, expenses and losses are taken into account in computing profits taxable as ordinary income. Further the payment of the manufactured dividend is not a substitute payment that has the effect of avoiding a hybrid mismatch on the underlying instrument because the ordinary tax treatment of the payer and payee have been preserved under the arrangement and the dividend is not tax-deductible for the issuer.

5. Recommendation 2.2 will apply to the arrangement to limit the ability of A Co to benefit from any withholding tax credits on the underlying dividend.

Analysis

6. While both parties to this arrangement would ordinarily treat this arrangement as an asset transfer, and therefore outside the scope of the hybrid financial instrument rule, the arrangement is a hybrid transfer (which is deemed to be a financial instrument for the purposes of these rules) because it is an asset transfer agreement where:

(a) under the laws of Country A, A Co is the owner of the shares and B Co's rights in those shares are treated as A Co's obligation to transfer the dividend to B Co; and

(b) under the laws of Country B, B Co is the owner of the shares while A Co's rights in those shares are treated as arising under the asset transfer agreement with B Co.

Ownership in this context includes any rules that result in the taxpayer being taxed as the cash-flows from the underlying asset.

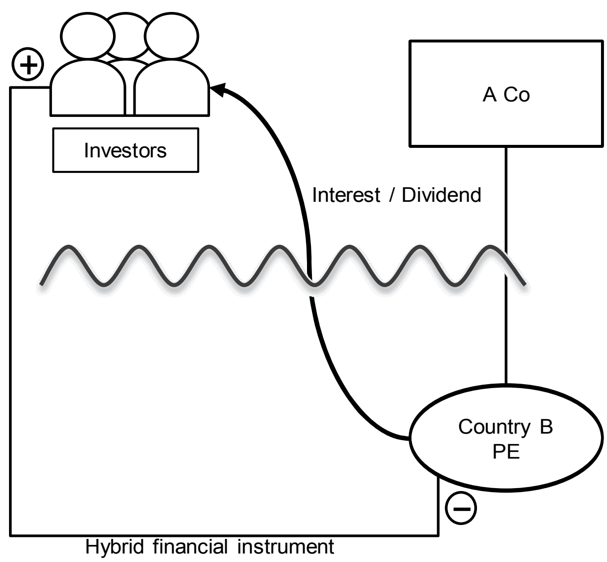
7. Although the arrangement is a hybrid transfer, the D/NI outcome that arises under the hybrid transfer is not attributable to the terms of the instrument (but to A Co's status as a trader) and will therefore not give rise to a hybrid mismatch. Because the underlying dividend is both taxable for A Co and exempt for B Co, the substitute payment rules also do not apply. If, however, the tax regime in Country A had unusual features, which meant that the dividend on the underlying shares was not taxable in Country A or if the arrangement had been deliberately structured as broken trade in order to allow B Co to receive an exempt return of purchase price rather than a taxable dividend on the underlying share, then the payment may be treated as a substitute payment caught by the hybrid financial instrument rule.

Example 2.1

Application of Recommendation 2.1 to franked dividends

Facts

1. In the example illustrated in the figure below, A Co is a company established and tax resident in Country A. A Co has a PE in Country B. Country A does not tax the net income of a foreign PE. A Co issues a bond to investors in Country A through the PE in Country B. The bond is issued for its principal amount and pays accrued interest every six months. The loan is subordinated to the ordinary creditors of A Co and payments of interest and principal can be suspended in the event A Co fails to meet certain solvency requirements. Some of the bonds issued by A Co are acquired by unrelated investors on the open market.



2. The bond is treated as a debt instrument under the laws of Country B and as an equity instrument under the laws of Country A. Country B grants a deduction to the PE for payments made under the bond. Country A treats the payments as a dividend paid by a resident company to a resident shareholder. Country A taxes dividends at the taxpayer's marginal rate but also permits the paying company to attach an "franking credit", which the shareholder can credit against the tax liability on the dividend.

Question

3. Whether an interest payment under the bond falls within the scope of the hybrid financial instrument rule and, if so, whether an adjustment is required to be made in accordance with that rule.

Answer

4. Under Recommendation 2.1, A Co should be prevented from attaching an imputation credit to the payment made under the bond.

5. If Country A does not apply Recommendation 2.1, Country B may be able to deny the PE of A Co a deduction for the interest payment if the investors are related parties or the loan was issued as part of a structured arrangement.

Analysis

Country A should apply Recommendation 2.1 to prevent A Co attaching an imputation credit to the payment on the bond

6. Recommendation 2.1 states that jurisdictions should not grant dividend relief for a deductible payment. Recommendation encourages countries to limit the availability of tax relief on dividends to prevent such tax relief being claimed where the profits out of which the distribution is made have not borne underlying tax. In the present case, the payment made under the bond has been paid out of such pre-tax income because:

(a) the payment was deductible under the laws of Country B; and

(b) while not deductible under Country A law, the profits out of which the payment is made were not subject to tax in Country A (due to the operation of the branch exemption).

The effect of Recommendation 2.1 is therefore that Country A, should prevent A Co from attaching an imputation credit to the payment made under the bond.

A payment made under the financial instrument will give rise to a hybrid mismatch

7. If Country A does not apply Recommendation 2.1 then there is still scope for Country B to apply Recommendation 1 on the grounds that the payment is deductible under the laws of Country B but sheltered from taxation as ordinary income in Country A.

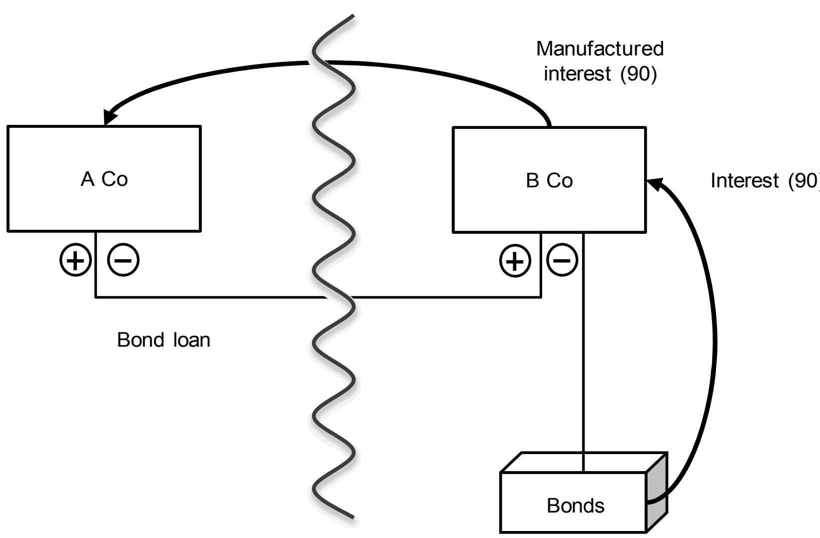
8. As the investors are not related, the hybrid financial instrument rule will only apply if the payment is made under a structured arrangement. In this case the loan itself may not have any features indicating that it was designed to produce a mismatch in tax outcomes. It is possible, however, that the tax benefits of the mismatch were marketed to the original investors in Country A or that the bond was primarily marketed to investors who could take advantage of the mismatch in tax outcomes. If this is the case then the A Co and those investors are likely to be party to the structured arrangement as they can reasonably be expected to be aware of the mismatch and have shared in the value of the tax benefit (through a return on the instrument that was calculated by reference to the benefit of the imputation credit).

Example 2.2

Application of Recommendation 2.2 to a bond lending arrangement

Facts

1. The figure below illustrates a securities loan that is similar to the structure described in **Example 1.32** except that the instrument loaned under the arrangement is a bond rather than a share. B Co is the "borrower" under the arrangement with obligations that include the requirement for B Co to pay A Co the amount of any interest payments that are paid on the underlying bonds (net of any withholding taxes) during the period of the loan (the "manufactured interest payment"). The net economic effect of this arrangement is that A Co continues to be exposed to the full risk and return of holding the bonds, through the obligations owed by B Co under the arrangement.



2. A simplified tax calculation showing the net effect of this arrangement is set out below. In this example it is assumed that the payment of 100 of interest on the bond is subject to 10% withholding tax and this tax is creditable against B Co's tax liability. B Co makes a manufactured payment of the interest payment (reduced by withholding tax) to A Co.

A Co			B Co		
	Tax	**Book**		**Tax**	**Book**
Income			Income		
Manufactured interest	90	90	Interest	90	90
Amounts withheld	10	0	Amounts withheld	10	0
			Expenditure		
			Manufactured interest	(90)	(90)
Net return		**90**	**Net return**		**0**
Taxable income	**100**		**Taxable income**	**10**	
Tax on income (30%)	(30)		Tax on income (30%)	(3)	
Tax credit	10		Tax credit	10	
Tax to pay		(20)	Tax benefit		7
After-tax return		**70**	**After-tax return**		**7**

3. Both A Co and B Co are treated as receiving an interest payment of 100 subject to foreign withholding taxes of 10%. B Co's taxable income (after the payment of the manufactured dividend payment) is 10. Despite taxing only the net income under the arrangement Country B still allows a credit for the whole of the withholding tax thus generating an excess credit that is eligible to bee set-off against Country B tax on other income (or certain other classes of income).

4. Ordinarily it would be expected that a payment of interest under the bond would generate a net taxation (in either Country A or B) of 20 (i.e. 30 of tax payable in the country of residence minus a credit for 10 of withholding tax). Because, however, in this example, both A Co and B Co have claimed tax credits in respect of the same payment the aggregate tax liability for both parties under the arrangement is 13 including a surplus 7 tax credit for B Co which (it is assumed) may be used against other income.

5. In this example the arrangement is not the product of a mismatch, as both Country A and B treat all amounts received under the arrangement as ordinary income, nevertheless the hybrid transfer permits A Co and B Co to double-dip on withholding tax credits to lower their effective tax under the instrument.

Question

6. Whether a securities lending arrangement falls within the scope of Recommendation 2.2 and, if so, to what extent an adjustment is required to be made in accordance with that rule.

Answer

7. The arrangement is a hybrid transfer that does not give rise to a D/NI outcome. Any jurisdiction that grants relief for tax withheld at source on a payment made under a hybrid transfer should restrict the benefit of the relief to the net taxable income of the taxpayer under the arrangement.

The arrangement is a hybrid transfer

8. The securities lending arrangement falls within the definition of a hybrid transfer because, under the laws of Country A, A Co is the owner of the bond and B Co's rights of in the bond are characterised as obligations owed to A Co, while, under the laws of Country B, B Co is the owner of the bond and A Co's ownership rights are treated as obligations of B Co.

Recommendation 2(2) applies to restrict the amount of foreign tax credits under a hybrid transfer

9. Recommendation 2.2 states that, "in order to prevent duplication of tax credits under a hybrid transfer, any jurisdiction that grants relief for tax withheld at source on a payment made under a hybrid transfer should restrict the benefit of such relief in proportion to the net taxable income of the taxpayer under the arrangement."

10. The credit should be allowed in each jurisdiction only up to amount of net income under the arrangement. A simplified tax calculation showing the net effect of these adjustments is set out below.

A Co			B Co		
	Tax	**Book**		**Tax**	**Book**
Income			Income		
Manufactured interest	90	90	Interest	90	90
Amounts withheld	10	0	Amounts withheld	10	0
			Expenditure		
			Manufactured interest	(90)	(90)
Net return		**90**	**Net return**		**0**
Taxable income	**100**		**Taxable income**	**10**	
Tax on income (30%)	(30)		Tax on income (30%)	(3)	
Tax credit	10		Tax credit	3	
Tax to pay		(20)	Tax to pay		0
After-tax return		**70**	**After-tax return**		**0**

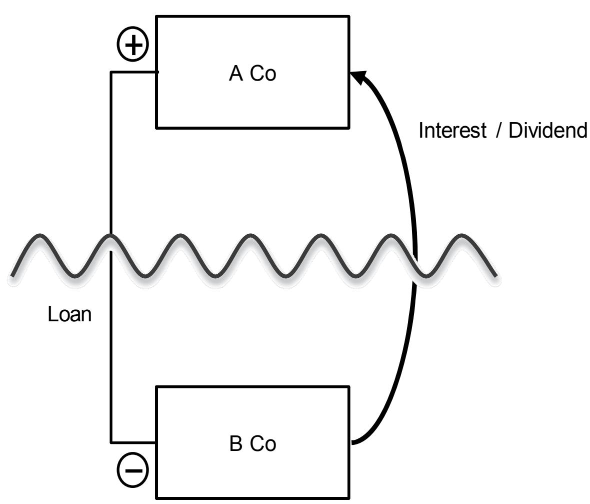
11. Limiting the credit to the extent of the taxpayer's net income under the arrangement has no effect on A Co's tax position in this example as A Co's net income from the arrangement is equal to the gross amount of the payment. The calculation continues to allow for to a duplication of credits under the laws of Country B, but only to the extent necessary to shelter the income in respect of the payment that has been withheld at source.

Example 2.3

Co-ordination of hybrid financial instrument rule and Recommendation 2.1

Facts

1. In the example illustrated in the figure below, A Co (a company resident in Country A) owns all the shares in B Co (a company resident in Country B). A Co lends money to B Co under a loan that pays accrued interest every 12 months on 1 October each year. The loan is subordinated to the ordinary creditors of B Co and payments of interest and principal can be suspended in the event B Co fails to meet certain solvency requirements.



2. The bond is treated as a debt instrument under the laws of Country B but as an equity instrument (i.e. a share) under the laws of Country A. Accordingly interest payments on the loan are treated as dividends under Country A law. Under its domestic law Country A generally exempts foreign dividends.

3. In Year 2 Country B introduces hybrid mismatch rules so that the deduction for the interest payment is denied in that year. One year later Country A amends its domestic law in line with Recommendation 2.1 so that the benefit of a dividend exemption for a deductible payment is no longer available under Country A law.

Question

4. What proportion of the payment is required to be brought into account under the hybrid mismatch rule by A Co and B Co in Years 2 to 4 of the arrangement?

Answer

5. The payer jurisdiction applying the primary response under the hybrid financial instrument rule in a period when the payee jurisdiction introduces domestic changes in accordance with Recommendation 2.1 (the switch-over period), should cease to apply the primary response to the extent the mismatch is neutralised by the introduction of the domestic law changes in the payee jurisdiction. The payer jurisdiction should continue, however, to make the adjustment required under the hybrid financial instrument rule for periods prior to the switchover period. Accordingly:

(a) Country B should deny B Co a deduction for a payment to the extent it gives rise to a mismatch in an accounting period that ends on or before the effective date of the domestic law changes in Country A but should grant B Co relief for any payment made during the switch-over period to the extent the mismatch is neutralised due to the operation of the new rules in Country A.

(b) Country A will apply the domestic law changes to the payment at the time it is treated as received although Country A should take into account the effect of any adjustments that were made under the hybrid financial instrument rule in Country B for periods ending on or before the effective date of the domestic law changes in Country A.

Analysis

No application of the hybrid financial instrument rule where mismatch is neutralised consistent with Recommendation 2.1

6. A payment under a hybrid financial instrument will not be treated as giving rise to a D/NI outcome if the mismatch is neutralised in the counterparty jurisdiction by a specific rule designed to align the tax treatment of the payment with tax policy outcomes applicable to an instrument of that nature. Specific rules of this nature include any rules in the payee jurisdiction, consistent with Recommendation 2.1, that limit the availability of a dividend exemption or equivalent tax relief to payments that are not deductible for tax purposes. Accordingly, if and when Country A introduces rules that deny the benefit of an exemption for a deductible dividend payment, Country B should cease to apply the primary response under the hybrid financial instrument rule.

Co-ordination between the hybrid financial instrument rule and Recommendation 2.1

7. Complications in the application of the rule and a risk of double taxation could arise, however, in situations where the payee jurisdiction applies the rules under Recommendation 2.1 to a payment that has already been subject to adjustment under the hybrid financial instrument rule in the payer jurisdiction. While the hybrid financial instrument rule will not apply to a payment that is included in ordinary income under the laws of Country A, equally, in order to minimise disruption to the rules in Country B and to avoid the need to calculate split periods or re-open old tax returns, Country B should

continue to apply the hybrid financial instrument rule to any payment in a period prior to the switch-over period.

8. A table setting out the effect of these adjustments in Years 2 to 4 is set out below. The table shows the accrued interest under the loan in each calendar year and the income tax consequences applying to payments made under the loan. In this table it is assumed that the interest payment is 100 each year and that B Co and A Co have no other income or expenditure. Country B and Country A both calculate income and expenditure for tax purposes on a calendar year basis.

	Country A A Co			Country B B Co			Total
Year 2		**Tax**	**Book**		**Tax**	**Book**	
	Income			Income			
	Dividend	0	100	Operating income	100	100	
				Expenditure			
				Interest	0	(100)	
	Net return		**100**	**Net return**		**0**	**100**
	Taxable income	**0**		**Taxable income**	**100**		**100**

	Country A A Co			Country B B Co			Total
Year 3		**Tax**	**Book**		**Tax**	**Book**	
	Income			Income			
	Dividend	75	100	Operating income	100	100	
				Expenditure			
				Interest	(100)	(100)	
	Net return		**100**	**Net return**		**0**	**100**
	Taxable income	**75**		**Taxable income**	**0**		**75**

Year 4	Country A A Co			Country B B Co			Total
		Tax	Book		Tax	Book	
	Income			Income			
	Dividend	100	75	Operating income	100	100	
				Expenditure			
				Interest	0	(100)	
	Net return		**75**	**Net return**		**0**	**75**
	Taxable income	**100**		**Taxable income**	**0**		**100**

9. In Year 2, Recommendation 2.1 has not yet been introduced into Country A law so that a deduction for the entire amount of the interest payment is denied under Country B law.

10. In Year 3, Recommendation 2.1 is introduced into Country A law from the beginning of that year.

(a) Country B does not apply the hybrid financial instrument rule in Year 3 as the entire amount of the payment for that period will be subject to taxation as ordinary income in Country A;

(b) The amount of the income included under Recommendation 2.1 should not include a payment to the extent it has been already subject to adjustment under the hybrid financial instrument rule in a prior period. Because Country B allows for interest expenses to be claimed on an accrual basis, a deduction for 25% of the interest payment has already been denied by Country B in the prior year (Year 2), accordingly the amount Country A treats as a deductible dividend should be reduced by the same proportion.

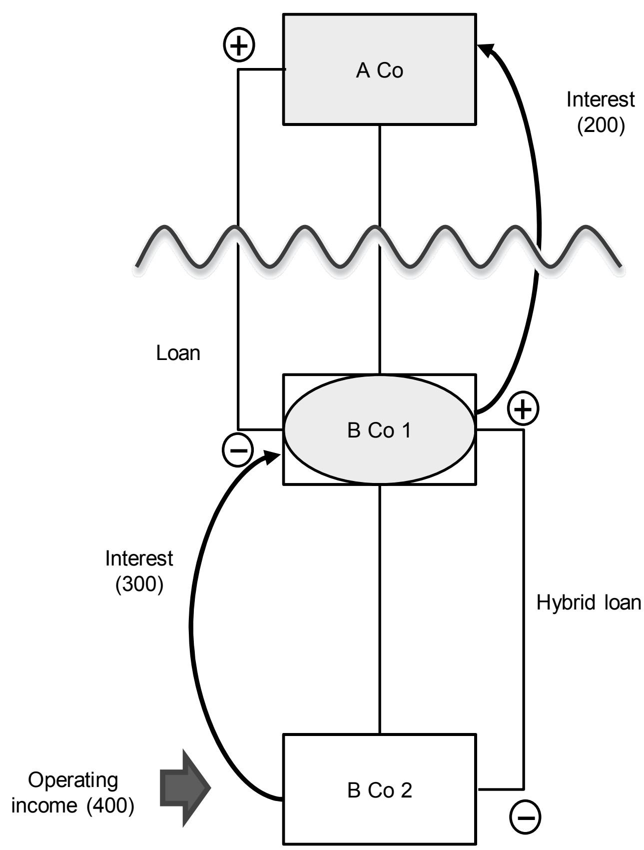
11. In Year 4 the loan matures and the final payment of accrued interest on the loan is paid on 1 October of Year 4. The hybrid financial instrument rule does not apply in Country B as the interest payment will be caught by Recommendation 2.1. The exemption is denied for the full amount of the interest payment (100) in Country A, effectively triggering an additional 25 of taxable income in the hands of B Co and reversing out the timing advantage that arose in the previous year due to the differences in the timing of the recognition of payments.

Example 3.1

Disregarded hybrid payment structure using a disregarded entity and a hybrid loan

Facts

1. In the example illustrated in the figure below, A Co establishes B Co 1 as the holding company for its operating subsidiary (B Co 2). B Co 1 is a hybrid entity (i.e. an entity that is treated as a separate entity for tax purposes in Country B but as a disregarded entity under Country A law). B Co 2 is treated as a separate taxable entity under Country A and B laws.



2. B Co 1 borrows money from A Co. B Co 1 on-lends that money under a hybrid loan. Interest payments on the loan are treated as ordinary income under Country B law but treated as exempt dividends under Country A law. A table setting out the combined net income position for A Co and the Country B Group is set out below.

Country A A Co	Tax	Book	Country B B Co 1	Tax	Book
Income			Income		
Interest paid by B Co 1	0	200	Interest paid by B Co 2	300	300
			Expenditure		
			Interest paid to A Co	(200)	(200)
			Net return		**100**
			Taxable income	**100**	
			B Co 2		
			Income		
			Operating Income	400	400
			Expenditure		
			Interest under hybrid loan	(300)	(300)
Net return		**200**	**Net return**		**100**
Taxable income	**0**		**Taxable income**	**100**	

3. Because B Co 1 is a disregarded entity under Country A law, the interest on the loan between A Co and B Co 1 is disregarded for tax purposes and does not give rise to taxable income in Country A. Although the payment of interest on the hybrid loan is recognised under Country A law it is treated as an exempt dividend for tax purposes and is not taken into account in calculating A Co's taxable income for the period. Accordingly A Co recognises no taxable income under this structure.

4. Under Country B law B Co 2 has 400 of operating income and is entitled to a deduction of 300 on the hybrid loan. B Co 1 recognises the interest payment on the hybrid loan but is further entitled to a deduction of 200 on the disregarded interest payment to A Co. Accordingly, in aggregate, the Country B Group recognises 200 of taxable income under this structure on a net return of 400.

Question

5. Are the tax outcomes described above subject to adjustment under the hybrid mismatch rules?

Answer

6. For both Country A and Country B, the hybrid financial instrument rule will not apply to the interest payment on the hybrid loan because the interest payment does not give rise to a D/NI outcome (as it is included in income under the laws of Country B).

However, the fact that B Co 1 is disregarded as a separate entity under the laws of Country B means that the deductible interest payment that B Co 1 makes to A Co is disregarded under Country A law and, accordingly, will be caught by the disregarded hybrid payments rule in Recommendation 3.

7. In the event that Country B does not apply the primary rule under Recommendation 3.1 to the interest payment made by B Co 1, then Country A should include the full amount of that interest payment in ordinary income under the defensive rule set out at Recommendation 3.2.

Analysis

Interest payment on the hybrid loan is not subject to adjustment under the hybrid financial instrument rule

8. Although the loan can be described as *hybrid* in the sense that payments on the loan are treated as deductible interest under the laws of Country B and exempt dividends under the laws of Country A, the loan does not give rise to a mismatch falling within the hybrid financial instrument rule because the interest is included in income under the laws of Country B.

The disregarded hybrid payments rule will apply to deny B Co 1 a deduction for the disregarded interest payment

9. In this case B Co 1 is a hybrid payer because both the payer and the payment are disregarded under the laws of Country A. Accordingly Country B should apply the primary recommendation to deny B Co 1 a deduction for the interest payment to the extent that payment exceeds dual inclusion income. The payment of interest on the hybrid loan does not constitute dual inclusion income because it is not included in ordinary income under the laws of Country A. Therefore the full amount of the interest deduction should be denied under Country B law. The table below illustrates the net effect of this adjustment.

Country A A Co	Tax	Book	Country B B Co 1	Tax	Book
Income			Income		
Interest paid by B Co 1	0	200	Interest paid by B Co 2	300	300
			Expenditure		
			Interest paid to A Co	0	(200)
			Net return		**100**
			Taxable income	**300**	
			B Co 2		
			Income		
			Operating Income	400	400
			Expenditure		
			Interest under hybrid loan	(300)	(300)
Net return		**200**	**Net return**		**100**
Taxable income	**0**		**Taxable income**	**100**	

10. B Co 1 is denied a deduction for the entire amount of the disregarded interest payment. The net effect of the adjustment is that the entire return under the arrangement is brought into account under Country B law.

In the event Country B does not make any adjustment A Co will treat the interest payment as ordinary income

11. If the disregarded hybrid payments rule is not applied to the payment in Country B then Country A should apply the rule to require the interest payment to be included in ordinary income. The table below illustrates the net effect of Country A making an adjustment under the disregarded hybrid payments rule.

Country A A Co			Country B B Co 1		
	Tax	Book		Tax	Book
Income			Income		
Interest paid by B Co 2	200	200	Interest paid by B Co 2	300	300
			Expenditure		
			Interest paid to A Co	(200)	(200)
			Net return		**100**
			Taxable income	**100**	
			B Co 2		
			Income		
			Operating Income	400	400
			Expenditure		
			Interest under hybrid loan	(300)	(300)
Net return		**200**	**Net return**		**100**
Taxable income	**200**		**Taxable income**	**100**	

12. A Co is required to bring into account, as ordinary income, the full amount of the interest payment so that the taxable income of A Co and B Co under the arrangement is equal to their net return under the arrangement.

Implementation solutions

13. B Co 1 is likely to prepare separate accounts showing all the amounts of income and expenditure that are subject to tax under Country B law. Country B could require B Co 1 to maintain a cumulative total of all the items of income that were dual inclusion income and prohibit B Co 1 from claiming deductions for a disregarded payment to the extent they exceeded this cumulative amount.

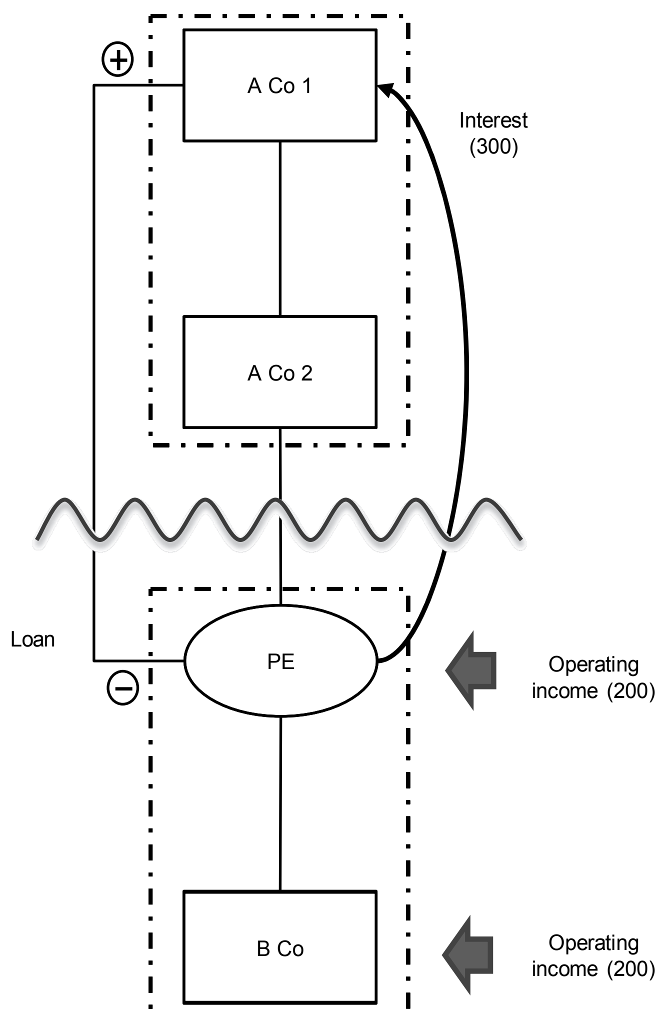
14. A Co will have information (obtained under Country B law) on the deductions that B Co 1 has claimed in Country B for intra-group payments and information (under Country A law) of the amount of B Co 1's net income that is attributed to A Co. Country A could require A Co to recognise ordinary income to the extent the former amount (the amount of deductions claimed by B Co 1 for disregarded payments) exceeds the latter (the amount of B Co 1's net income that is attributed to A Co under Country A law).

Example 3.2

Disregarded hybrid payment using consolidation regime and tax grouping

Facts

1. In the example set out in the figure below, A Co 1 forms a consolidated group with its wholly-owned subsidiary A Co 2. The effect of tax consolidation under Country law is that all transactions and payments between group members are disregarded for tax purposes. A Co 2 establishes a PE in Country B. The PE holds all of the shares in B Co. The PE is consolidated with B Co for tax purposes under Country B law.



2. A Co 2 borrows money from A Co 1. This loan is attributed to A Co 2's PE in Country B. The payment of interest on the loan is deductible under Country B law but is not recognised by A Co 1. A table setting out the combined net income position for Country A Group and Country B Group is set out below.

Country A **A Co 1**			**Country B** **A Co 2 and B Co combined**		
	Tax	**Book**		**Tax**	**Book**
Income			Income		
Interest paid by A Co 2	0	300	Operating income of A Co 2 and B Co	400	400
Operating income of A Co 2	200	0			
			Expenditure		
			Interest paid by A Co 2 to A Co 1 under loan	(300)	(300)
Net return		**300**	**Net return**		**100**
Taxable income	**200**		**Taxable income**	**100**	
Tax on income (30%)	(60)		Tax on income (30%)	(30)	
Tax to pay		(60)	Tax to pay		(30)
After-tax return		**240**	**After-tax return**		**70**

3. The only item of income recognised for tax purposes under Country A law is the operating income of the A Co 2's PE. This income is subject to tax at a 30% rate under Country A law. Under Country B law the 300 of interest paid by A Co 2 to A Co 1 is treated as deductible against the income of the Country B Group leaving the group with net taxable income of $100 which is subject to Country B tax at a 30% rate. The net effect of this structure is, therefore, that the entities in the AB Group derive a total net return of 400 but have taxable income of 300.

Question

4. Are the tax outcomes described above subject to adjustment under the hybrid mismatch rules?

Answer

5. Country B should apply the hybrid financial instrument rule to deny a deduction for the interest paid by A Co 2 to A Co 1 if the mismatch in the tax treatment of the interest payment can be attributed to the terms of the instrument between the parties. If the interest payment is not treated, under Country B law, as subject to adjustment under the hybrid financial instrument rule then Country B will apply the disregarded hybrid payments rule to deny A Co 2 a deduction for the interest payment to the extent the interest expense exceeds dual inclusion income.

6. In the event the deduction for the interest payment is not subject to adjustment under Country B law then Country A should treat the interest payment as included in income to the extent it exceeds dual inclusion income.

Analysis

Interest payment is potentially subject to adjustment under the hybrid financial instrument rule

7. Under Country B law, the interest payment is a deductible payment to a related party that gives rise to a mismatch in tax outcomes and will fall within the scope of the hybrid financial instrument rule if the mismatch can be attributed to differences in the tax treatment of the loan under the laws of Country A and B.

8. The fact that the loan and the interest payment itself may not be recognised under County A law, due to the operation of the tax consolidation regime in Country A, does not impact on whether the interest payment can be subject to adjustment under the hybrid financial instrument rule in Country B. The identification of a mismatch as a hybrid mismatch under a financial instrument is primarily a legal question that requires an analysis of the general rules for determining the character, amount and timing of payments under a financial instrument in the payer and payee jurisdictions. The hybrid financial instrument rule is designed so that it is not necessary for the taxpayer or tax administration to know precisely how the payments under a financial instrument have actually been taken into account in the calculation of the counterparty's taxable income in order to apply the rule.

9. The table below illustrates the net effect on the Country A Group and Country B Group of denying a deduction for the interest payment under the hybrid financial instrument rule.

Country A **A Co 1**			**Country B** **A Co 2 and B Co combined**		
	Tax	**Book**		**Tax**	**Book**
Income			Income		
Interest paid by A Co 2	0	300	Operating income of A Co 2 and B Co	400	400
Operating income of A Co 2	200	0			
			Expenditure		
			Interest paid by A Co 2 to A Co 1 under loan	0	(300)
Net return		**300**	**Net return**		**100**
Taxable income	**200**		**Taxable income**	**400**	
Tax on income (30%)	(60)		Tax on income (30%)	(120)	
Credit for taxes paid by A Co 2 in Country B	60				
Tax to pay		(0)	Tax to pay		(120)
After-tax return		**300**	**After-tax return**		**(20)**

10. The effect of Country B denying a deduction for the full amount of the interest payment made by A Co 2 is that all the income arising under the arrangement will be subject to tax under Country B law. The tax charge triggered in Country B by the

adjustment under the hybrid financial instrument rule means that A Co 1 benefits from a credit for taxes paid by A Co 2.

The disregarded hybrid payments rule will apply to deny the Country B Group a deduction for the interest payment

11. If the interest payment is not treated, under the laws of Country B as subject to adjustment under the hybrid financial instrument rule then Country B should apply the disregarded hybrid payments rule to deny the deduction for the interest payment if the payment falls within the description of a disregarded payment made by a hybrid payer.

12. In this case A Co 2 is a hybrid payer making a disregarded payment because it is a member of the same group under the tax consolidation regime in Country A and that regime treats all transactions and payments between consolidated group members as disregarded for tax purposes. Accordingly Country B should apply the primary recommendation to deny a deduction for the interest payment made by A Co 2 to A Co 1 to the extent that payment exceeds dual inclusion income. The table below illustrates the net effect of Country B making an adjustment under the disregarded hybrid payments rule for both groups.

Country A A Co 1			Country B A Co 2 and B Co combined		
	Tax	Book		Tax	Book
Income			Income		
Interest paid by A Co 2	0	300	Operating income of A Co 2 and B Co	400	400
Operating income of A Co 2	200	0			
			Expenditure		
			Interest paid by A Co 2 to A Co 1 under loan	(200)	(300)
Net return		**300**	**Net return**		**100**
Taxable income	**200**		**Taxable income**	**200**	
Tax on income (30%)	(60)		Tax on income (30%)	(60)	
Credit for taxes paid by A Co 1 in Country B	0				
Tax to pay		(60)	Tax to pay		(60)
After-tax return		**240**	**After-tax return**		**40**

13. A Co 2 is denied a deduction for the disregarded interest payment (300) to the extent the payment exceeds dual inclusion income (200). The net effect of the adjustment is that the full amount of the income under the arrangement is brought into account under Country A and B laws.

In the event Country B does not make any adjustment A Co 1 will treat the amount that gives rise to a DD outcome as included in income under Country A law

14. If the disregarded hybrid payments rule is not applied to the payment in Country B then Country A should apply the rule to require the payment to be included in ordinary income to the extent of the mismatch. The table below illustrates the net effect of Country A making an adjustment under the disregarded hybrid payments rule.

Country A A Co 1			Country B A Co 2 and B Co combined		
	Tax	Book		Tax	Book
Income			Income		
Interest paid by A Co 2	100	300	Operating income of A Co 2 and B Co	400	400
Operating income of A Co 2	200	0			
			Expenditure		
			Interest paid by A Co 2 to A Co 1 under loan	(300)	(300)
Net return		**300**	**Net return**		**100**
Taxable income	**300**		**Taxable income**	**100**	
Tax on income (30%)	(90)		Tax on income (30%)	(30)	
Credit for taxes paid by A Co 1 in Country B	0				
Tax to pay		(90)	Tax to pay		(30)
After-tax return		**210**	**After-tax return**		**70**

15. A Co 1 is required to bring into account, as ordinary income, the amount by which the interest deduction (300) exceeds A Co 2's dual inclusion income (200). The net effect of the adjustment is that the full amount of the income under the arrangement is brought into account under Country A and B laws.

Implementation solutions

16. Country B is likely to require A Co 2 to prepare separate accounts for the PE showing all the amounts of income and expenditure that are subject to tax under Country B law. Country B could prohibit an entity in the position of A Co 2 from utilising the benefit of the PE loss to the extent the PE has made deductible payments that were disregarded under Country A law. This solution may require further transaction specific rules that prevent A Co 2 entering into arrangements to stream non-dual inclusion income to the PE to soak-up unused losses.

17. The Country A Group will have information on the deductions that A Co 2 has claimed in Country B for intra-group payments and the amount of the PE's loss as calculated under Country B law. Country A could require a taxpayer in the position of A Co 1 to recognise as ordinary income in each accounting period, A Co 2's deductible intra-group payments to the extent they gave rise to a net loss for Country B tax purposes. This solution may require further transaction specific adjustments to the calculation of the

PE's net loss under Country B law which are designed to back-out material items that were treated as income under Country B law but would not be included under Country A law.

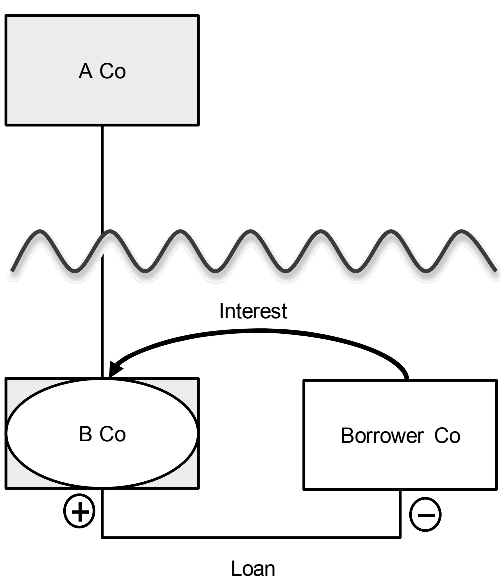
Example 4.1

Use of reverse hybrid by a tax exempt entity

Facts

1. In the example illustrated in the figure below, B Co is an entity incorporated in Country B that is treated as transparent for Country B tax purposes. Entities such as B Co are required under Country B law to maintain a shareholder register which must be made available to members of the public on request. In this case, B Co is wholly-owned by A Co, which treats B Co as a separate taxable person. A Co is exempt from tax under Country A law.

2. Borrower Co (a company resident in Country B) borrows money from B Co on arm's length and standard commercial terms and at a market interest rate. The arrangement is not marketed to Borrower Co as a tax-advantaged financing arrangement and Borrower Co is not provided with any information about the owners of B Co. The interest payments on the loan are deductible for the purposes of Country B law but not included in income by either B Co or A Co.



Question

3. Are the interest payments made by Borrower Co to B Co caught by the reverse hybrid rule?

Answer

4. The payments are not caught by the reverse hybrid rule because the mismatch in tax outcomes is not a hybrid mismatch. Furthermore the arrangement is not within the scope of the reverse hybrid rule because Borrower Co, A Co and B Co are not part of the same control group and Borrower Co is not party to a structured arrangement.

Analysis

Mismatch is not a hybrid mismatch

5. In this case the receipt of the interest payment is not recognised under the laws of either Country A or B and therefore the payment gives rise to a D/NI outcome, however the mismatch will not be treated as a hybrid mismatch unless the payment would have been included in ordinary income if it had been made directly to the investor.

6. Unlike in the hybrid financial instrument rule, which applies whenever the terms of the instrument were sufficient to bring about a mismatch in tax outcomes, the reverse hybrid rule will not apply unless the payment attributed to the investor would have been included as ordinary income if it had been paid directly to the investor (i.e. the interposition of the reverse hybrid must have been necessary to bring about the mismatch in tax outcomes). In this case, where income is allocated by a reverse hybrid to a tax exempt entity, the payment would not have been taxable even if it had been made directly to the investor and the reverse hybrid rule should therefore not apply to deny the deduction.

Arrangement is not in scope

7. If A Co were not a tax exempt entity under the laws of Country A, so that the interest payment *would* have been included in ordinary income if it had been made directly to A Co, then mismatch in tax outcomes would be treated as giving rise to a hybrid mismatch. As Borrower Co is not part of the same control group as A Co and B Co, the hybrid mismatch would only fall within the scope of the reverse hybrid rule under Country B law if it was made under a structured arrangement and Borrower Co was a party to that structured arrangement.

8. The facts and circumstances of this case would *prima facie* indicate a structured arrangement between A Co and B Co. In particular, the use of B Co as single purpose entity to make this loan appears to be an additional step inserted into the lending arrangement to produce the mismatch in tax outcomes. Borrower Co, however, should not be treated as a party to that structured arrangement, unless it (or any member of Borrower Co's control group) obtained a benefit under the hybrid mismatch or had sufficient information about the arrangement to be aware of the fact that it gave rise to a mismatch.

9. In this case, the loan is on arm's length and standard commercial terms and Borrower Co pays a market rate of interest. While Borrower Co might be aware (or in certain cases should be aware) of B Co's tax transparency, Borrower Co would not be expected, as part of its ordinary commercial due diligence, to take into account the tax treatment of A Co or whether the interest payment will be treated as ordinary income under the laws of Country A when borrowing money on standard terms from an unrelated party. In this case, in particular, Borrower Co derives no benefit from the mismatch and is not provided with information that would make it aware of the fact that the payment gives

rise to a mismatch in tax outcomes. Importantly, the test for whether a person is a party to structured arrangement is not intended to impose an obligation on that person to undertake additional due diligence on a commercial transaction over and above what would be expected of a reasonable and prudent person. Accordingly, even if A Co were not treated as an exempt entity under the laws of Country A, Borrower Co should not be treated as party to any structured arrangement between B Co and A Co.

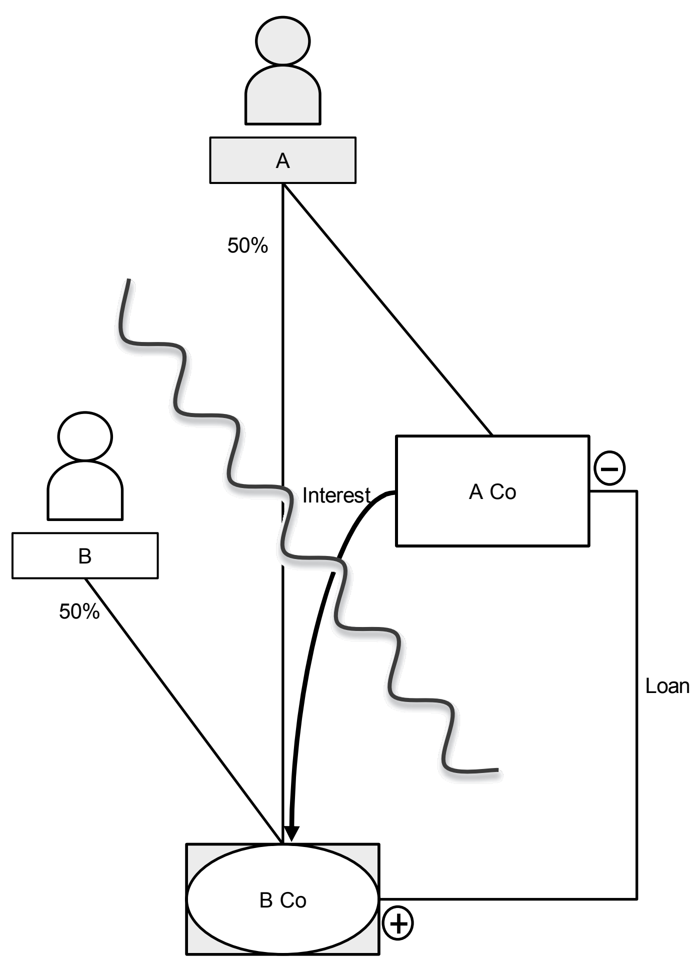
10. In contrast, however, and consistent with the analysis in, **Example 10.5**, if Borrower Co was originally approached by A Co for a loan and A Co proposed structuring the loan through a reverse hybrid in order to secure an improved tax outcome, the entire financing arrangement, including the loan to Borrower Co, would be treated as part of a single structured arrangement and Borrower Co will be treated as a party to that arrangement provided it had sufficient involvement in the design of the arrangement to understand how it had been structured and to anticipate what its tax effects would be.

Example 4.2

Application of Recommendation 4 to payments that are partially excluded from income

Facts

1. In the example illustrated in the figure below, two individuals, one resident in Country A (Individual A) and one in Country B (Individual B) intend to make a loan to A Co, a company wholly owned by Individual A. Rather than make the loan directly, A and B contribute equity to B Co, an entity incorporated in Country B. B Co loans money to A Co and A Co makes a deductible interest payment on the loan.



2. Under Country B law half the payment is attributed to Individual A and is exempt from tax as foreign source income of a non-resident. The other half of the payment is attributed to Individual B and is subject to tax at the full marginal rate applicable to interest income. Country A has implemented the hybrid financial instrument rules.

Question

3. To what extent is the interest payment made by A Co to B Co caught by the reverse hybrid rule in Country A.

Answer

4. The interest payment is made to a reverse hybrid. The payment of interest is deductible under the laws of the payer jurisdiction but the allocation of half the interest payment to a non-resident means that the payment is not fully included in ordinary income under the laws of Country B.

5. Provided the interest payment allocated to A would have been taxable if it had been made directly, then Country A should apply Recommendation 4 to the interest payment to deny A Co a deduction for half the interest payment.

Analysis

B Co is a reverse hybrid

6. A reverse hybrid is any person that is treated as transparent under the laws of the jurisdiction where it is established but as a separate entity by its investor. In this case the establishment jurisdiction is Country B (the country where B Co is incorporated). B Co is a resident taxpayer for Country B purposes and is treated as an ordinary company under the laws of Country A. However, under the laws of the jurisdiction where it is established, B Co is entitled to claim the benefit of an exemption from foreign source interest if that interest is allocated or attributed to a non-resident investor. This type of regime falls within the definition of a transparent regime because the laws of Country B permit or require B Co to allocate or attribute ordinary income to an investor (Individual A) and that allocation or attribution has the effect that the payment is subject to tax under the laws of the establishment jurisdiction at the investor's marginal rate. The allocation of the payment to individual A has no impact on A's tax treatment in Country A.

Payment gives rise to a partial D/NI outcome

7. A D/NI outcome will arise in respect of a payment to a reverse hybrid to the extent that the payment is deductible under the laws of one jurisdiction (the payer jurisdiction) and not included in ordinary income by a taxpayer under the laws of any other jurisdiction where the payment is treated as being received (the payee jurisdiction). In this case only half the payment is included in ordinary income under Country B law (and no amount of the payment is included in income under Country A law).

8. The adjustment under the reverse hybrid rule should result in an outcome that is proportionate and that does not lead to double taxation. In this case the payer jurisdiction should only deny a deduction for that part of the payment that is exempt from taxation under the laws of the establishment jurisdiction.

Arrangement is in scope

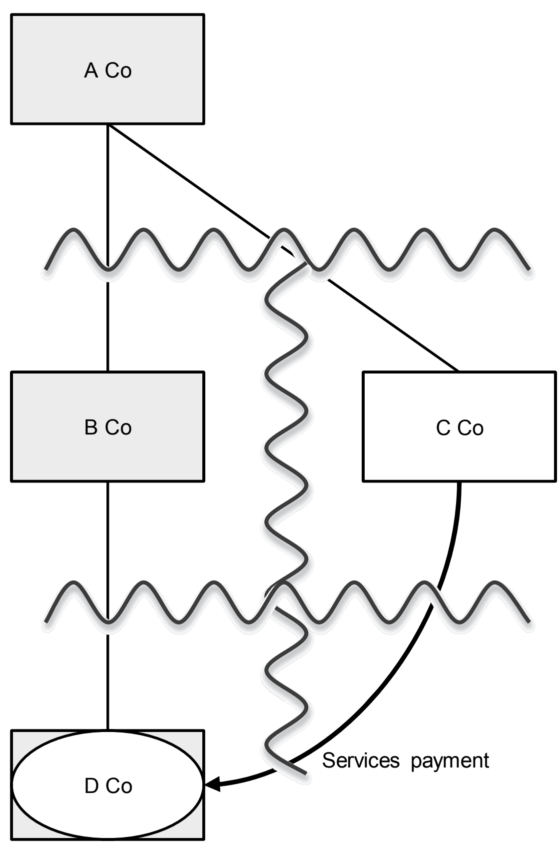
9. In this case the payer (A Co), the reverse hybrid (B Co) and the investor (A) are all part of the same control group because A holds at least 50% of them both. Even if A's holding in B Co was lower than 50%, the example suggests that B Co was inserted into the structure in order to produce the mismatch in tax outcomes. A Co would generally be considered a party to this structured arrangement as it is wholly-owned by one of the people responsible for the design of the arrangement.

Example 4.3

Recommendation 4 and payments that are included under a CFC regime

Facts

1. In the example illustrated in the figure below, A Co is a company resident in Country A which owns all of the shares in B Co (a company resident in Country B). B Co has established a reverse hybrid under the laws of Country D (D Co). D Co receives a services payment from C Co (a company resident in Country C and member of the same group).



2. Country A's CFC regime treats services income paid by a related party as attributable income and subjects such income to taxation at the full marginal rate applicable to income of that nature. D Co has no other items of income or expenditure.

Question

3. Does Recommendation 4 apply in Country C to deny the deduction for the services payment made by C Co to D Co?

Answer

4. The services payment does not give rise to a D/NI outcome as the payment is included in income under laws of Country A. Provided C Co can demonstrate to the tax authorities in Country C that such a payment has been attributed to A Co under the Country A CFC regime and will be subject to tax as ordinary income without the benefit of any deduction, credit or other tax relief then the services payment should not be treated as giving rise to a D/NI outcome under Recommendation 4.

Analysis

D/NI outcome in respect of a payment to a reverse hybrid

5. A D/NI outcome will arise in respect of a payment to a reverse hybrid to the extent that the payment is deductible under the laws of one jurisdiction (the payer jurisdiction) and not included in ordinary income by a taxpayer under the laws of any other jurisdiction where the payment is treated as being received (the payee jurisdiction). Accordingly if the services payment is brought into account as ordinary income in at least one jurisdiction then there will be no mismatch for the rule to apply to.

6. A payment that has been fully attributed to the ultimate parent of the group under a CFC regime and has been subject to tax at the full rate should be treated as having been included in ordinary income for the purposes of the reverse hybrid rule. In this case A Co includes the full amount of the intra-group services fee as ordinary income under its CFC rules. D Co has no other income so no question arises as to whether the full amount of such income has been attributed under A Co's CFC rules. The reverse hybrid rule therefore does not apply in such a case because the payment has not given rise to a mismatch in tax outcomes.

Example 4.4

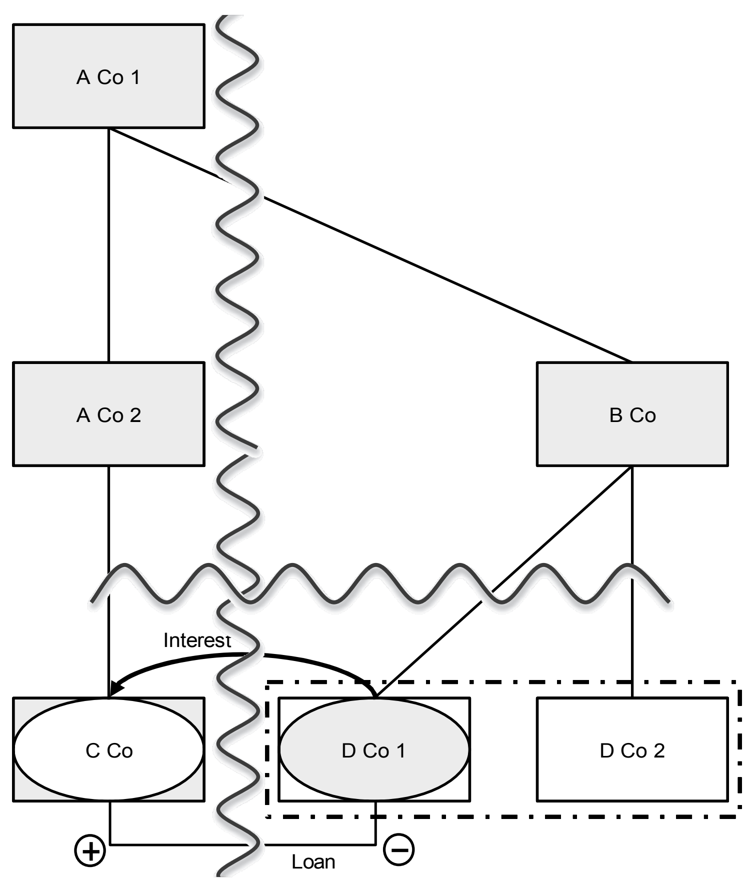
Interaction between Recommendation 4 and Recommendation 6

Facts

1. In the example illustrated in the figure below, A Co 1 and A Co 2 are companies resident in Country A. A Co 1 owns all the shares in A Co 2 and in B Co (a company resident in Country B).

2. A Co 2 has established C Co in Country C. C Co is treated as a disregarded entity for the purposes of Country C law but as a separate company for Country A purposes. Country A does not have any CFC or equivalent rules that would treat interest derived by a foreign controlled entity as attributable to its shareholder for tax purposes.

3. B Co has established a hybrid subsidiary in Country D (D Co 1). D Co 1 is consolidated for tax purposes with D Co 2 (another subsidiary of B Co.). C Co makes a loan to D Co 1. Country B and Country D have both introduced hybrid mismatch rules.



Question

4. Does Recommendation 4 (reverse hybrid rule) or Recommendation 6 (deductible hybrid payments rule) apply in Country B or D to deny the deduction for the interest payment under the loan?

Answer

5. The interest payment is made to a reverse hybrid and will give rise to a hybrid mismatch under Recommendation 4. Both B Co and D Co 1 are treated as payers under the hybrid mismatch rule and therefore both should deny a deduction for the interest payment under Recommendation 4.

6. As Recommendation 4 operates to deny the deduction in both Country B and D there is no scope for the application of the deductible hybrid payments rule under Recommendation 6.

Analysis

C Co is a reverse hybrid

7. A reverse hybrid is any person that is treated as transparent under the laws of the jurisdiction where it is established but as a separate entity by its investor (A Co 2). In this case the establishment jurisdiction is Country C (the country where C Co is incorporated). C Co is disregarded for Country C tax purposes, which means that all the income of C Co is treated as being derived directly by A Co 2 (its immediate parent). C Co is treated as a separate entity for tax purposes under Country A law so that the income allocated to A Co 2 under Country C law is not taken into account as ordinary income in Country A.

Payment gives rise to a D/NI outcome in Country D and Country B

8. A D/NI outcome will arise in respect of a payment to a reverse hybrid to the extent that the payment is deductible under the laws of one jurisdiction (the payer jurisdiction) and is not included in ordinary income by a taxpayer under the laws of any other jurisdiction where the payment is treated as being received (the payee jurisdiction).

9. As the payment is treated as made in both Country D and Country B both jurisdictions should apply the reverse hybrid rule. The tax treatment of the payment in the other payer jurisdiction is not relevant to the question of whether the payment gives rise to a D/NI outcome under the laws of the jurisdiction that is applying the rules.

Mismatch is a hybrid mismatch

10. A payment made to a reverse hybrid that gives rise to a D/NI outcome will be subject to adjustment under the reverse hybrid rule if that D/NI outcome would not have arisen had the payment been made directly to the investor. The identification of a mismatch as a hybrid mismatch under a reverse hybrid structure requires an analysis of how the payment would have been taxed under the laws of the investor jurisdiction. A payment of interest to C Co will be treated as giving rise to a mismatch if that payment would ordinarily have been taxable under Country A law.

11. Furthermore, in order to prevent a reverse hybrid being used to circumvent the operation of the hybrid financial instrument rule, the reverse hybrid rule will apply if an

interest payment made to A Co 2 would have been subject to adjustment under the primary rule in Recommendation 1. If, for example, the loan would have been treated as an equity instrument (i.e. a share) under Country A law and payments of interest treated as exempt dividends then D Co 1 and B Co will continue to deny the deduction for the payment.

No scope for the application of Recommendation 6

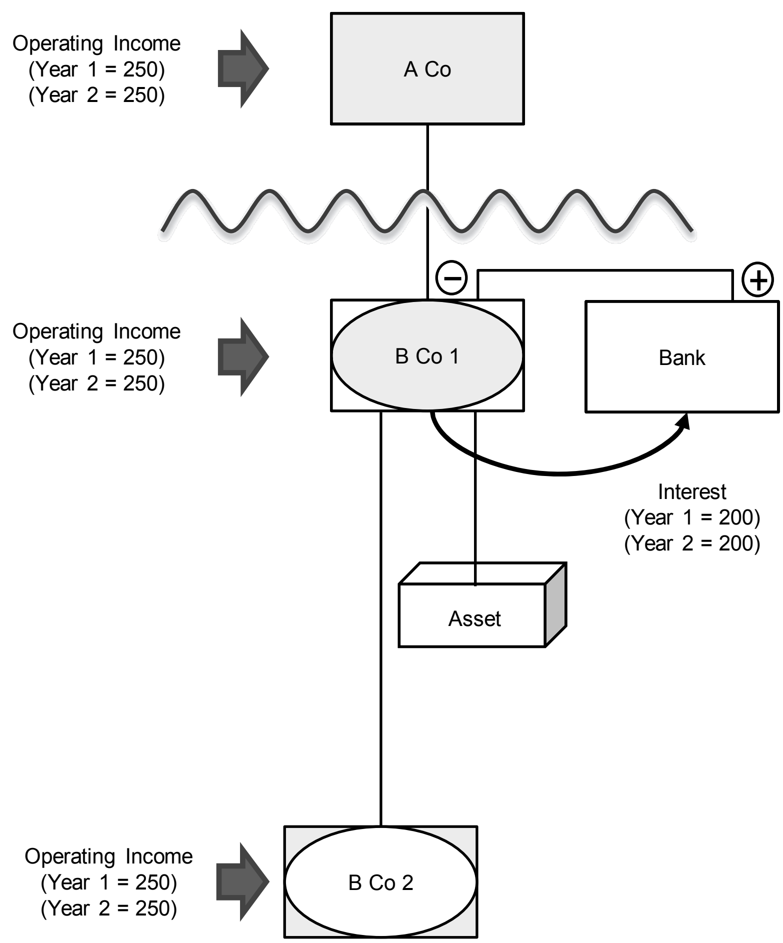
12. Because the effect of Recommendation 4 is to deny a deduction for the interest payment, the arrangement does not give rise to a DD outcome that falls within Recommendation 6.

Example 6.1

Accounting for timing and valuation differences

Facts

1. In the example illustrated in the figure below, A Co owns all of the shares in a hybrid subsidiary in Country B (B Co 1). B Co 1 has borrowed money from a local bank and holds depreciable property. B Co 1 also owns all of the shares in B Co 2.



2. B Co 1 is treated as a disregarded entity under Country A law but as a resident taxpayer in Country B so that all of B Co 1's income and expenditure are fully taxable in both countries. B Co 2 is a reverse hybrid that is treated as a separate entity, for the purposes of Country A law, but disregarded under Country B law. Because of the

differences between Country A and Country B law in the characterisation of B Co 2, all of B Co 2's income is treated as derived by B Co 1 (and is subject to tax under Country B law) but none of this income is brought into account under Country A law.

3. B Co 1 and B Co 2 each derive 500 of operating income over a two year period. Due to the way the arrangement has been structured, B Co 1's income and expenses (including depreciation allowances) are treated as taxable income and deductible expenditure under Country A and Country B laws. However differences in the way Country A and Country B recognise the amount and the timing of such income and expenditure mean that these items are recognised in different amounts and in different periods. In particular:

(a) Under the laws of Country A, 20% of B Co 1's operating income for the two year period is treated as derived in Year 1 (100) and 80% in Year 2 (400). Country A law also requires 50% of the interest expense accrued by B Co 1 in Year 1 (100) to be recognised in Year 2. Tax incentives in Country A also allow A Co to claim a larger depreciation allowance for the property held by B Co 1.

(b) Under Country B law, 60% of the income of B Co 1 (300) is treated as derived in Year 1 and 40% (200) in Year 2. The interest expense and depreciation deductions are, however, spread evenly over the two accounting periods.

4. Tables setting out the combined net income position for the AB Group for Years 1 and 2 are set out below.

	Country A A Co			**Country B B Co 1 and B Co 2 Combined**		
		Tax	**Book**		**Tax**	**Book**
Year 1	Income			Income		
	Operating income of A Co	250	250			
	Operating income of B Co 1	100	0	Operating income of B Co 1	300	250
				Operating income of B Co 2	250	250
	Expenditure			Expenditure		
	Interest paid by B Co 1	(100)	0	Interest paid by B Co 1	(200)	(200)
	Depreciation	(180)	0	Depreciation	(120)	(120)
	Net return		**250**	**Net return**		**180**
	Taxable income	**70**		**Taxable income**	**230**	

Year 2	Country A A Co	Tax	Book	Country B B Co 1 and B Co 2 Combined	Tax	Book
	Income			Income		
	Operating income of A Co	250	250			
	Operating income of B Co 1	400	0	Operating income of B Co 1	200	250
				Operating income of B Co 2	250	250
	Expenditure			Expenditure		
	Interest paid by B Co 1	(300)	0	Interest paid by B Co 1	(200)	(200)
	Depreciation	(180)	0	Depreciation	(120)	(120)
	Net return		**250**	**Net return**		**180**
	Taxable income	**170**		**Taxable income**	**130**	

Net return for Years 1 & 2		**500**		**360**
Taxable income for Years 1 & 2	**240**		**360**	

Country B law

5. In Year 1 B Co 1 and B Co 2 are treated, on a combined basis, as deriving a total of 550 of income and incurring 320 of deductions for tax purposes resulting in net taxable income of 230. In the following year, the Country B group recognises 100 less of operating income than in the previous year but has the same amount of deductions resulting in net taxable income of 130 for that year.

Country A law

6. Differences under Country A law in the recognition of timing of payments mean that Country A treats B Co 1 as only having derived 100 of operating income in Year 1 and having incurred 100 of interest expense. A Co is, however, entitled to a higher amount of depreciation than is available under Country B law. The net effect of these differences is that A Co is treated as deriving 70 of net taxable income in Year 1. In Year 2 Country A law requires A Co to recognise the additional income and expenses, effectively reversing out the timing differences that arose in Year 1. A Co continues to claim depreciation deductions at the higher rate leaving it with net taxable income for the period of 170.

7. The entities in this structure have an aggregate net return of 860 over the two year period while the net taxable income recognised under the arrangement is only 600. This indicates that up to 260 of double deductions are being set-off against non-dual inclusion income.

Question

8. How should the deductible hybrid payments rule be applied to neutralise the effect of the hybrid mismatch under this structure?

Answer

9. The laws of both Country A and B grant a deduction for the same payment (and for depreciation on the same asset) and accordingly these deductions give rise to a DD outcome. Similarly the income of B Co 1 should be treated as dual inclusion income under the laws of both jurisdictions as the item is included in ordinary income under the laws of the other jurisdiction.

10. The recommended response under the deductible hybrid payments rule is that the parent jurisdiction should deny the duplicate deduction to the extent it gives rise to a hybrid mismatch. In this case the application of the rule would result in Country A denying a deduction for 180 in Year 1 (being the amount by which A Co's interest and depreciation deductions exceed the amount of A Co's dual inclusion income) but Country A may allow that excess deduction to be carried-forward into Year 2 to be set-off against dual inclusion income that arises in the following year.

11. In the event Country A does not apply the primary response, Country B would deny a deduction to the extent it gives rise to a hybrid mismatch. In this case, the rule would result in Country B denying 20 of deductions in Year 1 (being the amount by which B Co 1's interest and depreciation deductions exceed the amount of B Co 1's dual inclusion income). Country B may allow that excess deduction to be carried-forward into subsequent years to be set-off against future dual inclusion income.

12. While it may be possible in straightforward cases to undertake a line by line comparison of each item of income and expenditure, tax administrations may choose to adopt an implementation solution for the deductible hybrid payments rule that preserves the policy objectives of the rule and arrives at a substantially similar result but is based, as much as possible, on existing domestic rules and tax calculations.

Analysis

The interest deduction and depreciation allowance give rise to a DD outcome

13. B Co 1 is a hybrid payer because; although it is resident in Country B (the payer jurisdiction), the interest payments and depreciation allowances trigger a duplicate deduction for A Co (an investor in B Co 1). These payments will be treated as giving rise to a double deduction to the extent they exceed dual inclusion income.

Determination of DD outcomes under Country A law and application of the primary response

14. The primary response under Recommendation 6 is that the parent jurisdiction (in this case Country A) should deny the duplicate deduction that is available under local law to the extent it exceeds dual inclusion income. The only item of income recognised under Country A law that is also treated as ordinary income under Country B law is the operating income of B Co 1. Accordingly, the amount of the deduction denied under the primary response in Year 1 is 180. Denying a deduction for this amount will cause A Co to recognise net income in Year 1 of 250.

15. Country A may permit A Co to carry-forward the excess deduction into the subsequent year so that it can be set-off against surplus dual inclusion income in the subsequent year. The calculation of these adjustments is illustrated in the table below. Example 6.1 – Table 2

Year 1	Country A A Co	Tax	Book	Calculation of adjustment under Country A law	Tax	Book	Carry forward
	Income			Dual inclusion income			
	Operating income of A Co	250	250				
	Operating income of B Co 1	100	0	Operating income of B Co 1		(100)	
	Adjustment	180					
	Expenditure			Double deductions			
	Interest paid by B Co 1	(100)	0	Interest paid by B Co 1		100	
	Depreciation	(180)	0	Depreciation		180	
	Net return		**250**				
	Taxable income	**250**		**Adjustment**		**180**	**(180)**

Year 2	Country A A Co	Tax	Book	Calculation of adjustment under Country A law	Tax	Book	Carry forward
	Income			Dual inclusion income			
	Operating income of A Co	250	250				
	Operating income of B Co 1	100	0	Operating income of B Co 1		(400)	
	Adjustment	80					
	Expenditure			Double deductions			
	Interest paid by B Co 1	(100)	0	Interest paid by B Co 1		300	
	Depreciation	(180)	0	Depreciation		180	
	Net return		**250**				
	Taxable income	**250**		**Adjustment**		**80**	**(260)**

16. A Co is denied a deduction for 180 in Year 1 and 80 in Year 2. The net effect of applying the deductible hybrid payments rule over the two year period is that A Co will be fully taxable on its non-dual inclusion income from its own activities over the two year period and will have an excess deduction to carry-forward that effectively represents the net loss (for tax purposes) arising from B Co 1's operations.

Defensive rule

17. The defensive rule under Recommendation 6 is that the payer jurisdiction (in this case Country B) should deny the duplicate deduction that is available under local law to the extent it exceeds dual inclusion income. In this example, the only item of income that is recognised under Country B law that will also be treated as ordinary income under Country A law is the operating income of B Co 1. Accordingly the amount of the deduction denied under the primary response in Year 1 is 20. Denying a deduction for this amount will cause B Co 1 to recognise net income in Year 1 of 250.

18. Country B may permit B Co 1 to carry-forward the excess deduction into the subsequent year so that it can be set-off against surplus dual inclusion income in the subsequent year. The effect of these adjustments is illustrated in the table below.

Year 1	Country B B Co 1 and B Co 2 Combined	Tax	Book	Calculation of adjustment under Country B law	Tax	Book	Carry forward
	Income			Dual inclusion income			
	Operating income of B Co 1	300	250				
	Operating income of B Co 2	250	250	Operating income of B Co 1		(300)	
	Adjustment	20					
	Expenditure			Double deductions			
	Interest paid by B Co 1	(200)	(200)	Interest paid by B Co 1		200	
	Depreciation	(120)	(120)	Depreciation		120	
	Net return		**180**				
	Taxable income	**250**		**Adjustment**		**20**	**(20)**

Year 2	Country B B Co 1 and B Co 2 Combined	Tax	Book	Calculation of adjustment under Country B law	Tax	Book	Carry forward
	Income			Dual inclusion income			
	Operating income of B Co 1	200	250				
	Operating income of B Co 2	250	250	Operating income of B Co 1		(200)	
	Adjustment	120					
	Expenditure			Double deductions			
	Interest paid by B Co 1	(200)	(200)	Interest paid by B Co 1		200	
	Depreciation	(120)	(120)	Depreciation		120	
	Net return		**180**				
	Taxable income	**250**		**Adjustment**		**120**	**(140)**

19. The net effect of applying the deductible hybrid payments rule over the two year period is that B Co 1 will be taxable on its non-dual inclusion income from B Co 2 (500) over the two year period and will have an excess deduction to carry-forward that effectively represents the net loss (for tax purposes) arising from B Co 1's operations.

Implementation solutions

20. In structures such as this it will generally be the case that tax returns have been prepared under the laws of both jurisdictions which will show the income and expenditure as determined under local law using domestic tax concepts. Tax administrations may use

these existing sources of information and tax calculations as a starting point for identifying duplicate deductions and dual inclusion income.

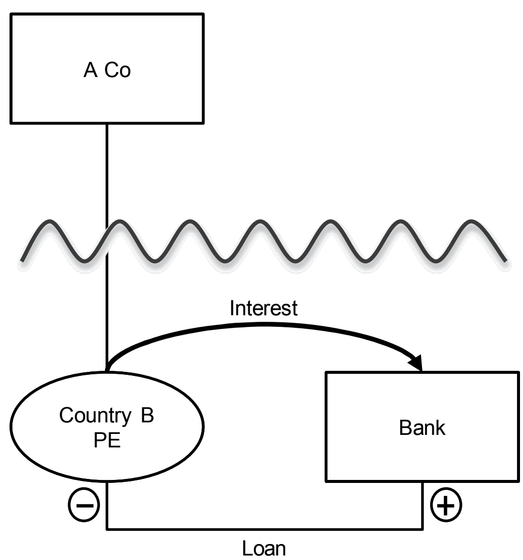
21. For example, Country A could require A Co to separately identify the items of income and deduction that are derived and incurred through B Co 1 and deny A Co a deduction to the extent of any adjusted net loss under such calculation. When applying the defensive rule, Country B could require the losses of B Co 1 to be applied only against income of B Co 1 and apply a loss-continuity rule that prevents B Co 1 from carrying any such losses forward in the event of a change of control.

Example 6.2

Whether DD may be set off against dual inclusion income

Facts

1. In the example illustrated in the figure below, A Co establishes a PE in Country B. The PE borrows money from a local bank. Interest on the loan is deductible in both Country A and Country B. The PE has no other income.



Question

2. Does the deductible hybrid payments rule apply to the interest payment by the PE?

Answer

3. The interest payment will be subject to the deductible hybrid payments rule unless:

(a) the rules in Country B prevent the payment from being set-off against income that is not dual inclusion income; or

(b) the taxpayer can establish, to the satisfaction of the tax administration, that the deduction has given rise to a stranded loss (i.e. the deduction cannot be set-off against the income of any person under the laws of the other jurisdiction).

Analysis

A Co is a hybrid payer making a payment that gives rise to a DD outcome

4. A Co falls within the definition of a "hybrid payer" as A Co is a non-resident making a payment of interest, which is deductible under the laws of Country B (the payer jurisdiction) and which triggers a duplicate deduction for A Co under the laws of Country A (the parent jurisdiction).

5. While income of the PE would presumably be taxable under the laws of both Country A and B, on the facts of this example, the payment will give rise to a DD outcome because the PE has no other income against which the deduction can be off-set.

DD outcome will give rise to a hybrid mismatch if deduction is capable of being set-off against non-dual inclusion income under Country B law

6. A payment results in a hybrid mismatch under the deductible hybrid payments rule where the deduction for that payment may be set-off against income that is not dual inclusion income. It is not necessary for a tax administration to know how the deduction has been used in the other jurisdiction before it applies the rule.

7. Under Country A law the interest deduction will automatically be eligible to be set-off against income of A Co, which may not have a source in Country B. Therefore, unless Country A applies the primary response under the deductible hybrid payments rule, the interest deduction may be set-off against non-dual inclusion income in that jurisdiction. Under Country B law the interest payment will give rise to a net loss. Whether this loss "may" be set-off in the future against non-dual inclusion income under Country B law will depend on the Country B rules governing the utilisation of losses and other interactions between Country A and B laws.

8. The PE may, for example, be able to join a tax grouping regime that would allow the benefit of the loss to be used against the income of another group member. Alternatively the PE may be able to structure an investment through a reverse hybrid in order to derive income that is only brought into account under the laws of the payer jurisdiction or it may be able to enter into a financial instrument or other arrangement where payments on the instrument will not be included in ordinary income in the parent jurisdiction. Unless the taxpayer can show that the interaction between Country A and B laws makes it practically impossible to utilise the deduction against anything other than dual inclusion income, the deduction should be treated as giving rise to a hybrid mismatch under Recommendation 6.3.

Application of the primary response

9. In this case the jurisdiction that should apply the primary response under the deductible hybrid payments rule is Country A. Country A should prevent A Co from offsetting the deduction against A Co's other income and require A Co to apply the excess deduction against dual inclusion income in another period in accordance with Country A law.

Application of the defensive rule

10. In the event Country A does not apply the primary response, Country B should prevent the PE from taking advantage of any structuring opportunities that would allow

the deduction for the payment to be set-off against income that is not dual inclusion income.

Treatment of stranded losses

11. Because the primary rule operates to restrict a deduction in the parent jurisdiction, even in circumstances where the deduction has not been utilised in the payer jurisdiction, the deductible hybrid payments rule has the potential to generate "stranded losses". This could occur, for example where A Co abandons its operations in Country B and winds up the PE in Country B at a time when it still has unused carry-forward losses from a prior period. In this case, Recommendation 6.1(d)(ii) provides that Country A's tax administration may permit those excess deductions to be set-off against non-dual inclusion income under the laws of Country A at that time provided the taxpayer can establish that the winding up of the PE in Country B will prevent A Co from using those losses in Country B.

Implementation solutions

12. If Country A requires A Co to prepare separate accounts for the PE showing the items of income and expenditure that are brought into account under Country A law then Country A could restrict the taxpayer's ability to deduct any net loss of the PE from the income of any member of the parent group. If, on the other hand, A Co is not required to prepare separate accounts for the branch, it could use the tax return and filing information in Country B to determine the net loss of the branch for Country B purposes, and after making adjustments for material items or amounts of income and expenditure that are not recognised under the law of the parent jurisdiction, deny A Co a deduction to the extent of any net loss as calculated under the rules of the parent jurisdiction.

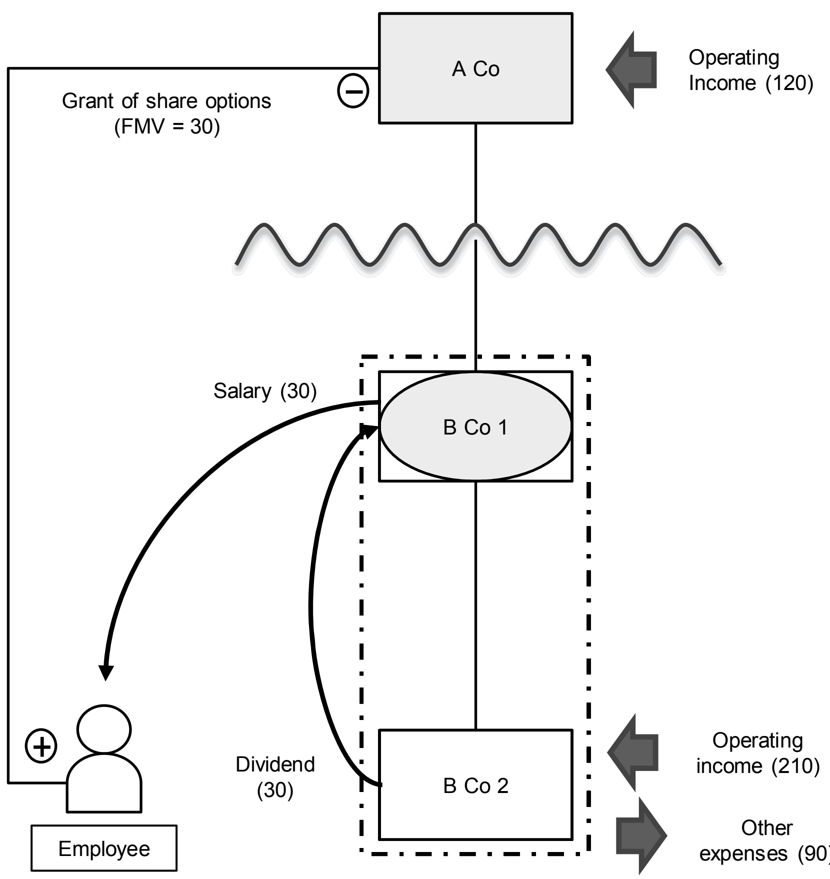
13. Country B will likely require the branch to prepare separate accounts showing all the amounts of income and expenditure that are subject to tax under Country B law. Country B could prohibit the branch from surrendering the benefit of any deductions to any other group member and implement other transaction specific rules designed to prevent taxable income from being shifted into the branch to soak up any net losses. Loss continuity rules may prevent the economic benefit of the carry-forward losses being used against dual inclusion income of another taxpayer.

Example 6.3

Double deduction outcome from the grant of share options

Facts

1. In the example illustrated in the figure below, A Co establishes B Co 1 as the holding company for its operating subsidiary (B Co 2). B Co 1 is a hybrid entity (i.e. an entity that is treated as a separate entity for tax purposes in Country B but as a disregarded entity under Country A law). B Co 1 and B Co 2 are members of the same tax group under Country B law which means that the net loss of B Co 1 can be set-off against the net income of B Co 2.



2. B Co 1 has a single employee. The employee is entitled to an annual salary (paid by B Co 1) The salary cost is funded by a dividend payment from B Co 2 that is excluded from taxation under Country B law. The employee also participates in a share incentive

scheme which provides the employee with an option to acquire shares in A Co at a discount to their market value. The market value of the share options is treated as a deductible employment expense. Below is a table setting out the tax position in respect of A Co, B Co 1 and B Co 2 under this structure.

Country A A Co			**Country B B Co 1**		
	Tax	**Book**		**Tax**	**Book**
Income			Income		
Operating income (A Co)	120	120			
Dividend from B Co 2	30		Dividend from B Co 2		30
Expenditure			Expenditure		
Salary and wages	(30)	-	Salary and wages	(30)	(30)
Share option grant	(30)	(30)	Share option grant	(15)	-
			Net return		**0**
			Taxable income (loss)	(45)	
			Loss surrender to B Co 2	45	
			Loss carry forward	**0**	
			B Co 2		
			Income		
			Operating Income	210	210
			Expenditure		
			Operating expenses	(90)	(90)
			Dividend paid to B Co 1	-	(30)
			Loss surrender	(45)	-
Net return		**90**	**Net return**		**90**
Taxable income	**90**		**Taxable income**	**75**	

Result under Country B law

3. B Co 1 is treated as incurring 45 of employment expenses. The cash portion of these expenses (i.e. the salary and wages) is funded by an exempt dividend from B Co 2. B Co 1’s net loss is surrendered to B Co 2 under the tax grouping regime of Country B and is applied against that company’s net income. B Co 2 has 75 of taxable income after taking into account expenses and the benefit of the loss surrendered by B Co 1.

Result under Country A law

4. A Co earns 120 of operating income from its activities in Country A. A Co also treats the dividend paid by B Co 2, to fund B Co 1's employment expenses, as ordinary income for tax purposes. Country A grants a deduction for the salary and wages and the value of the share options but uses a different valuation methodology for calculating the share option expense that results in a higher deduction.

5. The entities in this structure have a total net return of 180 under the arrangement but the aggregate taxable income under the arrangement is 165. This indicates that at least 15 of double deductions are being set-off against non-dual inclusion income.

Question

6. What adjustments should be made to tax returns of the AB group under the deductible hybrid payments rule?

Answer

7. In this case Country A should apply the primary response under the deductible hybrid payments rule and require A Co to carry-forward 30 of deductions into another period to be set-off against future dual inclusion income. In the event Country A does not apply the primary response, Country B should deny B Co a deduction of 15.

Analysis

The payment of the salary gives rise to a DD outcome

8. The question of whether a payment has given rise to a "DD outcome" is primarily a legal question that should be determined by an analysis of the character and tax treatment of the payment under the laws of both jurisdictions. This requires an assessment of the legal basis for the deduction in one jurisdiction and a comparison with the tax outcomes in the other jurisdiction to determine whether a deduction has been granted in respect of the same circumstances and on the same basis. If both jurisdictions grant a deduction for the same expenditure item, then that deduction should be treated as giving rise to a DD outcome. The labels that are ascribed to each category of payment (e.g. travel subsidy, meal allowance, or wages) are less significant than identifying what the deduction is for (i.e. employment expenses). If one jurisdiction treats a travel subsidy as a separate deductible allowance, while the other simply treats it as part of the taxpayer's salary or wages, then the payment will still be treated as giving rise to a DD outcome notwithstanding the different ways in which the payment is described under the laws of each jurisdiction.

9. In this case, both Country A and B treat salary or wages as deductible and accordingly such a payment will generally give rise to a DD outcome. Under the deductible hybrid payments rule the breakdown of salary and wages into its specific components (e.g. meal allowances, wages) is not important provided both jurisdictions are granting a deduction for the same expense. The final conclusion that a payment has given rise to a DD outcome should only be made, however after the application of any transaction or entity specific rules that prevent the deduction being claimed under the laws of either jurisdiction. No DD outcome would arise, for example, if A Co was a tax exempt entity that was not entitled to claim deductions for any type of expenditure.

The grant of the share options will give rise to a DD outcome

10. If the laws of both Country A and B treat the granting of the share options as a deductible expense then the grant of the shares will be treated as giving rise to a DD outcome to the extent of the deduction in each jurisdiction. Although there are differences between Country A and B in how the share options are valued this will generally not impact on the extent to which a payment has given rise to a mismatch in tax outcomes.

The payment of the dividend gives rise to dual inclusion income

11. While a payment must generally be recognised as ordinary income under the laws of both jurisdictions before it can be treated as dual inclusion income, a payment that is treated as ordinary income in the parent jurisdiction should still qualify as dual inclusion income if the payment is subject to taxation relief in the payer jurisdiction in order to relieve the payment from economic double taxation. In this case, the dividend paid by B Co 2 to B Co 1 is treated as an exempt intra-group dividend. The dividend is not deductible for B Co 2 and therefore does not trigger any further deductible expense under the laws of the payer jurisdiction and cannot be used to erode the tax base of Country B. Allowing the dividend recipient a deduction against this type of exempt or excluded equity return preserves the intended tax policy outcomes in both Country A and Country B and accordingly the dividend should be treated as dual inclusion income for the purposes of the deductible hybrid payments rule even where such dividend carries an entitlement to an underlying foreign tax credit in the parent jurisdiction. Such double taxation relief may give rise to tax policy concerns, however, if it has the same net effect as allowing for a DD outcome. In determining whether to treat an item of income, which benefits from such double-taxation relief, as dual-inclusion income, countries should seek to strike a balance between rules that minimise compliance costs, preserve the intended effect of such double taxation relief and prevent taxpayers from entering into structures that undermine the integrity of the rules.

Application of the primary response

12. In this case the jurisdiction that should apply the primary response under the deductible hybrid payments rule is Country A. Country A should deny A Co's duplicate deductions to the extent it gives rise to a mismatch in tax outcomes. The duplicate deduction will not give rise to a mismatch to the extent it does not exceed dual inclusion income as determined under the laws of the parent jurisdiction. In this case, the total amount of duplicate deduction incurred by A Co is 60 and A Co's dual inclusion income is 30. The total amount of adjustment that should be made under the deductible hybrid payments rule is therefore 30.

Country A A Co	Tax	Book
Income		
Operating income (A Co)	120	120
Dividend from B Co 2	30	
Adjustment	30	
Expenditure		
Salary and wages	(30)	
Share option grant	(30)	(30)
Income		
Net return		**90**
Taxable income	**120**	

Calculation of adjustment under Country A law	Tax	Book	Carry forward
Dual inclusion income			
Dividend from B Co 2		(30)	
Double deductions			
Salary and wages		30	
Share option grant		30	
Adjustment		**30**	**(30)**

Application of the defensive rule

13. In the event Country A does not apply the primary response, Country B should deny B Co a deduction for the payment to the extent necessary to prevent the deduction from being set-off against income that is not dual inclusion income. While the dividend paid by B Co 2 to B Co 1 is treated as exempt income under Country B law, this payment should be included in the calculation of dual inclusion income as it is included in income under the laws of Country A. In this case, the total amount of duplicate deduction incurred by B Co is (45) and A Co's dual inclusion income is 30. The total amount of adjustment required under the deductible hybrid payments rule under Country B law is 15.

Country B B Co 1	Tax	Book
Income		
Dividend from B Co 2		30
Adjustment	15	
Expenditure		
Salary and wages	(30)	
Share option grant	(15)	(30)
Income		
Net return		**0**
Taxable income (loss)	**(30)**	

Calculation of adjustment under Country B law	Tax	Book	Carry forward
Dual inclusion income			
Dividend from B Co 2		(30)	
Double deductions			
Salary and wages		30	
Share option grant		15	
Adjustment		**15**	**(15)**

Implementation solutions

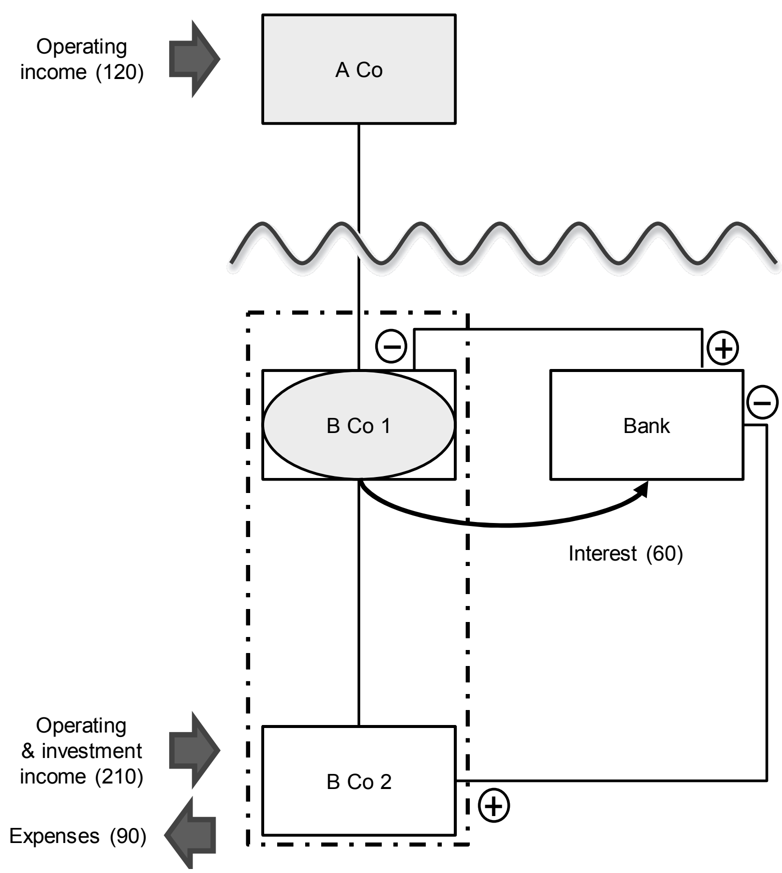
14. In this case, given that B Co has no income and incurs a limited amount of expenses, it may be possible for both Country A and B to make a direct comparison between the tax treatment of the employment expenses in both countries to determine whether and to what extent they give rise to a DD outcome. When applying the deductible hybrid payments rule, the tax administration in Country B should take into account, as dual inclusion income, any payment that is eligible for exclusion, exemption other forms of tax relief in order to avoid economic double taxation provided such payment is included in income under Country A law.

Example 6.4

Calculating dual inclusion income under a CFC regime

Facts

1. In the example illustrated in the figure below, A Co establishes B Co 1 as the holding company for its operating subsidiary (B Co 2).



2. B Co 1 is a hybrid entity (i.e. an entity that is treated as a separate entity for tax purposes in Country B but as a disregarded entity under Country A law). B Co 1 and B Co 2 are members of the same tax group under Country B law so that any net loss of B Co 1 can be surrendered under the grouping regime to be set-off against the income of B Co 2. B Co 1 borrows money from a local bank. The interest on the loan is treated as a deductible expense under both Country A and B laws.

3. B Co 2 is treated as a separate taxable entity by both A Co and B Co 1. Certain items of income derived by B Co 2 are, however, attributed to A Co under Country A's CFC regime. B Co 2 has funds on deposit with the same bank and earns interest income which is subject to tax in the hands of B Co 2. Below is a table setting out the tax position in respect of the AB Group under this structure.

Country A			**Country B**		
A Co			**B Co 1**		
	Tax	**Book**		**Tax**	**Book**
Income			Income		
Operating income (A Co)	120	120			
Attributed CFC Income from B Co 2	30	-			
Tax credit on attributed CFC Income	6	-			
Expenditure			Expenditure		
Interest paid by B Co 1	(60)	-	Interest paid	(60)	(60)
Net return		**120**	**Net return**		**(60)**
Taxable income	**96**		Taxable income (loss)	(60)	
Tax on income (30%)	(28.8)				
Credit for underlying foreign taxes	6		Loss surrender to B Co 2	60	
Tax to pay		(22.8)	**Loss carry forward**	**0**	
After-tax return		**97.2**			
			B Co 2		
			Income		
			Operating Income	180	180
			Interest Income	30	30
			Expenditure		
			Operating expenses	(90)	(90)
			Loss surrender	(60)	-
			Net return		**120**
			Taxable income	**60**	
			Tax on income (20%)	(12)	
			Tax to pay		(12)
			After-tax return		**108**

Result under Country B law

4. B Co 1 incurs 60 of interest expenses. The net loss resulting from this interest expense is surrendered under the tax grouping regime of Country B and applied against

the income of B Co 2. B Co 2 has 60 of taxable income after taking into account expenses and the benefit of the loss surrendered by B Co 1.

Result under Country A law

5. A Co earns 120 of net operating income from its activities in Country A and is entitled to claim the 60 of interest expenses incurred by B Co 1. A Co is also attributed, under the Country A's CFC regime, a gross amount of 30 interest derived by B Co 2 together with tax on that income of 6. This attributed income is brought into account as ordinary income and subject to tax at the full corporate rate after taking into account a credit for underlying taxes paid in Country B.

6. The total net return for the group is 180 while the net income for the group is 156 (including 6 of foreign tax credits).

Question

7. What adjustments should be made to tax returns of A Co and B Co 1 under the deductible hybrid payments rule?

Answer

8. A tax administration may treat the net income of a controlled foreign company (CFC) that is attributed to a shareholder of that company under a CFC or other offshore inclusion regime as dual inclusion income if the taxpayer can satisfy the tax administration that such income has been calculated on the same basis and is treated as ordinary income that is subject to tax at the full rate under the laws of both jurisdictions. Such income will be eligible to be treated as dual inclusion income even if it carries with it an entitlement to credit for underlying foreign taxes that shelters a liability to tax in the parent jurisdiction.

Analysis

Attributed income under a CFC regime can give rise to dual inclusion income.

9. In this simplified example, where there is a single item of interest income that is brought into account under the laws of both jurisdictions, the amount of attributed CFC income that may be treated as dual inclusion income is the amount recognised as ordinary income under the laws of Country A (including the benefit of any tax credits). The table below shows the effect of an adjustment under the deductible hybrids payment rule taking into account the operation of the CFC regime under Country A law.

Country A A Co	Tax	Book
Income		
Operating income (A Co)	120	120
Attributed CFC Income from B Co 2	30	-
Tax credit on attributed CFC Income	6	-
Expenditure		
Interest paid by B Co 1	(36)	-
Net return		**120**
Taxable income	**120**	
Tax on income (30%)	(36)	
Credit for underlying foreign taxes	6	
Tax to pay		(30)
After-tax return		**90**

10. The effect of this adjustment is that Country A permits A Co 1 to deduct the interest expense to the extent that interest is set-off against amounts that are included in income under Country A's CFC regime. The total amount of income brought into account under Country A and B laws is equal to 180. The reduced final level of tax in Country A (25%) is the result of Country A continuing to provide the benefit of a tax credit on dual inclusion income, despite the fact that the net dual inclusion income under Country A law is nil (after that income has been set-off against a duplicate deduction).

11. Under Country B law, the amount of income that is considered to be dual inclusion income is the 30 of interest income derived by B Co 2. Accordingly, this amount of loss should be treated as eligible for surrender under Country B law. The table below shows the effect of the adjustment on the tax position of B Co 2.

Country B B Co 2	Tax	Book
Income		
Adjustment	30	
Expenditure		
Interest paid by B Co 1	(60)	(60)
Net return		**(60)**
Taxable income	(30)	
Loss surrender to B Co 2	30	
Loss carry forward	**0**	

Calculation of adjustment under Country B law	Tax	Book	Carry forward
Dual inclusion income			
Interest income		(30)	
Double deductions			
Interest paid by B Co 1		60	
Adjustment		**30**	**(30)**

B Co 2	Tax	Book
Income		
Operating Income	180	180
Interest Income	30	30
Expenditure		
Operating expenses	(90)	(90)
Loss surrender	(30)	-
Net return		**120**
Taxable income	**90**	
Tax on income (20%)	(18)	
Tax to pay		(18)
After-tax return		**102**

12. Country B permits B Co 1 to surrender 30 of losses to B Co 2 (i.e. the amount that is included in ordinary income under Country A's CFC regime, ignoring the effect of any credits). The effect of this adjustment is that Country A and B will include an aggregate of 180 of income under the arrangement in addition to the foreign tax credit.

Implementation solutions

13. In cases where dual inclusion income carries a right to a tax credit for an underlying foreign taxes the parent jurisdiction could further choose to restrict the amount of the foreign tax credit to the tax liability of the net dual inclusion income under the arrangement. An illustration of the effect of these CFC changes is set out below:

Country A A Co		
	Tax	**Book**
Income		
Operating income (A Co)	120	120
Attributed CFC Income from B Co 2	30	-
Tax credit on attributed CFC Income	6	-
Expenditure		
Interest paid by B Co 1	(36)	-
Net return		**120**
Taxable income	**120**	
Tax on income (30%)	(36)	
Credit for underlying foreign taxes	0	
Tax to pay		(36)
After-tax return		**84**

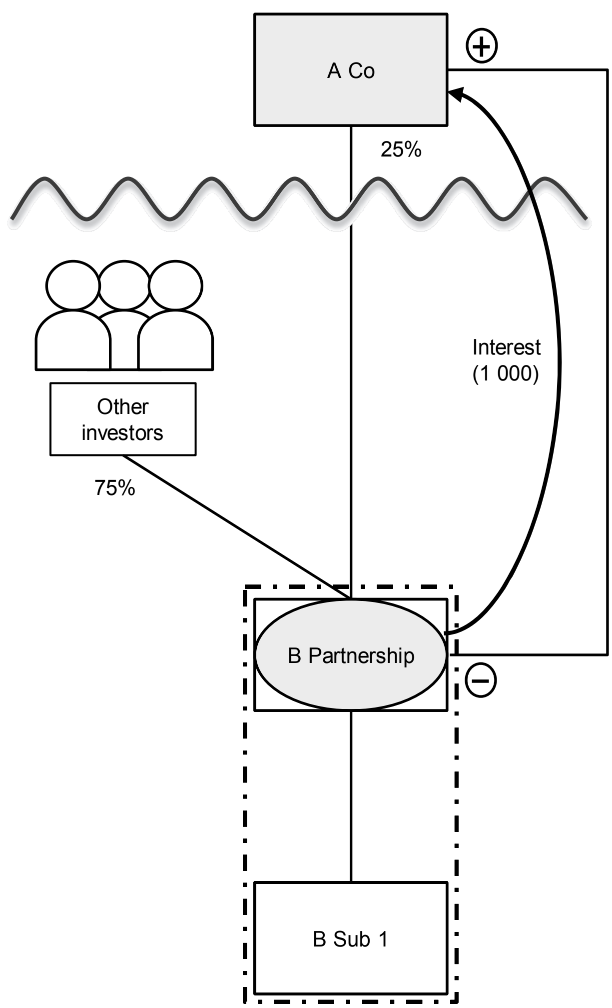
14. Adjusting the entitlement to foreign tax credits in this way would protect Country A from using double deduction structures to bring up tax credits without a corresponding income item. Denying the foreign tax credit in these cases would make it easier for a taxpayer to establish that the income attributed under the CFC regime is, in fact, dual inclusion that has been calculated on the same basis in both jurisdictions and is subject to tax in both jurisdictions at the full rate.

Example 6.5

DD outcome under a loan to a partnership

Facts

1. In the example illustrated in the figure below, B Partnership is a hybrid entity that is 25% owned by A Co (a company resident in Country A). The partnership has no income. A Co lends money to B Partnership.



2. The tax laws of Country A treat B Partnership as a transparent entity so that a proportionate share of the items of income, gain and expenditure derived and incurred by B Partnership are allocated (under Country A law only) through the partnership to A Co in accordance with A Co's interest in the partnership. B Partnership is consolidated with B Sub 1, which is treated as a separate taxable entity under Country B law.

3. The interest payment is treated as a deductible expense under Country B law and can be surrendered against income of B Sub 1 under Country B's tax grouping regime. Under Country A law, however, both the income from interest payment and the deduction from the interest expense are set-off against each other on the same tax return so that only net 75% of the interest payment (effectively the portion of the interest cost economically borne by the other investors) is included in A Co's income. If the interest payment under the loan is 1 000 and the partnership has no other income then a simplified tax calculation for A Co (assuming a corporate tax rate of 30%) can be illustrated as follows:

Country A A Co		
	Tax	**Book**
Income		
Interest	1 000	1 000
Expenditure		
Interest	(250)	-
Net return		**1000**
Taxable income	**750**	
Tax to pay (33%)		(250)
After-tax return		**750**

4. While A Co receives a net return of 1 000, its taxable income under the arrangement is reduced by the portion of the interest expense on the loan that is allocated to A Co under Country A law. The net effect of this allocation is that A Co is taxable on the net return under the arrangement at a rate of 25% rather than the statutory rate of 33%.

Question

5. Does Recommendation 6 apply to deny the deduction for any portion of the interest payment under the loan?

Answer

6. The interest payment falls within the deductible hybrid payments rule because the interest payment by the B Partnership gives rise to a deduction in Country B that may be set-off against income of B Sub 1 (under the tax grouping regime of Country B) and a duplicate deduction for A Co (an investor in B Partnership). Accordingly, under the primary rule, the duplicate deduction in Country A should be denied to the extent that exceeds the investor's dual inclusion income. A Co's dual inclusion income in this example is *nil* as the interest paid on the loan is not subject to tax in Country A.

Accordingly, Country A should deny a deduction for the full amount of the interest expense.

7. In the event that Country A does not apply the primary response under Recommendation 6, Country B should apply the defensive rule to restrict a deduction for the interest payment to the extent it gives rise to a duplicate deduction under Country A law and to the extent the interest payment is not set-off against dual inclusion income. Because B Partnership and A Co are not members of the same control group, the defensive rule will only apply, however, to the extent the mismatch arises under a structured arrangement and B Partnership is a party to that arrangement. The amount of the deduction denied under the defensive rule is the entire amount of the interest payment (i.e. 1 000) as that is the amount necessary to eliminate the mismatch in tax outcomes.

Analysis

B Partnership is a hybrid payer making a payment that gives rise to a DD outcome

8. The partnership falls within the definition of a "hybrid payer" as it is tax resident in Country B and makes a deductible payment in that jurisdiction that triggers a duplicate deduction for an investor in the partnership (A Co) under the laws of another jurisdiction (Country A). If the partnership had other income this would likely be dual inclusion income that could be offset against the deduction under the laws of both jurisdictions. In this case, however, the partnership derives no other income and, accordingly, the entire amount of the interest payment gives rise to a DD outcome.

If mismatch is not neutralised under Country A law then Country B should deny a deduction for the interest payment under the secondary rule

9. In the case of hybrid entities such as partnerships, the parent jurisdiction is the jurisdiction where the partner is resident (Country A), Country A should therefore deny the full amount of the deduction (250) in order to neutralise the mismatch in tax outcomes.

10. In the event Country A does not apply the primary rule, Country B should deny the deduction to the extent necessary to neutralise the mismatch. This will result in a deduction being denied for the full amount of the interest payment (1 000), because any deduction incurred by the partnership in these circumstances, that is in excess of dual inclusion income, will give rise to a mismatch in tax outcomes due to the tax transparency of the partnership under Country A law.

Secondary rule will not apply unless B Partnership is a party to structured arrangement

11. The secondary rule will not apply unless the mismatch arises within the confines of a control group or under a structured arrangement and the payer is a party to that structured arrangement. A payer will not be a party to a structured arrangement if it could not reasonably have been expected to be aware of the hybrid mismatch and did not share in the value of the tax benefit arising from it. In this case the partnership would not necessarily be expected to be aware of the tax treatment adopted by A Co (because B Partnership is not treated as transparent under the law of County B) and unless the pricing

of the loan reflects the benefit of the resulting mismatch the partnership will not be treated as sharing in the value of the tax benefit.

Implementation solutions

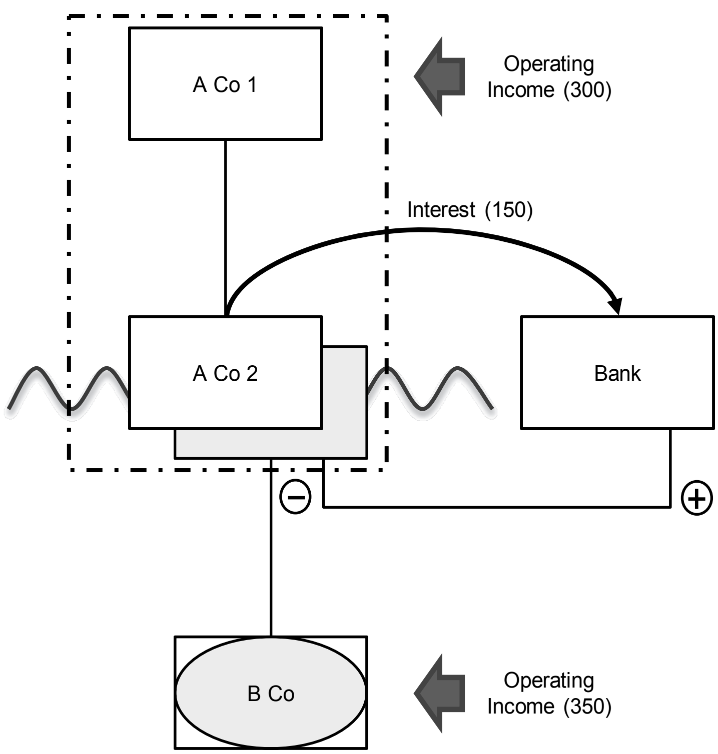
12. In this case, the easiest way of preventing a double deduction being set-off against non-dual inclusion income under Country A law would be for Country A to prevent A Co from claiming any net loss from the partnership. Country B could restrict the ability of the partnership to surrender the benefit of any resulting net loss under Country B's tax grouping regime and impose further transaction specific rules that prevent B Partnership from entering into transactions designed to stream non-dual inclusion income to the partnership in order to soak-up unused losses.

Example 7.1

DD outcome using a dual resident entity

Facts

1. In the example illustrated in the figure below A Co 1 owns all of the shares in A Co 2. A Co 2 is resident for tax purposes in both Country A and Country B. A Co 1 is consolidated with A Co 2 under Country A law. A Co 2 acquires all the shares in B Co. B Co is a reverse hybrid that is treated as a separate entity, for the purposes of Country A law, but disregarded under Country B law.



2. A Co 2 borrows money from a bank. Interest on the loan is deductible in both Country A and Country B. A Co 2 has no other income or expenditure. A table setting out the combined net income position for the AB Group is set out below.

Country A A Co 1			Country B A Co 1 and B Co Combined		
	Tax	Book		Tax	Book
Income			Income		
Operating income of A Co 1	300	300	Operating income of B Co	350	350
Expenditure			Expenditure		
Interest paid by A Co 2 to bank	(150)	-	Interest paid by A Co 2 to bank	(150)	(150)
Net return		**300**	**Net return**		**200**
Taxable income	**150**		**Taxable income**	**200**	

3. Country A's tax consolidation regime permits A Co 2's interest payment (150) to be directly set-off against the operating income of A Co 1 leaving A Co 1 with 150 of taxable income. Under Country B law, the taxable income of B Co is treated as derived by A Co 2 and is set-off against A Co 2's interest deduction, leaving the Country B Group with taxable income of 200. The net effect of this structure is, therefore, that the entities in the AB Group derive a net return of 500 of net income but only have taxable income of 350.

Question

4. Are the tax outcomes described above subject to adjustment under the dual resident payer rule?

Answer

5. Both Country A and B should apply the dual resident payer rule to deny the benefit of the interest deduction. While having both countries apply the same rule to the same payment raises the risk of double taxation there is no reliable way of ordering the application of the rules and structuring alternatives are available which can prevent double taxation from arising.

6. If the dual resident ceases to be a dual resident excess deductions may be able to be applied against non-dual inclusion income under the rule in Recommendation 7.1 (c) dealing with stranded losses.

Analysis

Application of the dual resident payer rule

7. A Co 2 is a dual resident entity and the interest payment triggers deductions under the laws of both jurisdictions where A Co 2 is resident. A person should be treated as a resident of a jurisdiction for tax purposes if they qualify as tax resident in that jurisdiction or they are taxable in that jurisdiction on their worldwide net income. A person will be treated as a resident of a jurisdiction even if that person forms part of a tax consolidation group which treats that person as a disregarded entity for local law purposes. Thus, if the tax consolidation regime in Country A was to treat all the taxpayers in the same

consolidated group as a single taxpayer and to disregard the transactions between them, A Co 2 would still be treated as a resident of Country A for the purposes of the rule.

8. A Co 2 has no other income so that the deduction gives rise to a DD outcome under the laws of both Country A and B. The tax consolidation regime in Country A and the ability of A Co 2 to invest in a reverse hybrid under Country B law mean that, in each case, the DD outcome gives rise to a hybrid mismatch. Accordingly, both Country A and B, should deny the interest deduction under the dual resident payer rule. A table setting out the combined effect of these adjustments is set out below.

Country A A Co 1		
	Tax	**Book**
Income		
Operating income of A Co 1	300	300
Adjustment	150	
Expenditure		
Interest paid by A Co 2 to bank	(150)	-
Net return		**300**
Taxable income	**300**	

Calculation of adjustment under Country A law			**Carry forward**
	Tax	**Book**	
Dual inclusion income			
Double deductions			
Interest paid by A Co 2 to bank		150	
Adjustment		**150**	**(150)**

Country B A Co 1 and B Co		
	Tax	**Book**
Income		
Operating income of B Co	350	350
Adjustment	150	
Expenditure		
Interest paid by A Co 2	(150)	(150)
Net return		**200**
Taxable income	**350**	

Calculation of adjustment under Country B law			**Carry forward**
	Tax	**Book**	
Dual inclusion income			
Double deductions			
Interest paid by A Co 2 to bank		150	
Adjustment		**150**	**(150)**

9. As can be seen from the above table, the net effect of applying the dual resident payer rules in both jurisdictions is to increase the aggregate amount of taxable income to 650. This is in excess of the actual net income under the arrangement. Structuring opportunities are available to A Co 2, however, that will eliminate the net tax burden. A Co 2 could, for example, loan the borrowed money to A Co 1 at an equivalent rate of interest. As illustrated in the table below, the effect of on-lending the money will be to create dual inclusion income that will eliminate the mismatch in tax outcomes.

Country A A Co 1	Tax	Book	Country B A Co 2 and B Co Combined	Tax	Book
Income			Income		
Operating income of A Co 1	300	300	Operating income of B Co	350	350
			Interest paid by A Co 1	150	150
Expenditure			Expenditure		
Interest paid by A Co 2 to bank	(150)	-	Interest paid by A Co 2 to bank	(150)	(150)
Interest paid by A Co 1 to A Co 2	-	(150)			
Net return		**150**	**Net return**		**300**
Taxable income	**150**		**Taxable income**	**300**	

10. The net effect of on-lending the money to A Co 1 is to create an amount of dual inclusion income that is equal to the double deduction thus eliminating any mismatch in tax outcomes under the laws of both jurisdictions and ensuring the aggregate net income under the arrangement is subject to tax under the laws of both jurisdictions. Although this interest payment is not taxable under Country A law (because it would be a payment made between members of a consolidated group) it would meet the definition of dual inclusion income because, in this case, the effect of consolidation is to relieve the payee from the economic double taxation on the same income.

11. An alternative way of escaping the effect of the over-taxation under the rule would be to pay a dividend from B Co that was taxable under the laws of Country A. Although this dividend would not be taxable under Country B law (because it would be a payment made by a disregarded entity) it would meet the definition of dual inclusion income because it is excluded from taxation under the laws of Country B in order to relieve the payee from the effects of double taxation. This will be the case even where the parent jurisdiction recognises a tax credit for underlying foreign taxes paid on the distribution. The effect of paying a dividend to A Co 2 is illustrated in the table below.

Country A A Co 1	Tax	Book	Country B A Co 2 and B Co Combined	Tax	Book
Income			Income		
Operating income of A Co 1	300	300	Operating income of B Co	350	350
				-	-
Expenditure			Expenditure		
Interest paid by A Co 2 to bank	(150)	-	Interest paid by A Co 2 to bank	(150)	(150)
Dividend paid by B Co	150				
Net return		**300**	**Net return**		**200**
Taxable income	**300**		**Taxable income**	**200**	

12. The effect of dividend is to create an additional amount of dual inclusion income under Country A law that is equal to the interest deduction thus eliminating any mismatch in tax outcomes under the laws of Country A. Although the dividend is not taken into account under Country B law the dividend is still considered to be dual inclusion income because the exclusion granted under Country B law simply protects the taxpayer in Country B from double taxation on the same economic income.

Treatment of stranded losses

13. As with the deductible hybrid payments rule, the dual resident payer rule has the potential to generate "stranded losses" in circumstances where it restricts the deduction in both jurisdictions or where the deduction that arises in the other jurisdiction is unable to be utilised for commercial reasons. Stranded losses could arise, for example under the laws of Country A if the operating income of B Co was insufficient to cover the interest obligations on the bank loan. If a dual resident entity with excess deductions under the dual resident payer rule abandons its dual resident status, the residence jurisdiction may release those excess losses and allow them to be set-off against non-dual inclusion income if the residence jurisdiction is satisfied that the taxpayer can no longer take advantage of any carry-forward losses in the other jurisdiction.

Implementation solutions

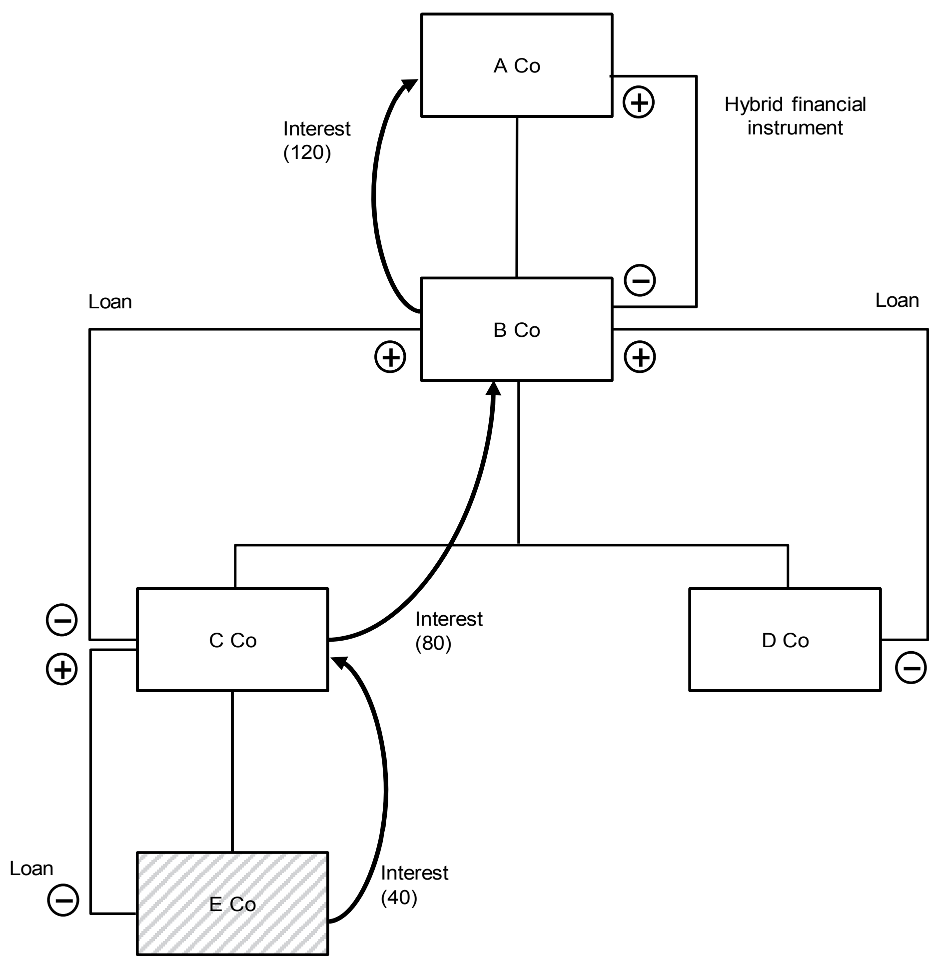
14. Countries may choose to prevent dual resident entities joining any tax consolidation or other grouping regime and may introduce transaction specific rules designed to prevent such entities from streaming non-dual inclusion income to a dual resident entity to soak-up unused losses.

Example 8.1

Structured imported mismatch rule

Facts

1. In the example illustrated in the figure below, A Co (a company resident in Country A) is the parent of the ABCDE Group. A Co provides financing to B Co (a wholly-owned subsidiary of A Co resident in Country B) under a hybrid financial instrument. Interest payments on the loan are deductible under Country B law but not included in ordinary income under Country A law. B Co on-lends the money provided under the hybrid financial instrument to C Co and D Co (companies that are resident in Country C and D respectively). C Co on-lends money to E Co (a wholly-owned subsidiary of C Co resident in Country E).



2. All loans are made as part of the same intra-group financing arrangement. The figure above illustrates the group financing structure and the total gross amount of interest payments made in each accounting period under this structure. E Co (the shaded entity) is the only group entity resident in a country that has implemented the recommendations set out in the report.

Question

3. Whether the interest payments made by E Co to C Co are subject to adjustment under the imported mismatch rule and, if so, the amount of the adjustment required under that rule.

Answer

4. E Co's imported mismatch payment and the payment under the hybrid financial instrument that gives rise to a hybrid deduction are payments made under the same structured imported mismatch arrangement. Country E should, therefore, deny the full amount of the interest deduction under the structured imported mismatch rule. See the flow diagram at the end of this example which outlines of the steps to be taken in applying the structured imported mismatch rule.

Analysis

The interest payment made by E Co and the payment giving rise to the hybrid deduction are part of the same structured arrangement

5. In this case the money raised under the hybrid financing instrument has been on-lent to other group companies as part of the same financing arrangement. All the lending transactions and associated payments made under the group financing arrangement (including the loan to E Co) should be treated as part of the same structured arrangement. Accordingly, the payment made by B Co under the hybrid financial instrument, which gives rise to the hybrid deduction, and the imported mismatch payment made by E Co, which is subject to adjustment under the imported mismatch rules in Country E, should be treated as made under the same structured arrangement.

Country E should deny the full amount of the interest deduction under the structured imported mismatch rule

Step 1 –B Co's payment under the hybrid financial instrument gives rise to a direct hybrid deduction

6. A Co has provided financing to B Co under a hybrid financial instrument. Interest payments on that financial instrument are deductible under Country B law but not included in ordinary income under Country A law. The interest payments therefore give rise to a direct hybrid deduction for B Co of 120.

Step 2 –the imported mismatch payment and the hybrid deduction are part of the same structured arrangement

7. The payment made by B Co under the hybrid financial instrument and the imported mismatch payment made by E Co are treated as part of the same structured

arrangement (see analysis above). The structured imported mismatch rule requires the payer jurisdiction to deny a deduction under an imported mismatch payment to the extent the income from such payment is offset (directly or indirectly) against a hybrid deduction under the same structured arrangement.

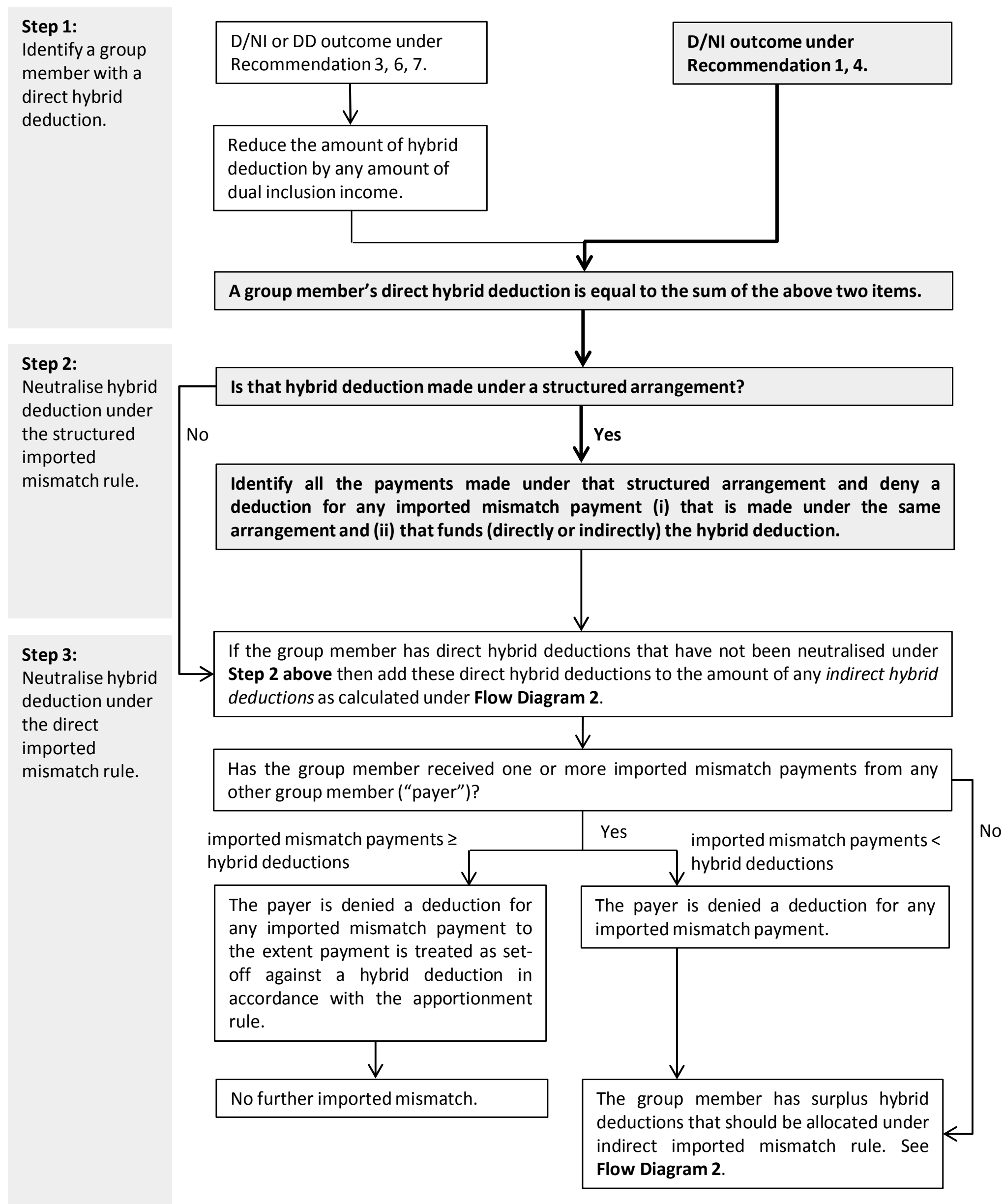
8. The taxpayer should apply a tracing approach to determine the extent to which the imported mismatch payment has been indirectly offset against that hybrid deduction. The tracing approach requires E Co to trace the chain of payments that give rise to offsetting income and expenditure under the structured arrangement through tiers of intermediate entities to determine the extent to which the payment has directly or indirectly funded the hybrid deduction. The mechanical steps involved in tracing the payment flows are described below:

(a) B Co's payment to A Co under the hybrid financial instrument gives rise to a hybrid deduction of (120). C Co has made a cross-border payment to B Co under the same arrangement of (80). The lower of these two numbers (i.e. 80) is treated as the amount of C Co's indirect hybrid deduction under an imported mismatch arrangement.

(b) C Co's indirect hybrid deduction under the imported mismatch arrangement is 80, E Co's cross-border payment to C Co under the same arrangement is 40. The lower of these two numbers (i.e. 40) is treated as the amount of E Co's indirect hybrid deduction under the imported mismatch arrangement. Country E should therefore deny 40 of deduction under the imported mismatch rule.

Flow Diagram 1 (Example 8.1)

Neutralising hybrid deduction under the structured and direct imported mismatch rule

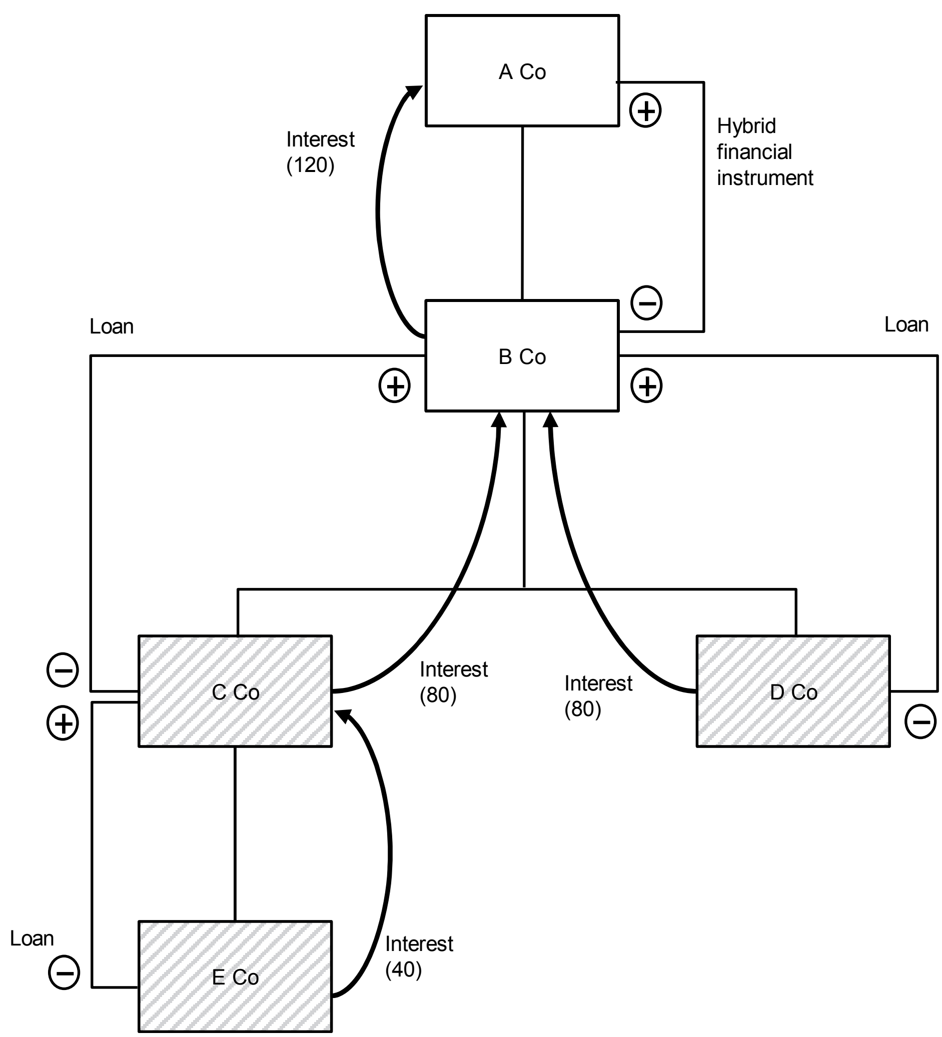


Example 8.2

Structured imported mismatch rule and direct imported mismatch rule

Facts

1. The facts are the same as in **Example 8.1** except that B Co already has an existing funding arrangement in place with D Co that is unconnected with the group financing structure and that C Co, D Co and E Co (the shaded entities) are all resident in jurisdictions that have implemented the recommendations set out in the report. The figure below illustrates the total gross interest payments made in each accounting period under the group's financing structure.



Question

2. Whether the interest payments made by C Co, D Co or E Co are subject to adjustment under the imported mismatch rule and, if so, the amount of the adjustment required under the rule.

Answer

3. The structured imported mismatch rule will apply in Country C to deny the full amount of C Co's interest deduction.

4. The interest payment made by D Co should not be treated as made under a structured arrangement unless the D Co loan and the other group financing arrangements were entered into as part of the same overall scheme, plan or understanding. Country D should, however, apply the direct imported mismatch rule to deny half of the interest payment paid to B Co (i.e. 40 of deductions should be denied under Country D law).

5. The interest payment made by E Co is made to a payee that is subject to the hybrid mismatch rules. The payment is therefore not an imported mismatch payment and is not subject to adjustment under Recommendation 8.

6. See the flow diagram at the end of this example which outlines of the steps to be taken in applying the imported mismatch rule.

Analysis

No application of the imported mismatch rule in Country E

7. The imported mismatch rule will not apply to any payment made to a payee that is a taxpayer in a jurisdiction that has implemented the full set of recommendations set out in the report. The hybrid mismatch rules in Country C will neutralise the effect of any hybrid mismatch arrangements entered into by C Co (including the effect of any imported mismatch arrangements) so that the income from any payment made by E Co to C Co will not be offset against a hybrid deduction.

D Co's interest payment is not made under a structured imported mismatch arrangement

8. The interest payments made by C Co are treated as paid under a structured imported mismatch arrangement because the hybrid financial instrument and the loan between C Co and B Co are part of the same group financing arrangement. The loan between C Co and D Co was in place before the hybrid financial arrangement was entered into and, unless that loan could be shown to be part of the same scheme plan or understanding as the financing arrangements put in place for the rest of the group, then the interest payment made by D Co should be treated as outside the scope of the structured imported mismatch rules.

The interest payments made by C Co and D Co should be subject to adjustment under the structured and direct imported mismatch rule

Step 1 – B Co's payment under the hybrid financial instrument gives rise to a direct hybrid deduction

9. The interest payments under the hybrid financial instrument give rise to a direct hybrid deduction for B Co of 120.

Step 2 –B Co's hybrid deduction and C Co's imported mismatch payment are part of the same structured arrangement

10. The payment made by B Co under the hybrid financial instrument and the imported mismatch payment made by C Co should be treated as part of the same structured arrangement (see the analysis in **Example 8.1** above).

11. The structured imported mismatch rule requires the payer jurisdiction to deny a deduction for an imported mismatch payment to the extent the income from such payment is offset (directly or indirectly) against a hybrid deduction under the same structured arrangement. In this case B Co has a hybrid deduction of 120 and C Co has made a cross-border payment to B Co under the same arrangement of 80. Accordingly the full amount of the imported mismatch payment is treated as set-off against the hybrid deduction under the structured imported mismatch rule.

Step 3 – B Co's remaining hybrid deductions should be treated as set-off against the imported mismatch payment made by D Co

12. The direct imported mismatch rule should be applied in Country D to deny D Co a deduction for the interest payment made to B Co to the extent that the income from that payment is off-set against any remaining hybrid deductions.

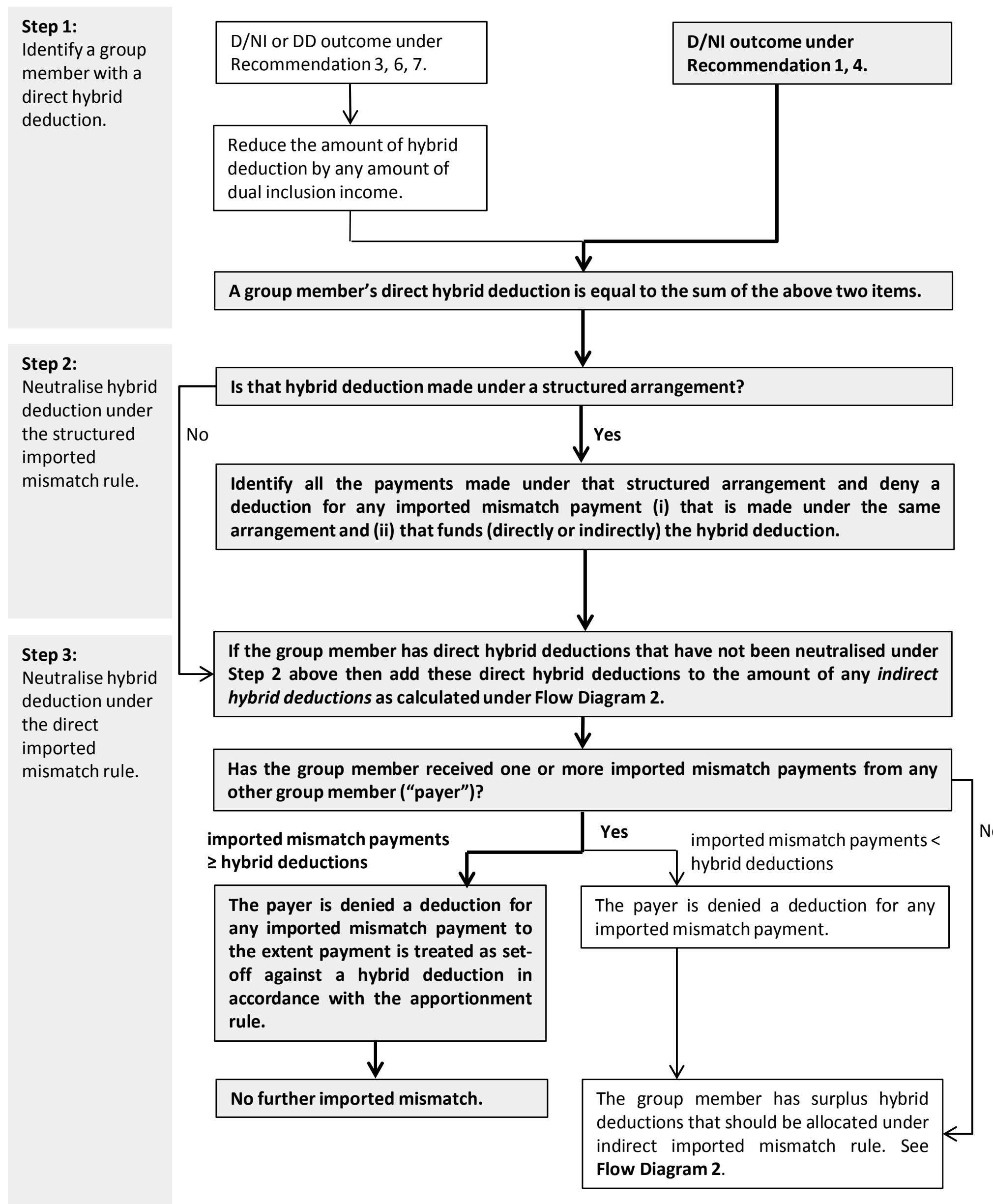
13. The guidance to the imported mismatch rule sets out an apportionment formula which can be used to determine the extent to which an imported mismatch payment has been directly set-off against any remaining hybrid deductions. The formula is as follows:

$$\text{Imported mismatch payment made by payer} \quad \times \quad \frac{\text{Total amount of remaining hybrid deductions incurred}}{\text{Total amount of imported mismatch payments received}}$$

14. On the facts of this example the ratio of remaining hybrid deductions to imported mismatch payments is 40/80 so that half the imported mismatch payments made by D Co to B Co are subject to adjustment under the direct imported mismatch rule.

Flow Diagram 1 (Example 8.2)

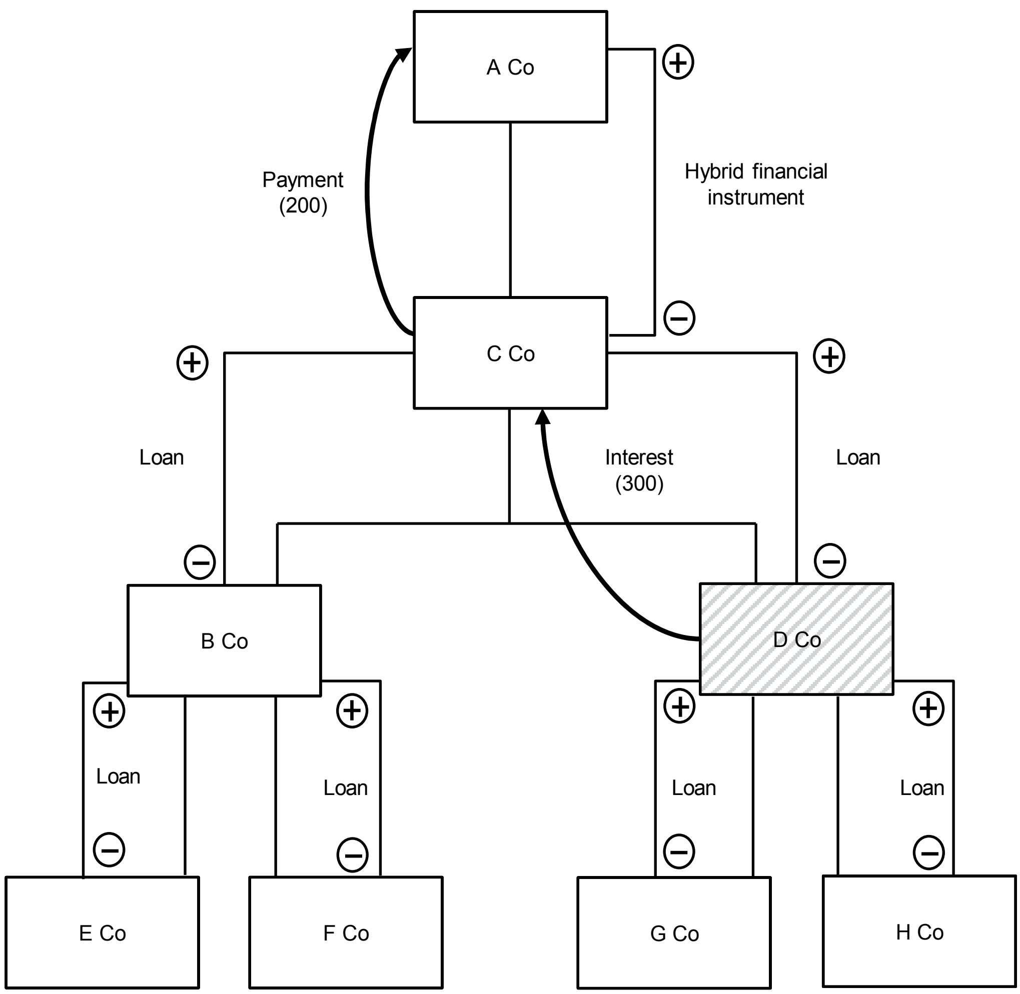
Neutralising hybrid deduction under the structured and direct imported mismatch rule



Example 8.3

Application of the direct imported mismatch rule

1. The figure below sets out the financing arrangements for companies that are members of the same group. In this case A Co has lent money to C Co. C Co has lent money to B Co and D Co and B Co and D Co have lent money to their subsidiaries. Each company is tax resident in different jurisdiction.



2. As illustrated in the diagram, the loan between A Co and C Co is a hybrid financial instrument. The hybrid financial instrument is not, however, entered into as part of a wider structured arrangement. The hybrid deduction arising under the hybrid financial instrument is 200. D Co (the shaded entity) is the only entity in the group that is

resident in a country that has implemented the recommendations set out in the report. D Co makes a deductible intra-group interest payment to C Co of 300.

Question

3. Whether the interest payment made by D Co is subject to adjustment under the imported mismatch rule and, if so, the amount of the adjustment required under the rule.

Answer

4. Country D should deny D Co a deduction for two-thirds (i.e. 200) of the interest paid to C Co. See the flow diagram at the end of this example which outlines of the steps to be taken in applying the imported mismatch rule.

Analysis

D Co's interest payments should be subject to adjustment under the direct imported mismatch rule

Step 1 – C Co's payment under the hybrid financial instrument gives rise to a direct hybrid deduction

5. The interest payments under the hybrid financial instrument give rise to a direct hybrid deduction for C Co of 200.

Step 2 – the structured imported mismatch rule does not apply

6. The facts of this example assume that the hybrid financial instrument is not entered into as part of a wider structured arrangement. Therefore the structured imported mismatch rule does not apply.

Step 3 – The imported mismatch payment made by D Co is treated as set-off against C Co's hybrid deduction under the direct imported mismatch rule

7. The direct imported mismatch rule should be applied in Country D to deny D Co a deduction for the interest payment to the extent C Co offsets the income from that payment against any hybrid deductions. The guidance to the imported mismatch rule sets out an apportionment formula which can be used to determine the extent to which an imported mismatch payment has been directly set-off against the hybrid deduction of a counterparty. The formula is as follows:

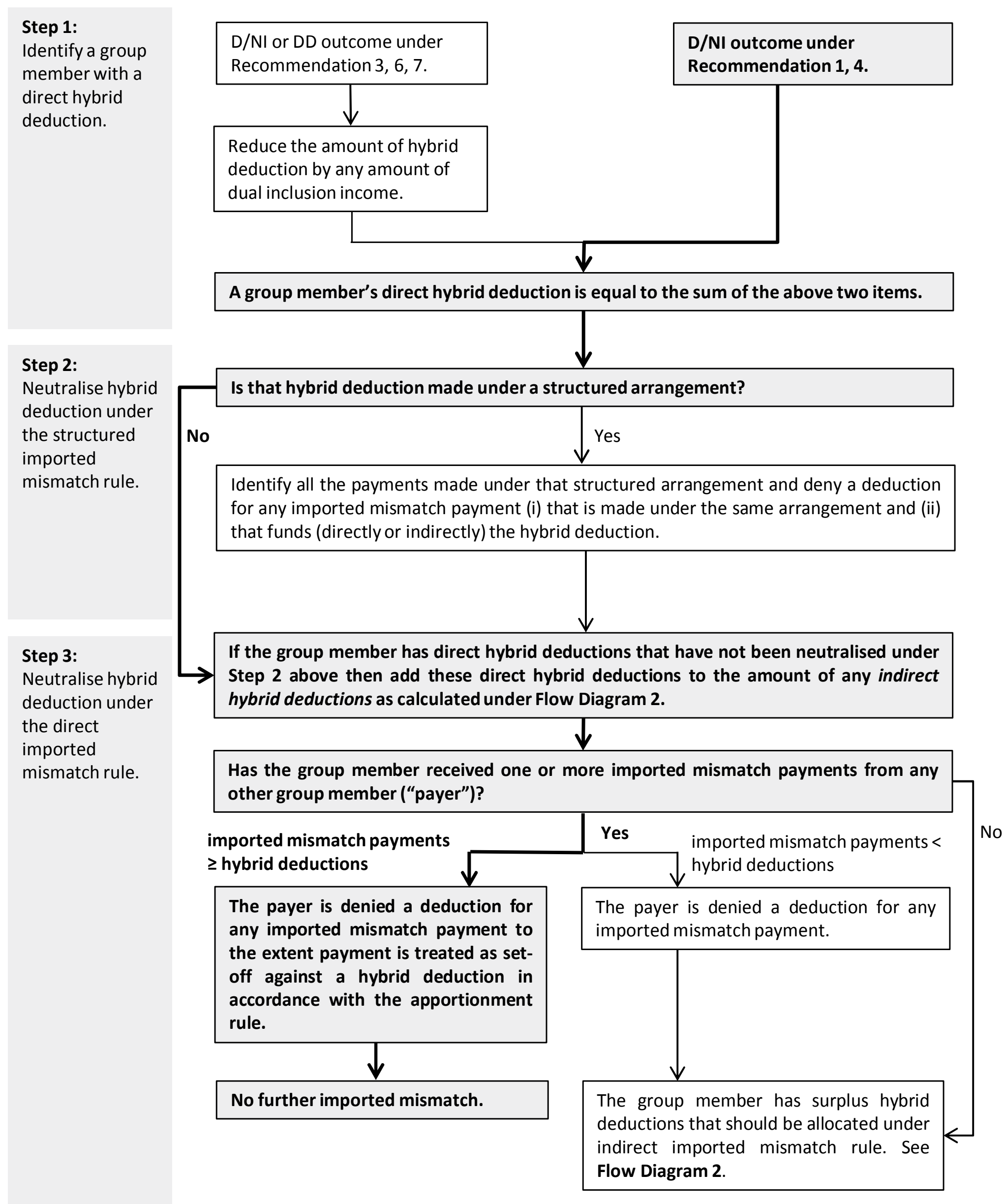
$$\text{Imported mismatch payment made by payer} \quad x \quad \frac{\text{Total amount of remaining hybrid deductions incurred}}{\text{Total amount of imported mismatch payments received}}$$

8. In this case C Co receives only one imported mismatch payment (from D Co). Accordingly the amount of D Co's imported mismatch payment that should be treated as set-off against the hybrid deduction (and therefore the amount of deduction disallowed under Country D law) is calculated as follows:

$$\text{Imported mismatch payments made by D Co} \quad x \quad \frac{\text{C Co's hybrid deduction}}{\text{Imported mismatch payments received by C Co}} = 300 \quad x \quad \frac{200}{300} = 200$$

Flow Diagram 1 (Example 8.3)

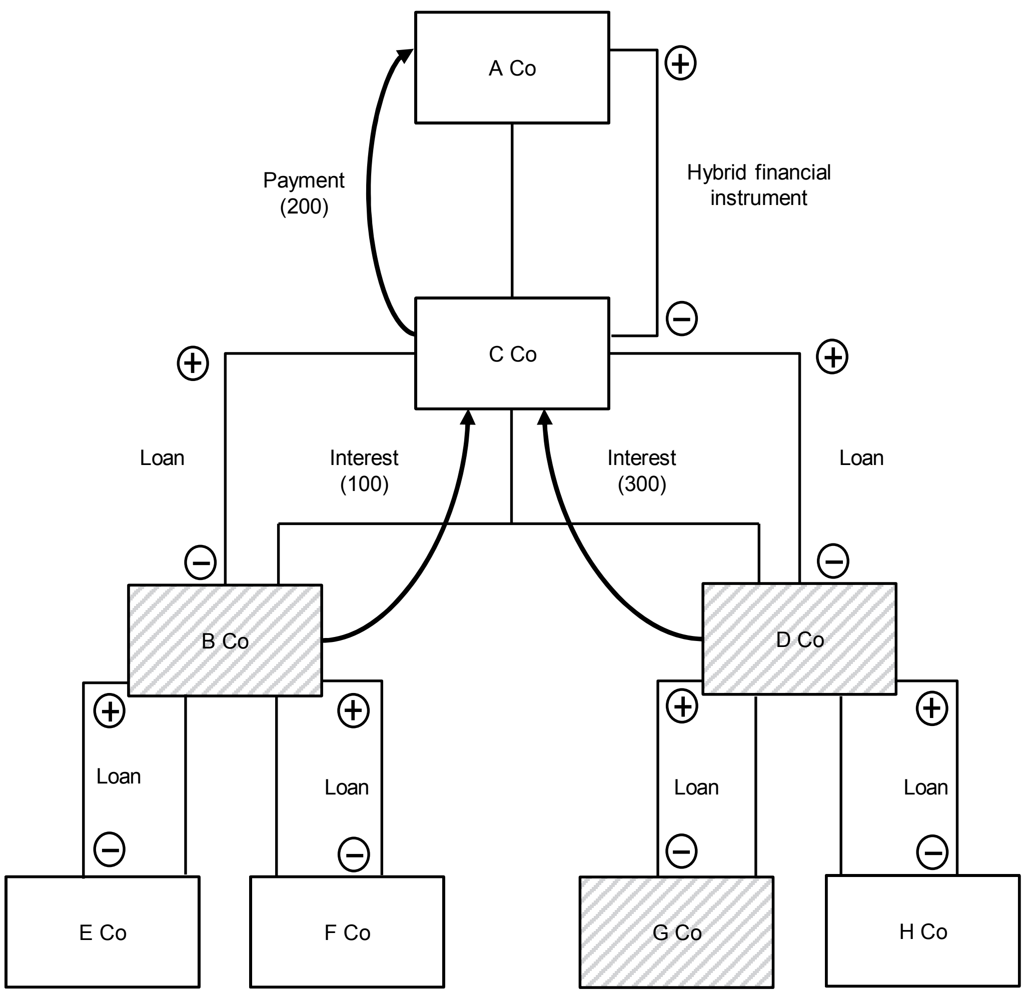
Neutralising hybrid deduction under the structured and direct imported mismatch rule



Example 8.4

Apportionment under direct imported mismatch rule

1. The facts as set out in the diagram below are the same as in **Example 8.3**, except that both B Co and D Co (the shaded entities) are resident in a country that has implemented the recommendations set out in the report. B Co makes a deductible intra-group interest payment to C Co of 100 and D Co makes a deductible intra-group interest payment to C Co of 300.



Question

2. Whether the interest payments made by B Co or D Co are subject to adjustment under the imported mismatch rule and, if so, the amount of the adjustment required under the rule.

Answer

Country B and Country D should deny their taxpayers a deduction for half (i.e. 50 and 150 respectively) of the interest paid to C Co. See the flow diagram at the end of this example which outlines of the steps to be taken in applying the imported mismatch rule.

Analysis

The interest payments made by B Co and D Co should be subject to adjustment under the direct imported mismatch rule

Step 1 – C Co's payment under the hybrid financial instrument gives rise to a direct hybrid deduction

3. The interest payments under the hybrid financial instrument give rise to a direct hybrid deduction for C Co of 200.

Step 2 – the structured imported mismatch rule does not apply

4. The facts of this example assume that the hybrid financial instrument is not entered into as part of a wider structured arrangement. Therefore the structured imported mismatch rule does not apply.

Step 3 – the imported mismatch payments made by B Co and D Co are treated as set-off against C Co's hybrid deduction under the direct imported mismatch rule

5. The direct imported mismatch rule should be applied, in both Country B and Country D, to deny B Co and D Co (respectively) deductions for the interest payments made to C Co to the extent these payments are offset against any hybrid deductions. The guidance to the imported mismatch rule sets out an apportionment formula which can be used to determine the extent to which an imported mismatch payment has been directly set-off against a counterparty's hybrid deductions. The formula is as follows:

$$\text{Imported mismatch payment made by payer} \times \frac{\text{Total amount of remaining hybrid deductions incurred}}{\text{Total amount of imported mismatch payments received}}$$

6. In this case the proportion of each imported mismatch payment that should be treated as set-off against a hybrid deduction (and therefore subject to adjustment under the laws imported mismatch rules in the payer jurisdiction) is calculated as follows:

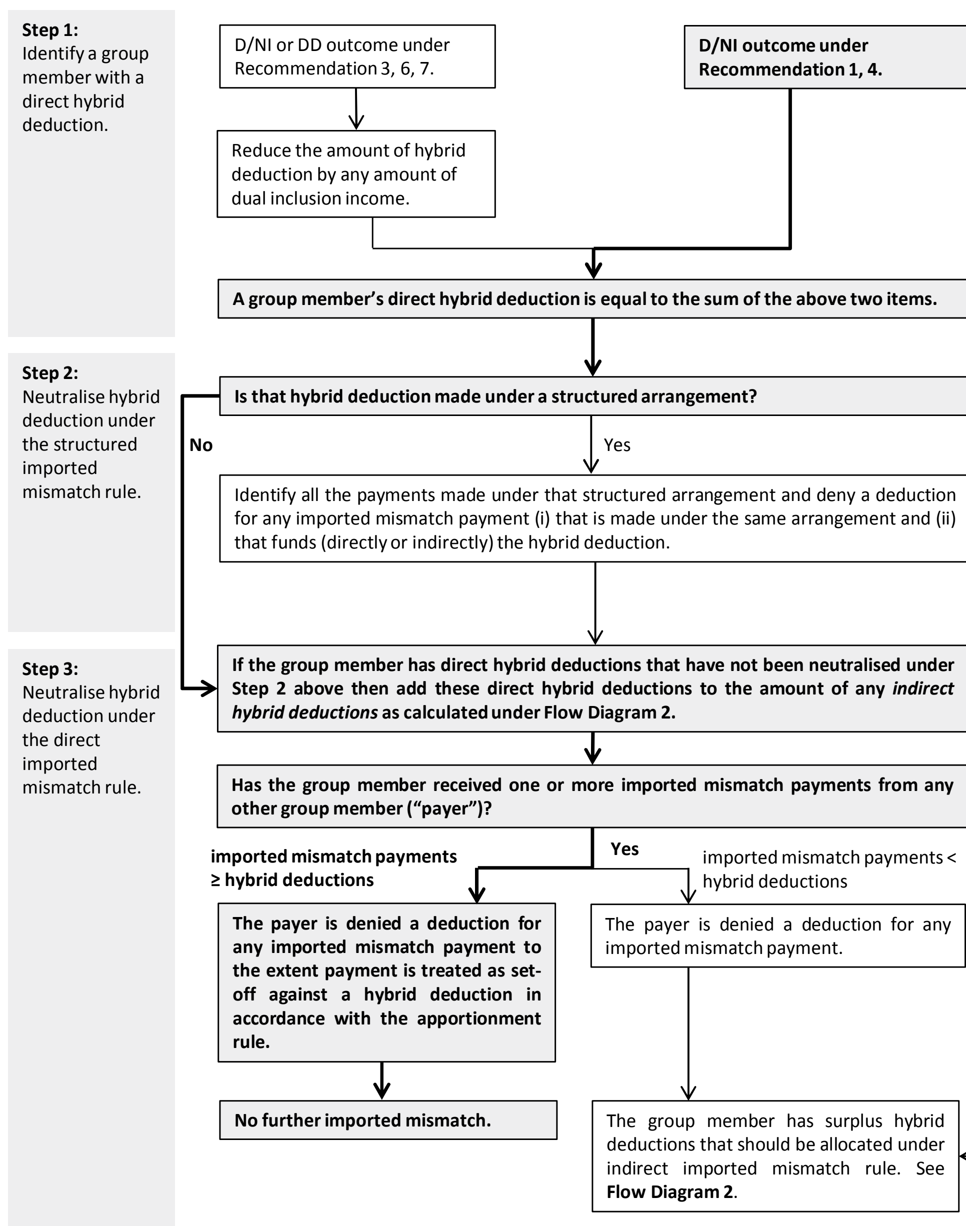
$$\frac{\text{C Co's hybrid deduction}}{\text{Imported mismatch payments received by C Co}} = \frac{200}{100 + 300} = \frac{200}{400} = \frac{1}{2}$$

7. Applying this ratio under the direct imported mismatch rules of Country B and Country D, the amount of interest deduction denied under Country B law will be 50

(i.e. 1/2 x 100) and the amount of interest deduction denied under Country D law will be 150 (i.e. 1/2 x 300).

Flow Diagram 1 (Example 8.4)

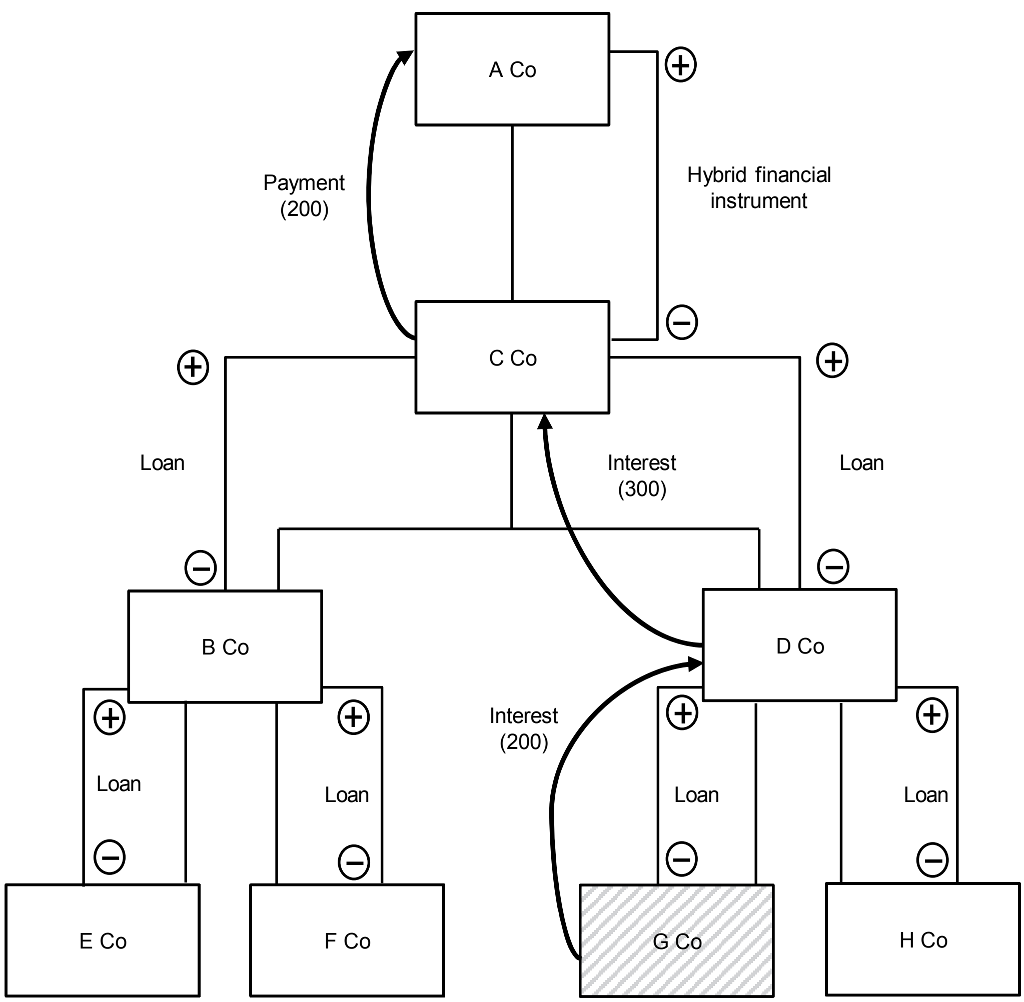
Neutralising hybrid deduction under the structured and direct imported mismatch rule



Example 8.5

Application of the indirect imported mismatch rule

1. The facts illustrated in the figure below are the same as in **Example 8.3**, except that G Co (the shaded entity) is the only group entity resident in a jurisdiction that has implemented the recommendations set out in the report. G Co makes a deductible intra-group interest payment to D Co of 200 and D Co makes a deductible intra-group interest payment to C Co of 300



Question

2. Whether the interest payment made by G Co is subject to adjustment under the imported mismatch rule and, if so, the amount of the adjustment required under the rule.

Answer

3. Country G should deny G Co a deduction for all (i.e. 200) of the interest paid to D Co. See the flow diagrams at the end of this example which outline the steps to be taken in applying the imported mismatch rule.

Analysis

C Co's hybrid deduction is not set-off against an imported mismatch payment under the structured or direct imported mismatch rule

Step 1 – C Co's payment under the hybrid financial instrument gives rise to a direct hybrid deduction

4. The interest payments under the hybrid financial instrument give rise to a direct hybrid deduction for C Co of 200.

Step 2 – the structured imported mismatch rule does not apply

5. The facts of this example assume that the hybrid financial instrument is not entered into as part of a wider structured arrangement. Therefore the structured imported mismatch rule does not apply.

Step 3 – the direct imported mismatch rules does not apply

6. In this case the *direct imported mismatch rule* does not apply as the group entities that are *directly* funding the hybrid deduction (i.e. B Co and D Co) are resident in jurisdictions that have not implemented the imported mismatch rules.

The interest payments made by G Co should be subject to adjustment under the indirect imported mismatch rule

7. As C Co's hybrid deduction has not been neutralised under the structured or direct imported mismatch rule, the indirect imported mismatch rule applies to determine the extent to which C Co's surplus hybrid deduction should be treated as giving rise to an indirect hybrid deduction for another group member.

Step 1 – C Co has surplus hybrid deductions of 200

8. In this case the total amount of C Co's surplus hybrid deduction will be the amount of the direct hybrid deduction that is attributable to payments under the hybrid financial instrument (200) minus any amount of hybrid deduction that has been neutralised under either the structured or direct imported mismatch rules (0).

Step 2 – C Co's surplus hybrid deduction are fully set-off against funded taxable payments

9. C Co must first treat that surplus hybrid deduction as being offset against funded taxable payments received from group entities. A taxable payment will be treated as a funded taxable payment to the extent the payment is directly funded out of imported mismatch payments made by other group entities. In this case G Co makes an imported mismatch payment of 200 to D Co and, accordingly, two-thirds (i.e. 200/300) of the taxable payments that D Co makes to C Co should be treated as funded taxable payments.

10. In this case the funded taxable payment by D Co (200) is equal to the total amount of C Co's surplus hybrid deduction (200). C Co is therefore treated as setting-off all of its surplus hybrid deduction against funded taxable payments which results in D Co having an indirect hybrid deduction of 200.

Step 3 – C Co has no remaining surplus hybrid deduction

11. C Co's surplus hybrid deduction is fully set-off against funded taxable payments and C Co therefore has no remaining surplus hybrid deduction to be set-off against other taxable payments.

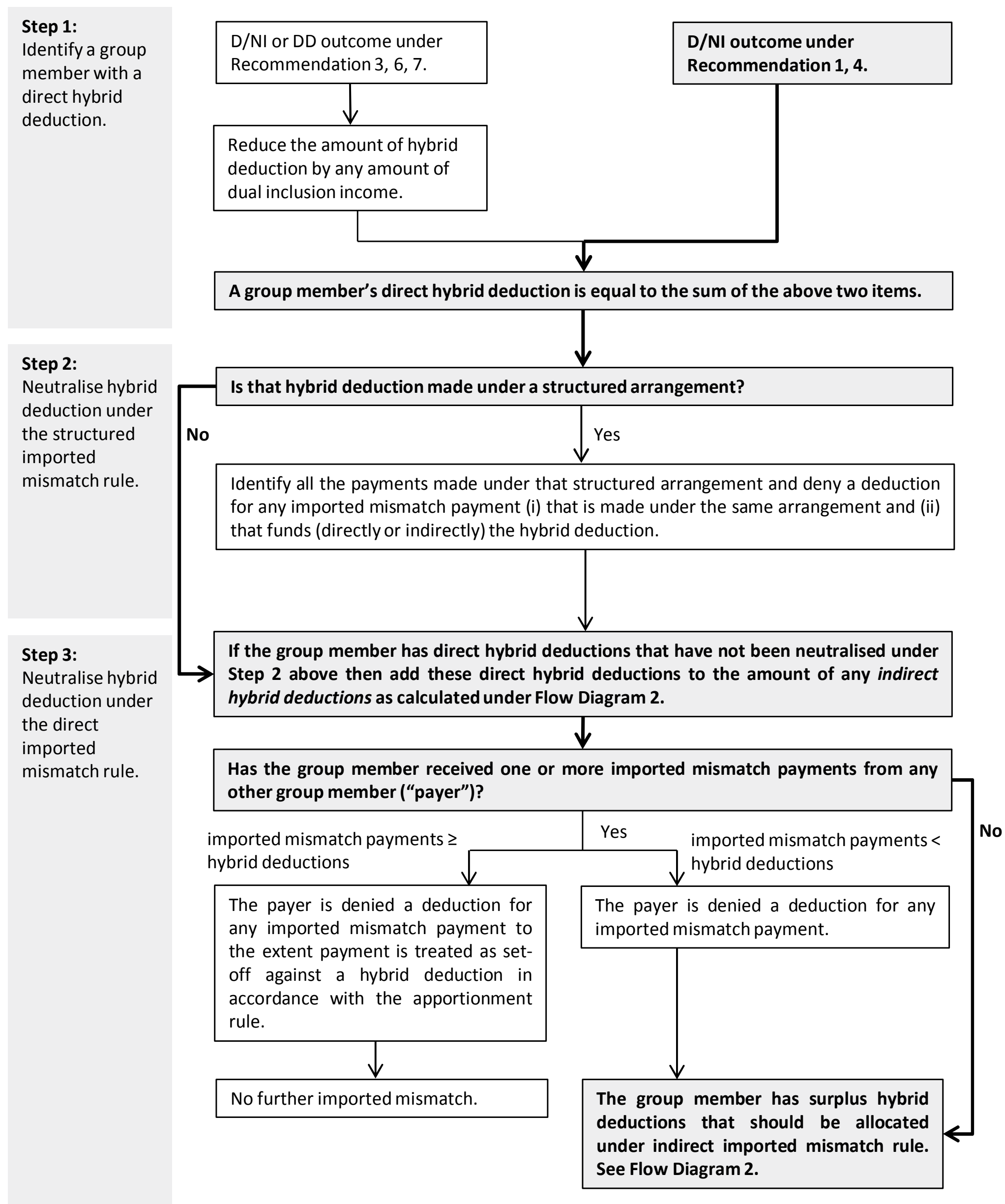
Step 4 – D Co's indirect hybrid deduction is neutralised in accordance with the direct imported mismatch rule

12. The indirect hybrid deduction incurred by D Co under Step 2 above is treated as being set-off against imported mismatch payments made by G Co. The amount of deduction that is treated as set-off against G Co's imported mismatch payment is calculated on the same basis as under the direct imported mismatch rule:

$$\text{Imported mismatch payments made by G Co} \times \frac{\text{D Co's hybrid deduction}}{\text{Imported mismatch payments received by D Co}} = 200 \times \frac{200}{200} = 200$$

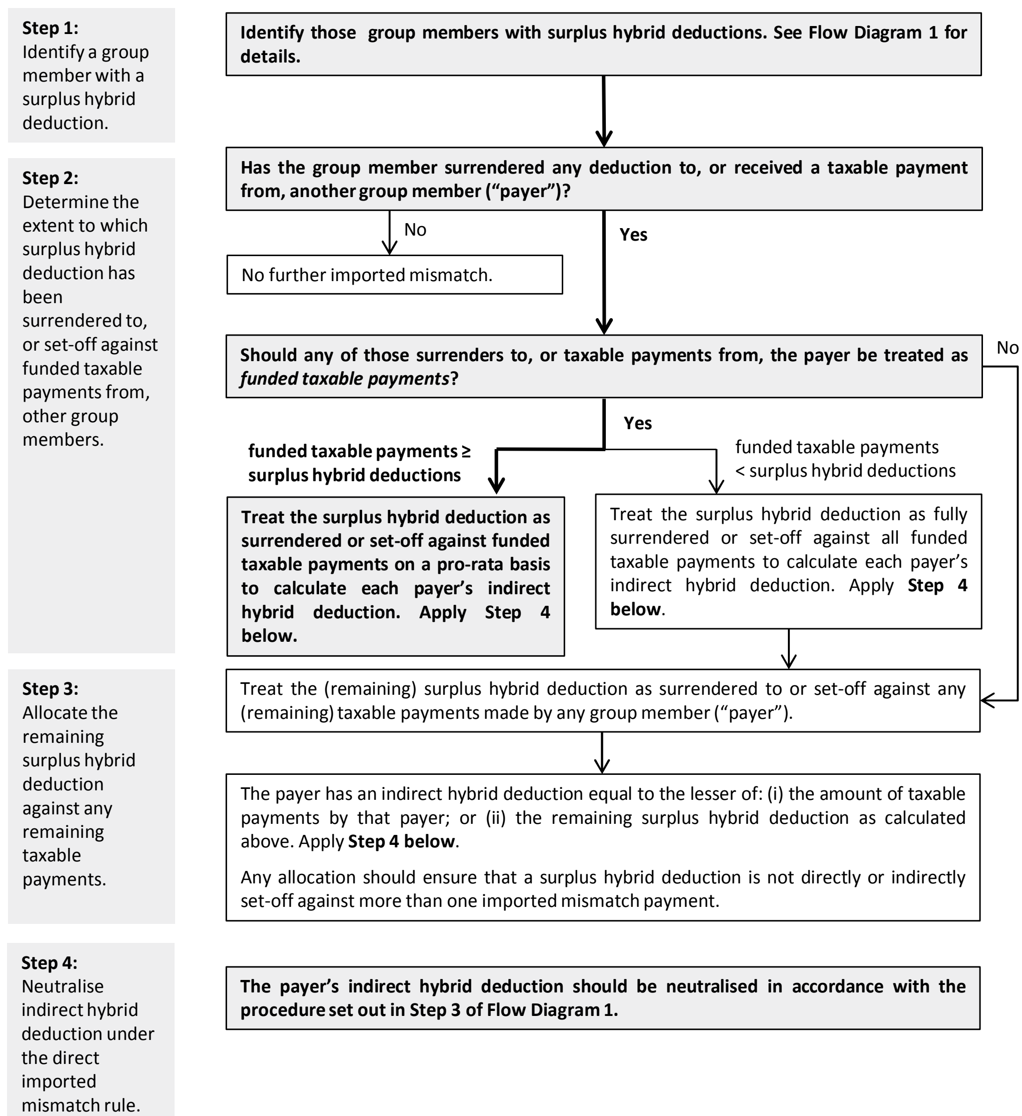
Flow Diagram 1 (Example 8.5)

Neutralising hybrid deduction under the structured and direct imported mismatch rule



Flow Diagram 2 (Example 8.5)

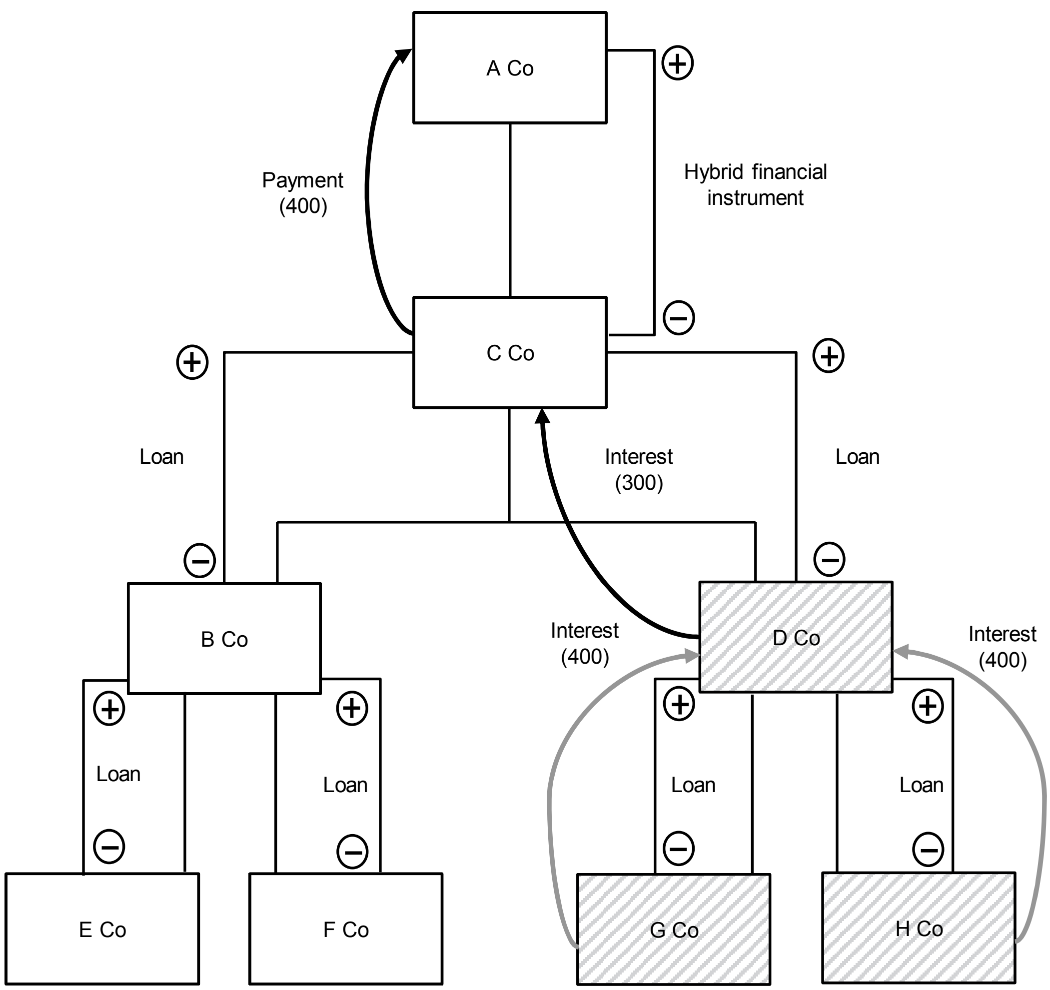
Allocating surplus hybrid deduction under the indirect imported mismatch rule



Example 8.6

Payments to a group member that is subject to the imported mismatch rules

1. The facts illustrated in the figure below are the same as in **Example 8.3**, except that D Co, G Co and H Co (the shaded entities) are all resident in jurisdictions that have implemented the recommendations set out in the report. G Co and H Co each make a deductible intra-group interest payment to D Co of 400 and D Co makes a deductible intra-group interest payment to C Co of 300. C Co's hybrid deduction is 400.



Question

2. Whether the interest payments made by G Co, H Co or D Co are subject to adjustment under the imported mismatch rule and, if so, the amount of the adjustment required under the rule.

Answer

3. Country D should deny D Co a deduction for all (i.e. 300) of the interest paid to C Co. No adjustment is required under the imported mismatch payments made by G Co and H Co as these payments are made to a taxpayer that is subject to the imported mismatch rule under the laws of its own jurisdiction. See the flow diagrams at the end of this example which outline the steps to be taken in applying the imported mismatch rule.

Analysis

No application of the imported mismatch rule in Country G or H

4. The imported mismatch rule will not apply to any payment made to a payee that is a taxpayer in a jurisdiction that has implemented the full set of recommendations set out in the report. The ability of D Co to generate direct or indirect hybrid deductions is eliminated through the hybrid mismatch rules in Country D, so that the income from any imported mismatch payment made by G Co or H Co cannot be offset against an indirect hybrid deduction incurred by D Co.

D Co's interest payments should be subject to adjustment under the imported mismatch rule

Step 1 – C Co's payment under the hybrid financial instrument gives rise to a direct hybrid deduction

5. The interest payments under the hybrid financial instrument give rise to a direct hybrid deduction for C Co of 400.

Step 2 – the structured imported mismatch rule does not apply

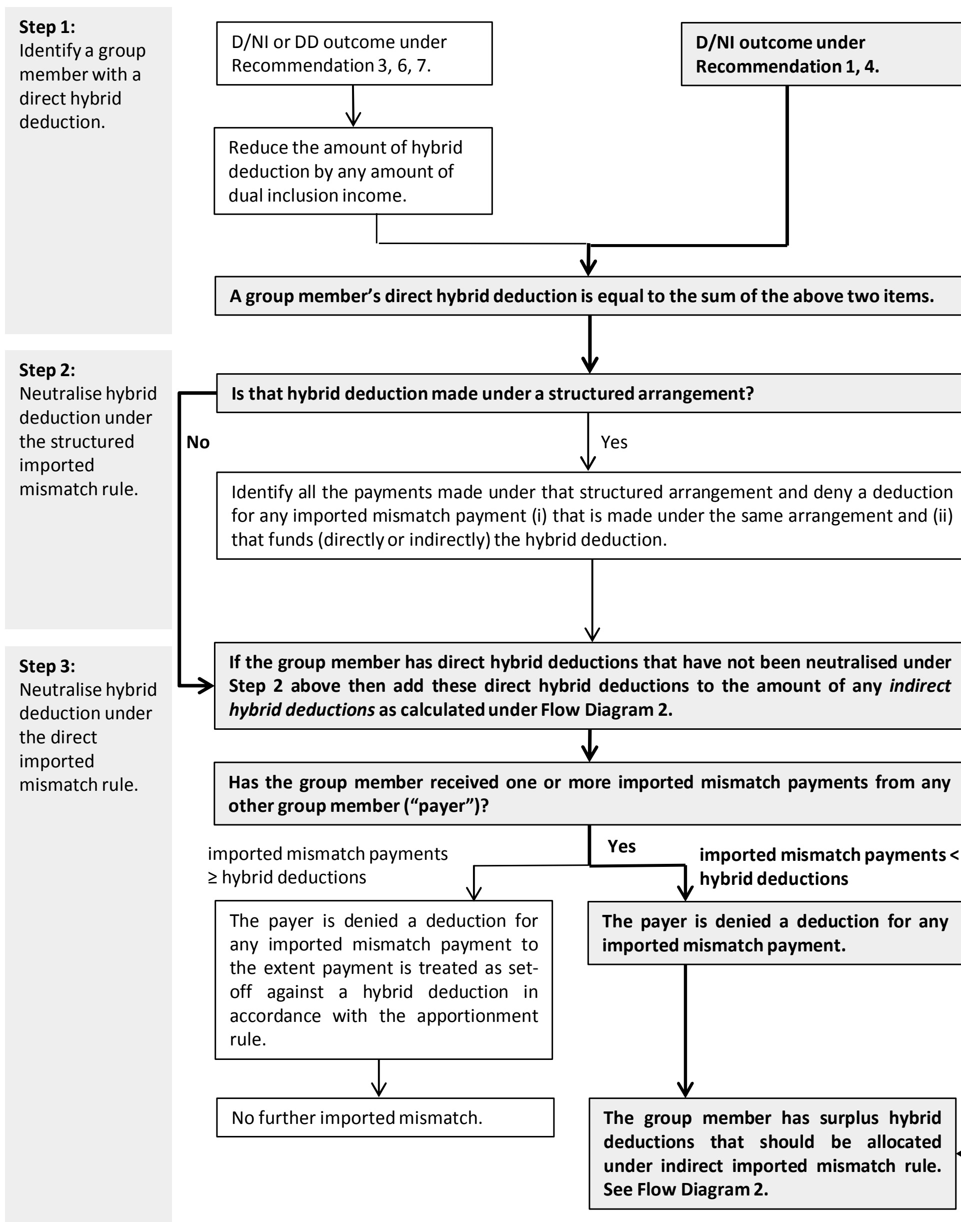
6. The facts of this example assume that the hybrid financial instrument is not entered into as part of a wider structured arrangement. Therefore the structured imported mismatch rule does not apply.

Step 3 – the imported mismatch payment made by D Co is treated as set-off against C Co's hybrid deduction under the direct imported mismatch rule

7. The direct imported mismatch rule should be applied in Country D to deny D Co a deduction for the interest payment to the extent C Co offsets the income from that payment against any hybrid deductions. In this case C Co receives only one imported mismatch payment (from D Co) which is less than the amount of C Co's hybrid deductions. D Co should therefore be denied a deduction for the full amount of the imported mismatch payment and C Co will have surplus hybrid deductions that would be eligible to be allocated in accordance with the indirect imported mismatch rule.

Flow Diagram 1 (Example 8.6)

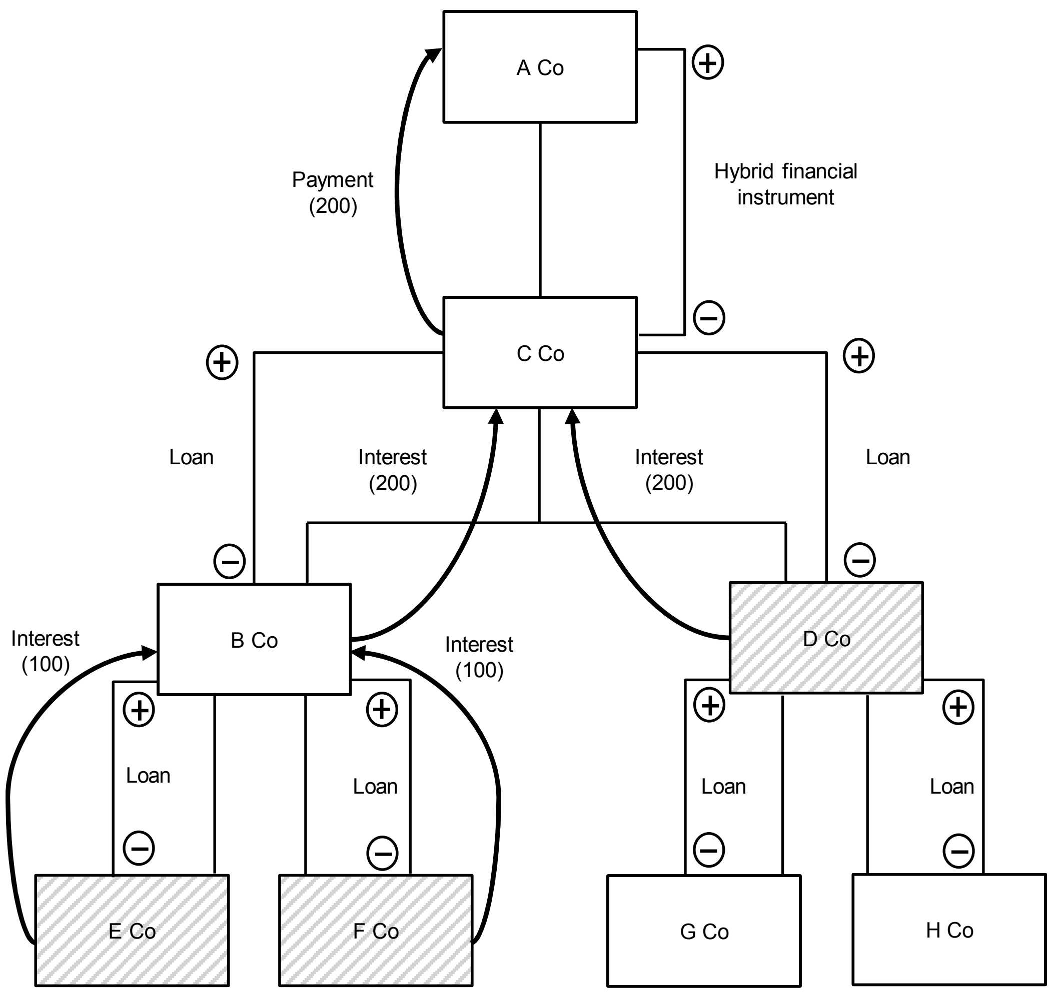
Neutralising hybrid deduction under the structured and direct imported mismatch rule



Example 8.7

Direct imported mismatch rule applies in priority to indirect imported mismatch rule

1. The facts illustrated in the figure below are the same as in **Example 8.3**, except that D Co, E Co and F Co (the shaded entities) are all resident in jurisdictions that have implemented the recommendations set out in the report. E Co and F Co each make a deductible intra-group interest payment to B Co of 100 and D Co makes a deductible intra-group interest payment to C Co of 200. C Co's hybrid deduction is 200.



Question

2. Whether the interest payment made by E Co, F Co or D Co is subject to adjustment under the imported mismatch rule and, if so, the amount of the adjustment required under the rule.

Answer

3. Country D should deny D Co a deduction for all (i.e. 200) of the interest paid to C Co. C Co has no surplus hybrid deduction so that the application of the indirect imported mismatch rule in Country E and Country F does not result in any denial of a deduction for E Co or F Co. See the flow diagram at the end of this example which outlines of the steps to be taken in applying the imported mismatch rule.

Analysis

D Co's interest payments should be subject to adjustment under the imported mismatch rule

Step 1 – C Co's payment under the hybrid financial instrument gives rise to a direct hybrid deduction

4. The interest payments under the hybrid financial instrument give rise to a direct hybrid deduction for B Co of 200.

Step 2 – the structured imported mismatch rule does not apply

5. The facts of this example assume that the hybrid financial instrument is not entered into as part of a wider structured arrangement. Therefore the structured imported mismatch rule does not apply.

Step 3 – the imported mismatch payment made by D Co is treated as set-off against C Co's hybrid deduction under the direct imported mismatch rule

6. The direct imported mismatch rule should be applied in Country D to deny D Co a deduction for the interest payment to the extent C Co offsets the income from that payment against any hybrid deductions. The guidance to the imported mismatch rule sets out an apportionment formula which can be used to determine the extent to which an imported mismatch payment has been directly set-off against a counterparty's hybrid deductions. The formula is as follows:

$$\text{Imported mismatch payment made by payer} \quad \times \quad \frac{\text{Total amount of remaining hybrid deductions incurred}}{\text{Total amount of imported mismatch payments received}}$$

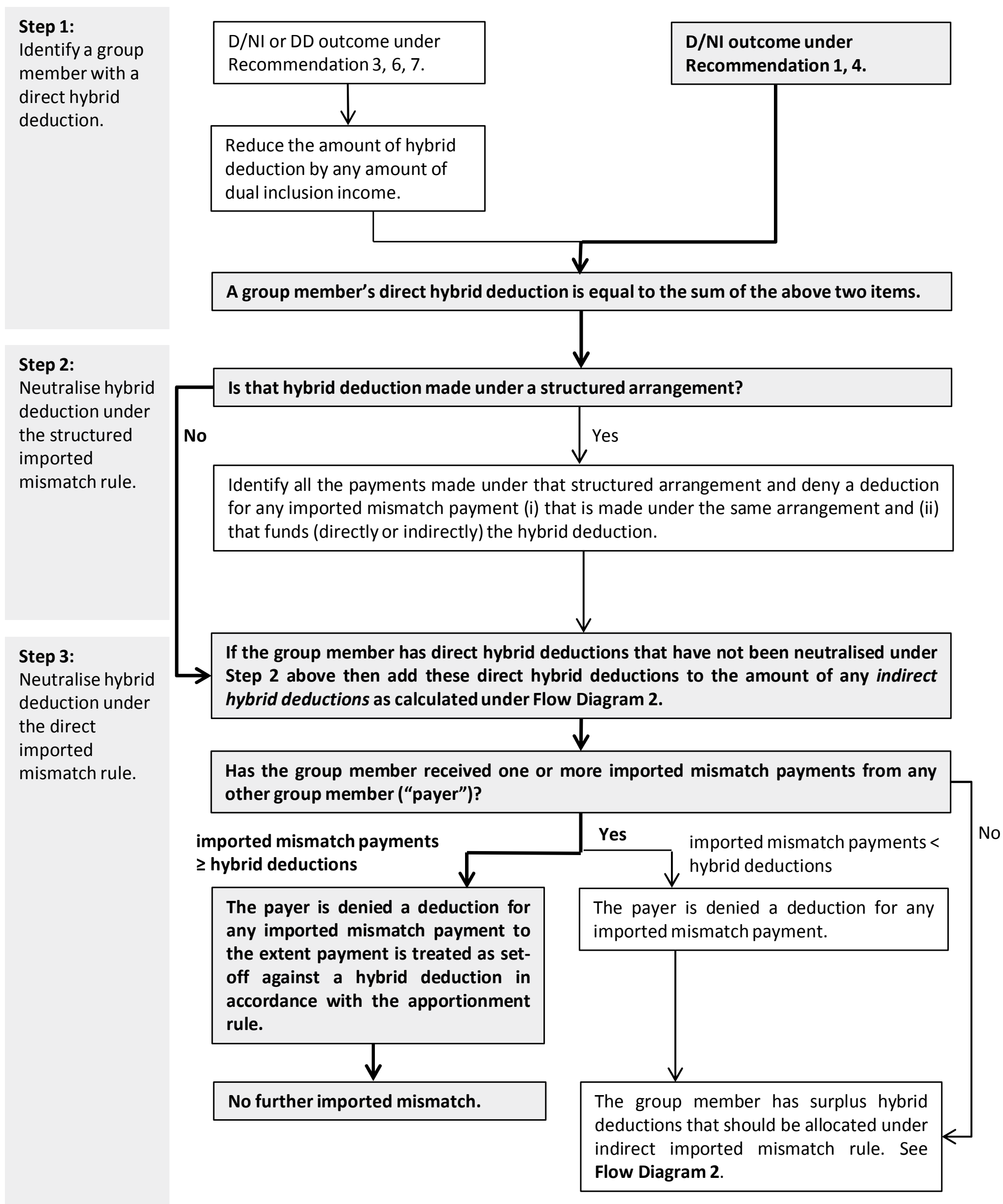
7. In this case C Co receives only one imported mismatch payment (from D Co). Accordingly the amount of D Co's imported mismatch payment that should be treated as set-off against the hybrid deduction (and therefore the amount of deduction disallowed under Country D law) is calculated as follows:

$$\text{Imported mismatch payments made by D Co} \times \frac{\text{C Co's hybrid deduction}}{\text{Imported mismatch payments received by C Co}} = 200 \times \frac{200}{200} = 200$$

8. Under this formula, all of C Co's hybrid deductions are treated as set-off against imported mismatch payments. C Co therefore has no surplus hybrid deductions and there is no scope to apply the indirect imported mismatch rule.

Flow Diagram 1 (Example 8.7)

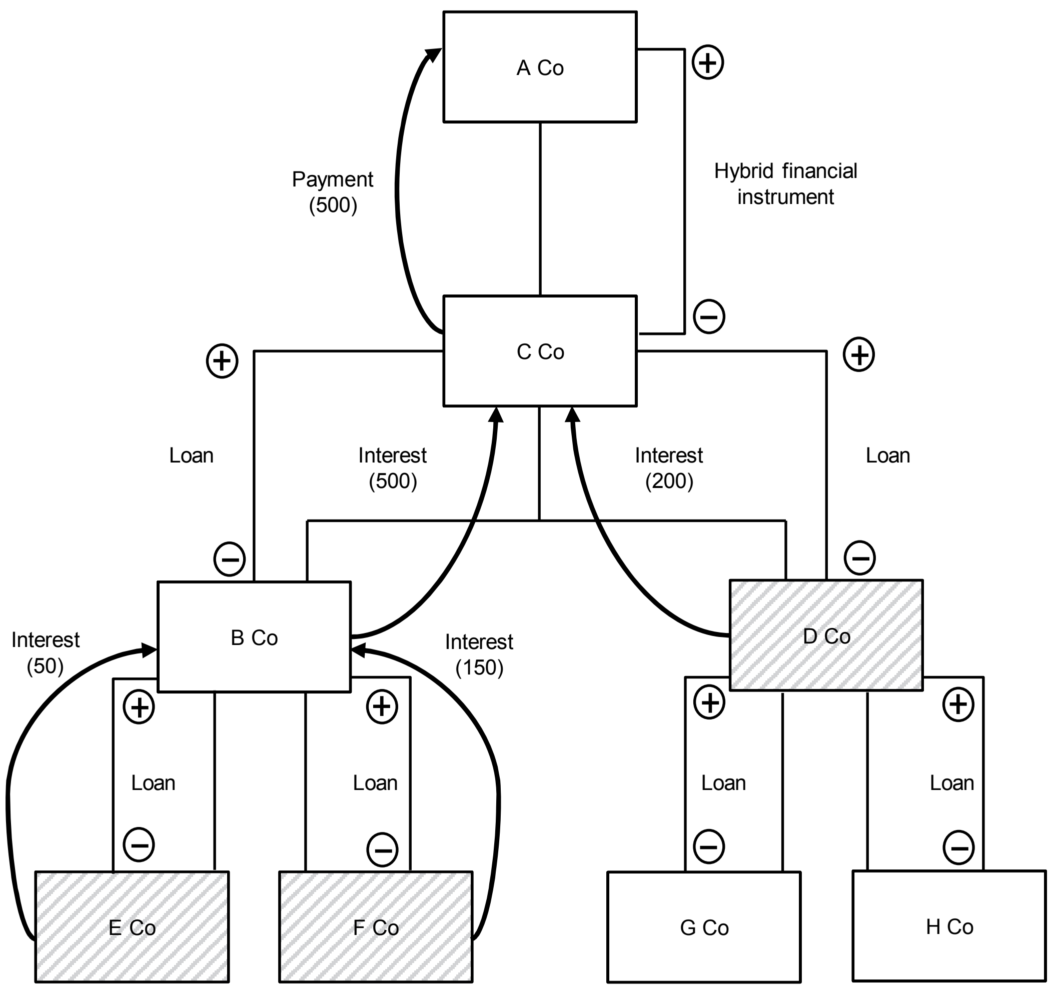
Neutralising hybrid deduction under the structured and direct imported mismatch rule



Example 8.8

Surplus hybrid deduction exceeds funded taxable payments

1. The facts illustrated in the figure below are the same as in **Example 8.3**, except that D Co, E Co and F Co (the shaded entities) are all resident in jurisdictions that have implemented the recommendations set out in the report. E Co makes a deductible intra-group interest payment to B Co of 50 while F Co makes a deductible intra-group interest payment to B Co of 150. D Co makes a deductible intra-group interest payment to C Co of 200 and B Co makes a payment of 500. C Co's hybrid deduction is 500.



Question

2. Whether the interest payment made by D Co, E Co, or F Co is subject to adjustment under the imported mismatch rule and, if so, the amount of the adjustment required under the rule.

Answer

3. Countries D, E and F should deny D Co, E Co and F Co (respectively) a deduction for all the imported mismatch payments made by those taxpayers. C Co and B Co each are treated as having a remaining hybrid deduction of 100. See the flow diagrams at the end of this example which outline the steps to be taken in applying the imported mismatch rule.

Analysis

D Co's interest payments should be subject to adjustment under the imported mismatch rule

Step 1 – C Co's payment under the hybrid financial instrument gives rise to a direct hybrid deduction

4. The interest payments under the hybrid financial instrument give rise to a direct hybrid deduction for C Co of 500.

Step 2 – the structured imported mismatch rule does not apply

5. The facts of this example assume that the hybrid financial instrument is not entered into as part of a wider structured arrangement. Therefore the structured imported mismatch rule does not apply.

Step 3 – the imported mismatch payment made by D Co is treated as set-off against C Co's hybrid deduction under the direct imported mismatch rule

6. The direct imported mismatch rule should be applied in Country D to deny D Co a deduction for the interest payment to the extent C Co offsets the income from that payment against any hybrid deductions. In this case C Co receives only one imported mismatch payment (from D Co) which is less than the amount of C Co's hybrid deductions. D Co should therefore be denied a deduction for the full amount of the imported mismatch payment.

The interest payments made by E Co and F Co should be subject to adjustment under the indirect imported mismatch rule

7. As C Co's hybrid deduction has not been fully neutralised under the structured or direct imported mismatch rule, the indirect imported mismatch rule applies to determine the extent to which C Co's surplus hybrid deduction should be treated as giving rise to an indirect hybrid deduction for another group member.

Step 1 –C Co has surplus hybrid deductions of 300

8. In this case C Co's surplus hybrid deduction will be the amount of hybrid deduction that is attributable to payments under the hybrid financial instrument (500) minus any amount of hybrid deduction that has been neutralised under either the structured or direct imported mismatch rules (200).

Step 2 –C Co's surplus hybrid deduction are set-off against funded taxable payments

9. C Co must first treat that surplus hybrid deduction as being offset against funded taxable payments received from group entities. A taxable payment will be treated as a funded taxable payment to the extent the payment is directly funded out of imported mismatch payments made by other group entities. In this case B Co receives an imported mismatch payment of 50 from E Co and 150 from F Co and, accordingly, two fifths (i.e. 200/500 of the taxable payments that B Co makes to C Co should be treated as funded taxable payments.

10. In this case the funded taxable payment by B Co (200) is less than the total amount of C Co's surplus hybrid deduction (300). C Co therefore treats its surplus hybrid deduction as fully set-off against the funded taxable payment made by B Co which results in B Co having an indirect hybrid deduction of 200.

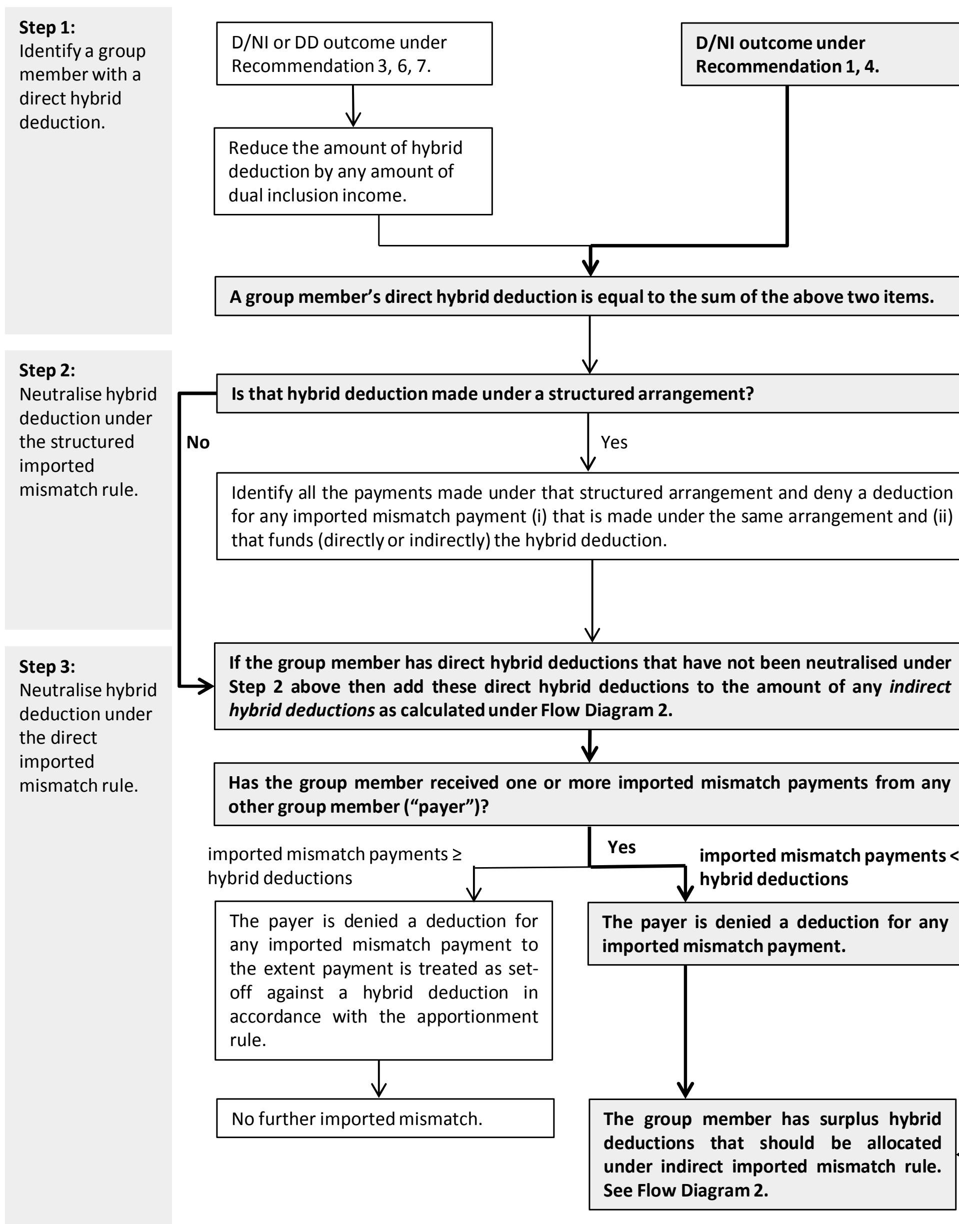
Step 3 – C Co's remaining surplus hybrid deductions are treated as set-off against any remaining taxable payments

11. C Co has a remaining surplus hybrid deduction of 100. This remaining surplus hybrid deduction should be treated as fully set-off against the remaining taxable payments made by B Co. This deemed offset will generate a further indirect hybrid deduction of 100 for B Co. Care should be taken, however, when applying the imported mismatch rule to ensure that the attribution of hybrid deductions under this step does not result in the same hybrid deduction being treated as offset against more than one imported mismatch payment. Any reduction in C Co's remaining surplus hybrid deduction (for example, as a consequence of the receiving an additional imported mismatch payment) should therefore be reflected in a corresponding adjustment to the amount of B Co's indirect hybrid deduction.

Step 4 – B Co's indirect hybrid deduction is neutralised in accordance with the direct imported mismatch rule

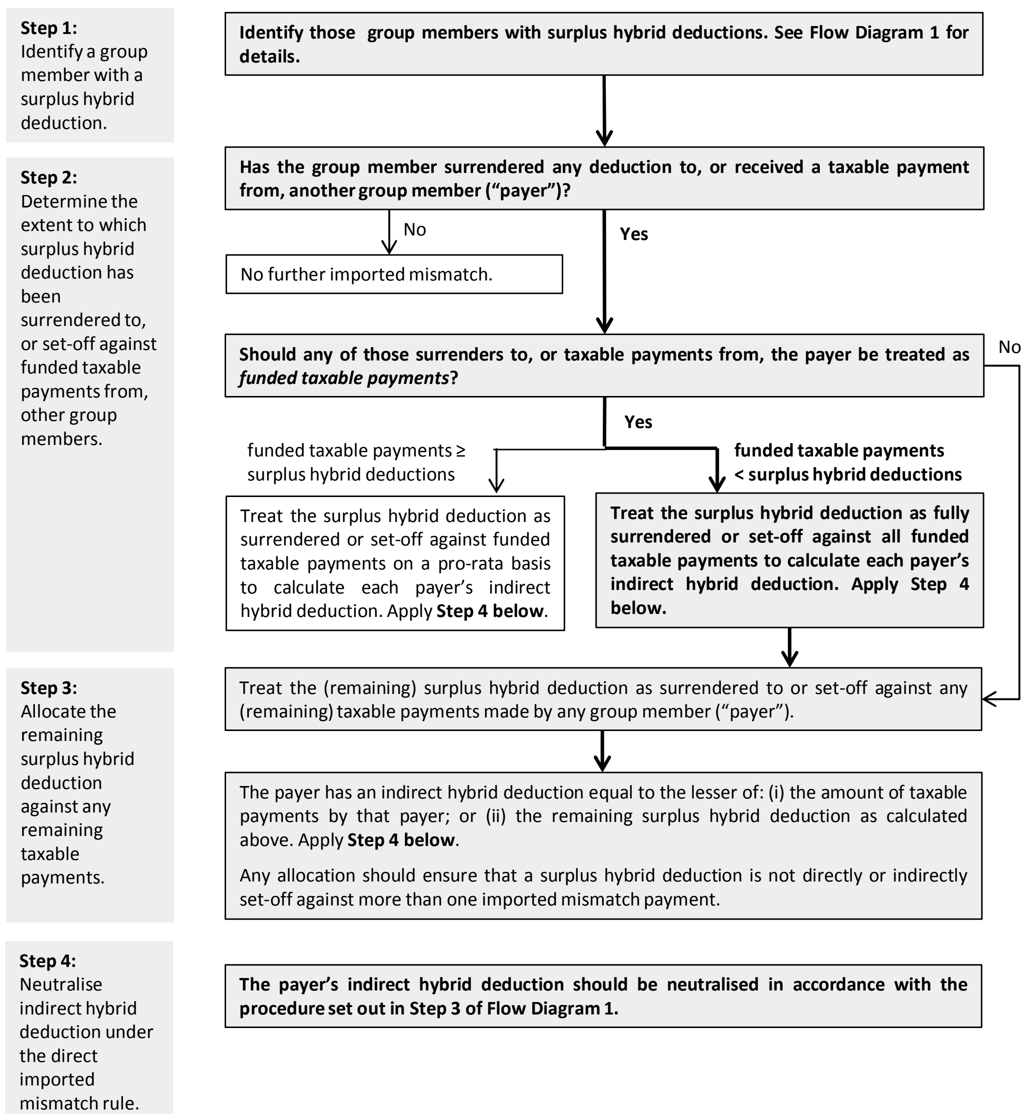
12. B Co treats indirect hybrid deduction as being set-off against imported mismatch payments made by E Co and F Co. The calculation is the same as under the direct imported mismatch rule. The proportion of deduction that E Co and F Co should be denied on their respective imported mismatch payments is 100% because B Co's indirect hybrid deductions are at least equal to the amount of imported mismatch payments it receives from E Co and F Co.

Flow Diagram 1 (Example 8.8)
Neutralising hybrid deduction under the structured and direct imported mismatch rule



Flow Diagram 2 (Example 8.8)

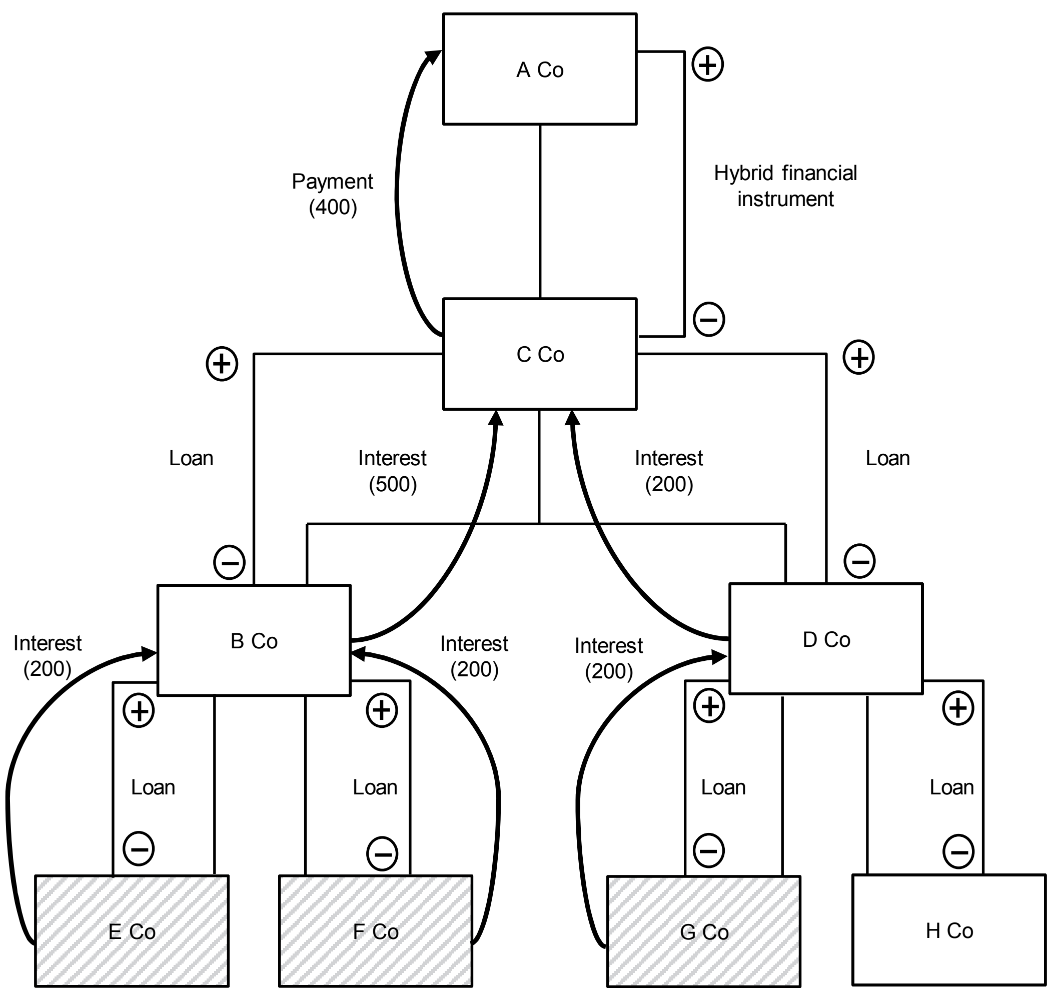
Allocating surplus hybrid deduction under the indirect imported mismatch rule



Example 8.9

Surplus hybrid deduction does not exceed funded taxable payments

1. The facts illustrated in the figure below are the same as in **Example 8.3**, except that E Co, F Co and G Co (the shaded entities) are all resident in jurisdictions that have implemented the recommendations set out in the report. E Co and F Co make deductible intra-group interest payment to B Co of 200 and B Co makes a deductible intra-group interest payment to C Co of 500. G Co makes a deductible intra-group interest payment to D Co of 200 and D Co makes a deductible intra-group interest payment to C Co of 200. C Co's hybrid deduction is 400.



Question

2. Whether the interest payment made by E Co, F Co or G Co is subject to adjustment under the imported mismatch rule and, if so, the amount of the adjustment required under the rule.

Answer

3. Countries E, F and G should deny their taxpayers a deduction for two-thirds (133) of the interest payments. See the flow diagrams at the end of this example which outline the steps to be taken in applying the imported mismatch rule.

Analysis

C Co's hybrid deduction is not set-off against an imported mismatch payment under the structured or direct imported mismatch rule

Step 1 – C Co's payment under the hybrid financial instrument gives rise to a direct hybrid deduction

4. The interest payments under the hybrid financial instrument give rise to a direct hybrid deduction for C Co of 400.

Step 2 – the structured imported mismatch rule does not apply

5. The facts of this example assume that the hybrid financial instrument is not entered into as part of a wider structured arrangement. Therefore the structured imported mismatch rule does not apply.

Step 3 – the direct imported mismatch rules does not apply

6. In this case the *direct imported mismatch rule* does not apply as the group entities that are *directly* funding the hybrid deduction (i.e. B Co and D Co) are resident in jurisdictions that have not implemented the imported mismatch rules.

The interest payments made by E Co, F Co and G Co should be subject to adjustment under the indirect imported mismatch rule

7. As C Co's hybrid deduction has not been neutralised under the structured or direct imported mismatch rule, the indirect imported mismatch rule applies to determine the extent to which C Co's surplus hybrid deduction should be treated as giving rise to an indirect hybrid deduction for another group member.

Step 1 – C Co has surplus hybrid deductions of 400

8. In this case C Co's surplus hybrid deduction will be the amount of hybrid deduction that is attributable to payments under the hybrid financial instrument (400) minus any amount of hybrid deduction that has been neutralised under either the structured or direct imported mismatch rules (0).

Step 2 – C Co's surplus hybrid deduction are set-off against funded taxable payments

9. C Co must first treat that surplus hybrid deduction as being offset against funded taxable payments received from group entities. A taxable payment will be treated as a funded taxable payment to the extent the payment is directly funded out of imported mismatch payments made by other group entities. In this case the interest payments of 200 that B Co receives from E Co and F Co, and the payment of 200 that D Co receives from G Co, are imported mismatch payments and, accordingly, four fifths (i.e. 400/500 of the taxable payments that B Co makes to C Co and all (i.e. 200/200) of the interest payments C Co receives from D Co should be treated as funded taxable payments.

10. In this case the funded taxable payment received by C Co (600) exceeds C Co's surplus hybrid deduction (400). C Co therefore treats its surplus hybrid deduction as set-off against the funded taxable payments on a pro-rata basis. C Co's hybrid deduction must be apportioned between the taxable payments made by B Co and D Co so that B Co has an indirect hybrid deduction of 267 and D Co has an indirect hybrid deduction of 133, calculated as follows:

$$\frac{\text{Funded taxable payments made by payer}}{\text{Funded taxable payments received by C Co}} \times \text{C Co's surplus hybrid deduction}$$

Step 3 – C Co has no remaining surplus hybrid deduction

11. C Co's surplus hybrid deduction is fully set-off against funded taxable payments and C Co therefore has no remaining surplus hybrid deduction to be set-off against other taxable payments.

Step 4 – B Co and D Co's indirect hybrid deduction is neutralised in accordance with the direct imported mismatch rule

12. B Co's indirect hybrid deduction should be treated as set-off against the imported mismatch payments made by E Co and F Co. The calculation is the same as under the direct imported mismatch rule. The guidance to the direct imported mismatch rule sets out an apportionment formula which can be used to determine the extent to which an imported mismatch payment has been directly set-off against a counterparty's indirect hybrid deduction. The formula is as follows:

$$\frac{\text{B Co's hybrid deductions}}{\text{Imported mismatch payments received by B Co}} = \frac{267}{200 + 200} = \frac{267}{400} = \frac{2}{3}$$

Therefore two-thirds of the imported mismatch payments made by E Co and F Co are subject to adjustment under the imported mismatch rule.

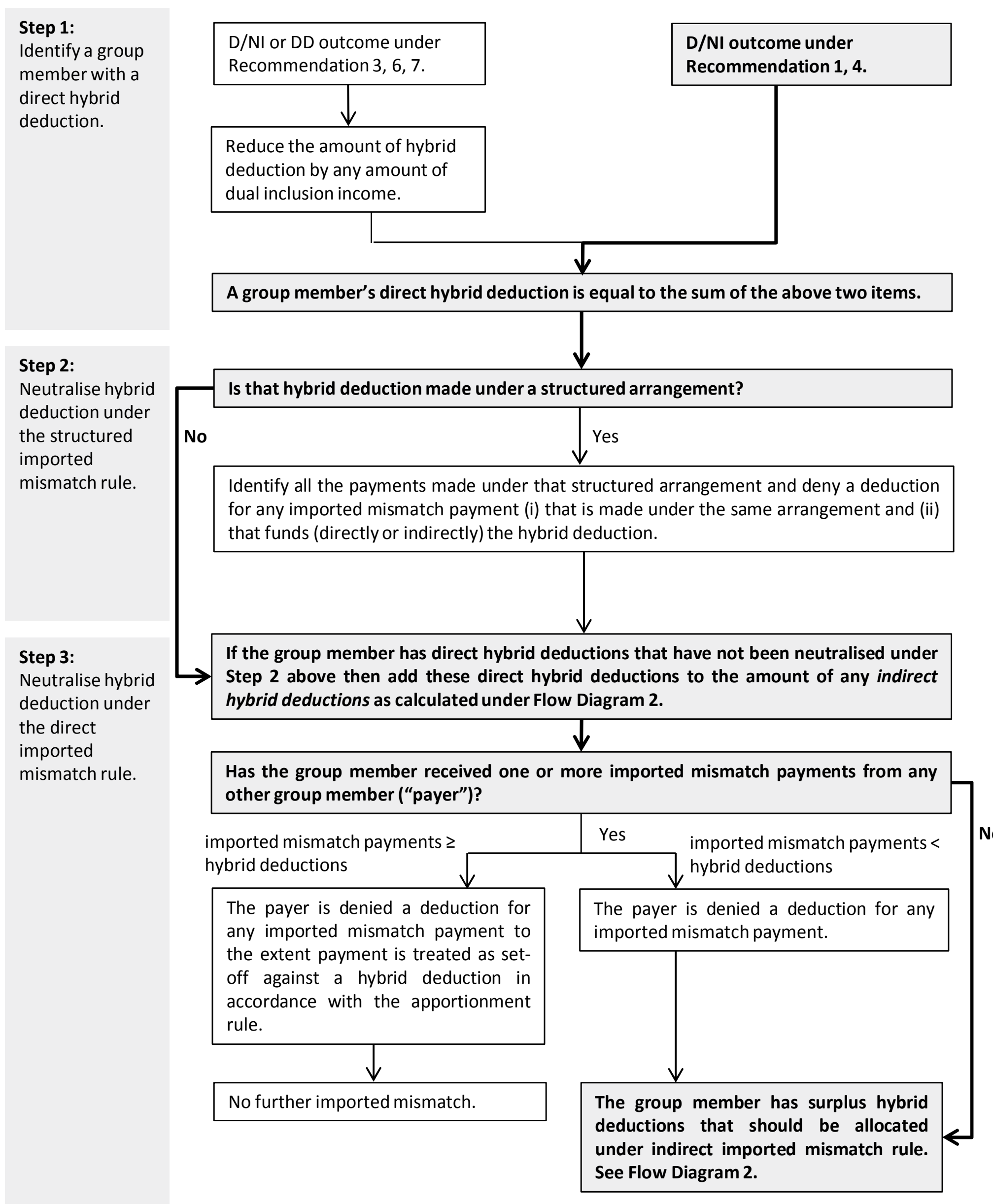
13. The calculation with respect to G Co's imported mismatch payment is the same. D Co's indirect hybrid deduction should be treated as set-off against that imported mismatch payments using the same apportionment formula. The proportion of deduction that G Co should be denied on its imported mismatch payment is calculated as follows:

$$\frac{\text{D Co's hybrid deductions}}{\text{Imported mismatch payments received by D Co}} = \frac{133}{200} = \frac{2}{3}$$

14. Applying these ratios under the direct imported mismatch rules of Country E, F and G the amount of interest deduction denied under the laws of each Country will be 150 (i.e. 2/3 x 200).

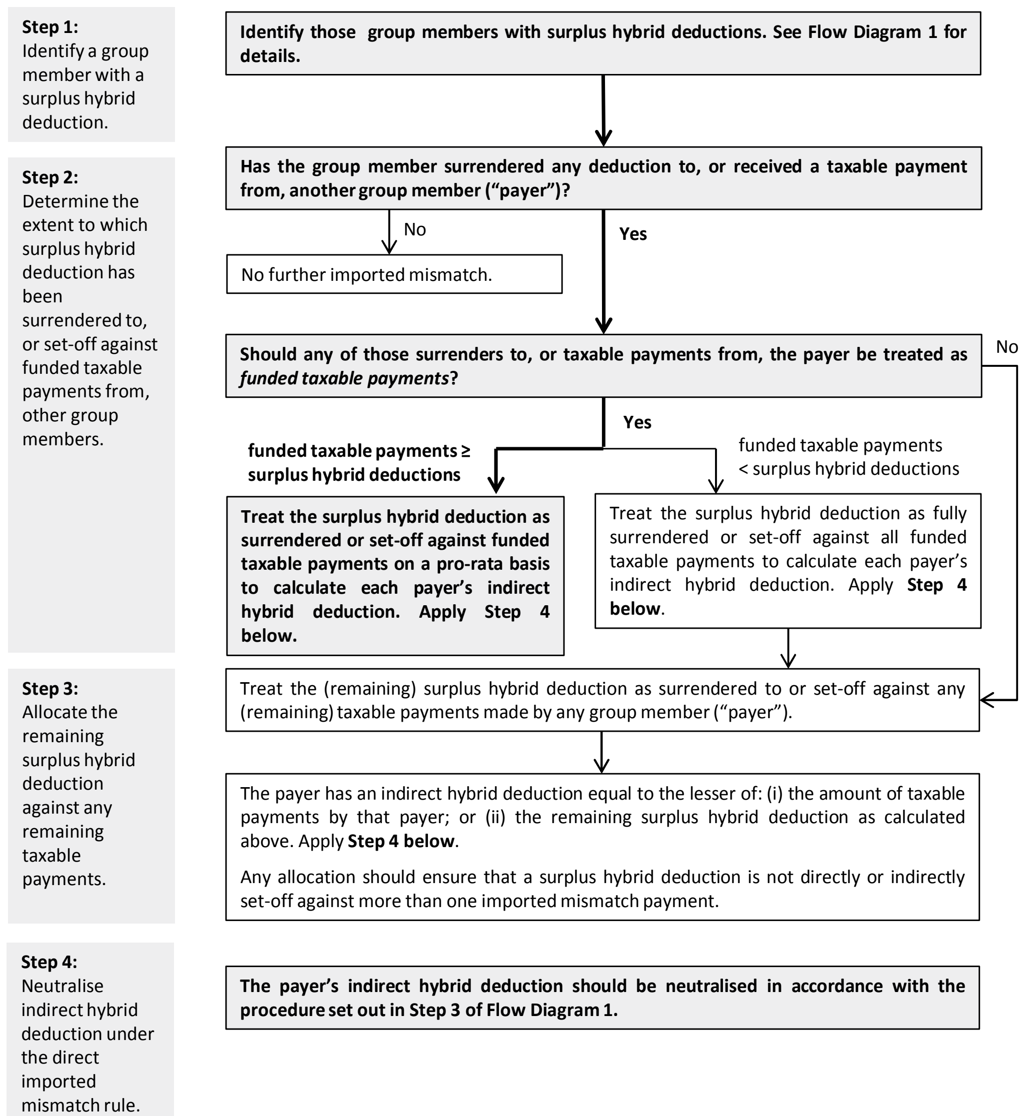
Flow Diagram 1 (Example 8.9)

Neutralising hybrid deduction under the structured and direct imported mismatch rule



Flow Diagram 2 (Example 8.9)

Allocating surplus hybrid deduction under the indirect imported mismatch rule

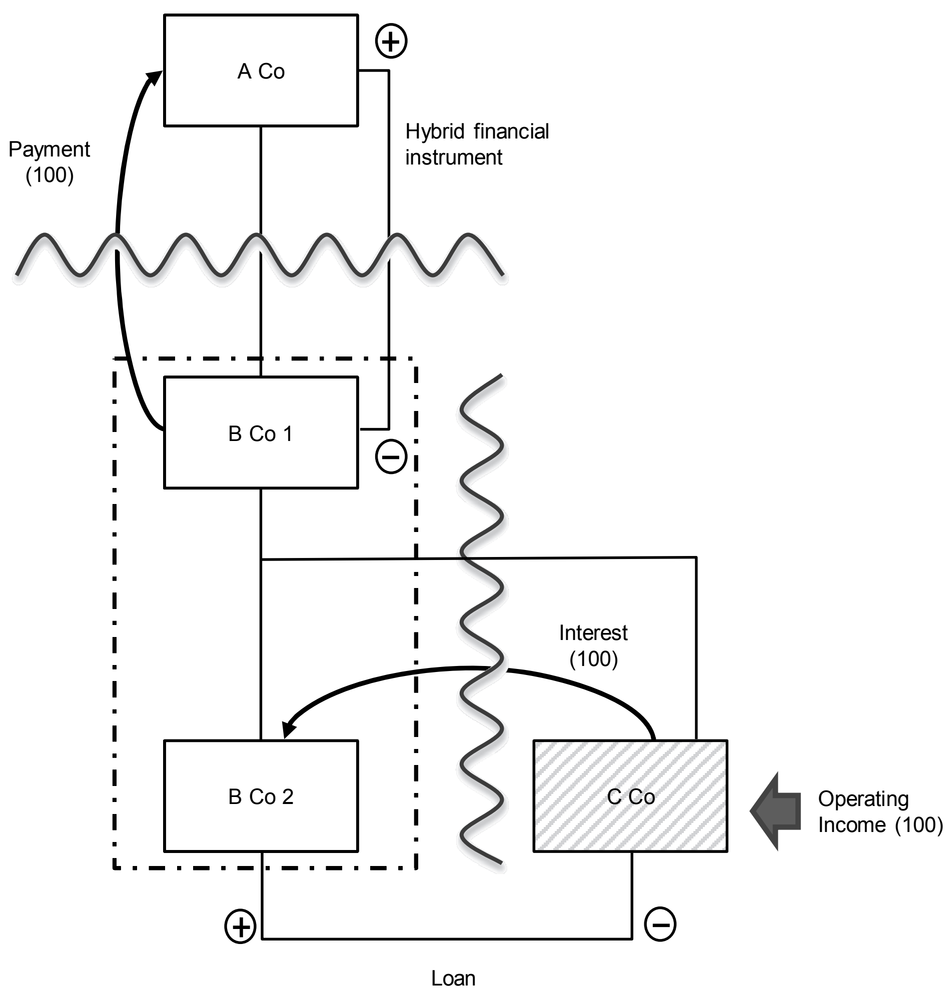


Example 8.10

Application of the imported mismatch rule to loss surrender under a tax grouping arrangement

Facts

1. In the example illustrated in the figure below, A Co (a company resident in Country A), B Co 1 and B Co 2 (companies resident in Country B) and C Co (a company resident in Country C) are all members of the ABC group. Companies B Co 1 and B Co 2 are members of the same tax group for the purposes of Country B law. These tax grouping rules allow one company to surrender a loss to another group member.



2. C Co receives operating income of 100 and makes an interest payment of 100 to B Co 2. B Co 1 makes interest payment of 100 to A Co under a hybrid financial

instrument. The payments of interest under the hybrid financial instrument are treated as deductible interest payments under Country B law but as exempt dividends under Country A law. The hybrid financial instrument is not, however, entered into as part of a wider structured arrangement.

3. Country B treats the hybrid financial instrument as an ordinary debt instrument and grants B Co 1 a deduction for interest paid on the loan. This interest payment is not included in A Co's ordinary income. This discrepancy in tax treatment results in a hybrid mismatch giving rise to a D/NI outcome and a net loss for B Co 1. That loss is surrendered by B Co 1 to B Co 2 under the tax grouping rule and set-off against the income from the interest payment received from C Co. The table below illustrates the effect of this transaction for the members of the ABC group.

Country A Law A Co	Tax	Book	Country B Law B Co 1	Tax	Book
Income			Income		
Dividend	0	100			
			Expenditure		
			Interest paid	(100)	(100)
Net return		**100**	**Net return**		**(100)**
Taxable income	**0**		Taxable income (loss)	(100)	
			Loss surrender to B Co 2	100	
			Loss carry-forward	**0**	

Country C Law C Co	Tax	Book	B Co 2	Tax	Book
Income			Income		
Ordinary income	100	100	Interest	100	100
Expenditure			Expenditure		
Interest	(100)	(100)	Loss surrender from B Co 1	(100)	
Net return		**0**	**Net return**		**100**
Taxable income	**0**		**Taxable income**	**0**	

4. C Co (the shaded entity) is the only group entity resident in a Country that has implemented the recommendations set out in the report.

Question

5. Whether the interest payments made by C Co are subject to adjustment under the imported mismatch rule, and, if so, the amount of the adjustment required under the rule?

Answer

6. The payment of interest by C Co is subject to adjustment under the imported mismatch rule because B Co 1's hybrid deduction is indirectly set-off against the interest income paid by C Co to B Co 2. Country C should therefore deny C Co a deduction for all the interest paid to B Co 2. See the flow diagrams at the end of this example which outline the steps to be taken in applying the imported mismatch rule.

Analysis

B Co 1's hybrid deduction is not set-off against an imported mismatch payment under the structured or direct imported mismatch rule

Step 1 – B Co 1's payment under the hybrid financial instrument gives rise to a direct hybrid deduction

7. The interest payments under the hybrid financial instrument give rise to a direct hybrid deduction for B Co 1 of 100.

Step 2 – the structured imported mismatch rule does not apply

8. The facts of this example assume that the hybrid financial instrument is not entered into as part of a wider structured arrangement. Therefore the structured imported mismatch rule does not apply.

Step 3 – the direct imported mismatch rule does not apply

9. In this case the *direct imported mismatch rule* does not apply as B Co 1 does not directly receive any imported mismatch payments from another group member.

The interest payments made by C Co should be subject to adjustment under the indirect imported mismatch rule

10. As B Co 1's hybrid deduction has not been neutralised under the structured or direct imported mismatch rule, the indirect imported mismatch rule applies to determine the extent to which B Co 1's surplus hybrid deduction should be treated as giving rise to an indirect hybrid deduction for another group member.

Step 1 –B Co 1 has surplus hybrid deductions of 100

11. In this case B Co 1's surplus hybrid deduction will be the amount of hybrid deduction that is attributable to payments under the hybrid financial instrument (100) minus any amount of hybrid deduction that has been neutralised under either the structured or direct imported mismatch rules (0).

Step 2 –B Co 1's surplus hybrid deduction are treated as fully set-off against funded taxable payments

12. B Co 1 has surrendered a loss of 100 to B Co 2. This loss surrender is treated in the same way as a funded taxable payment because it is treated as set-off against an imported mismatch payment. In this case the amount of the loss surrender is equal to the income from the imported mismatch payment and so 100% of the amount surrendered should be treated as set-off against a funded taxable payment under the indirect imported mismatch rule.

Step 3 – B Co 1 has no remaining surplus hybrid deduction

13. B Co 1's surplus hybrid deduction is fully set-off against funded taxable payments and B Co 1 therefore has no remaining surplus hybrid deduction to be set-off against other taxable payments.

Step 4 – B Co 2's indirect hybrid deduction is neutralised in accordance with the direct imported mismatch rule

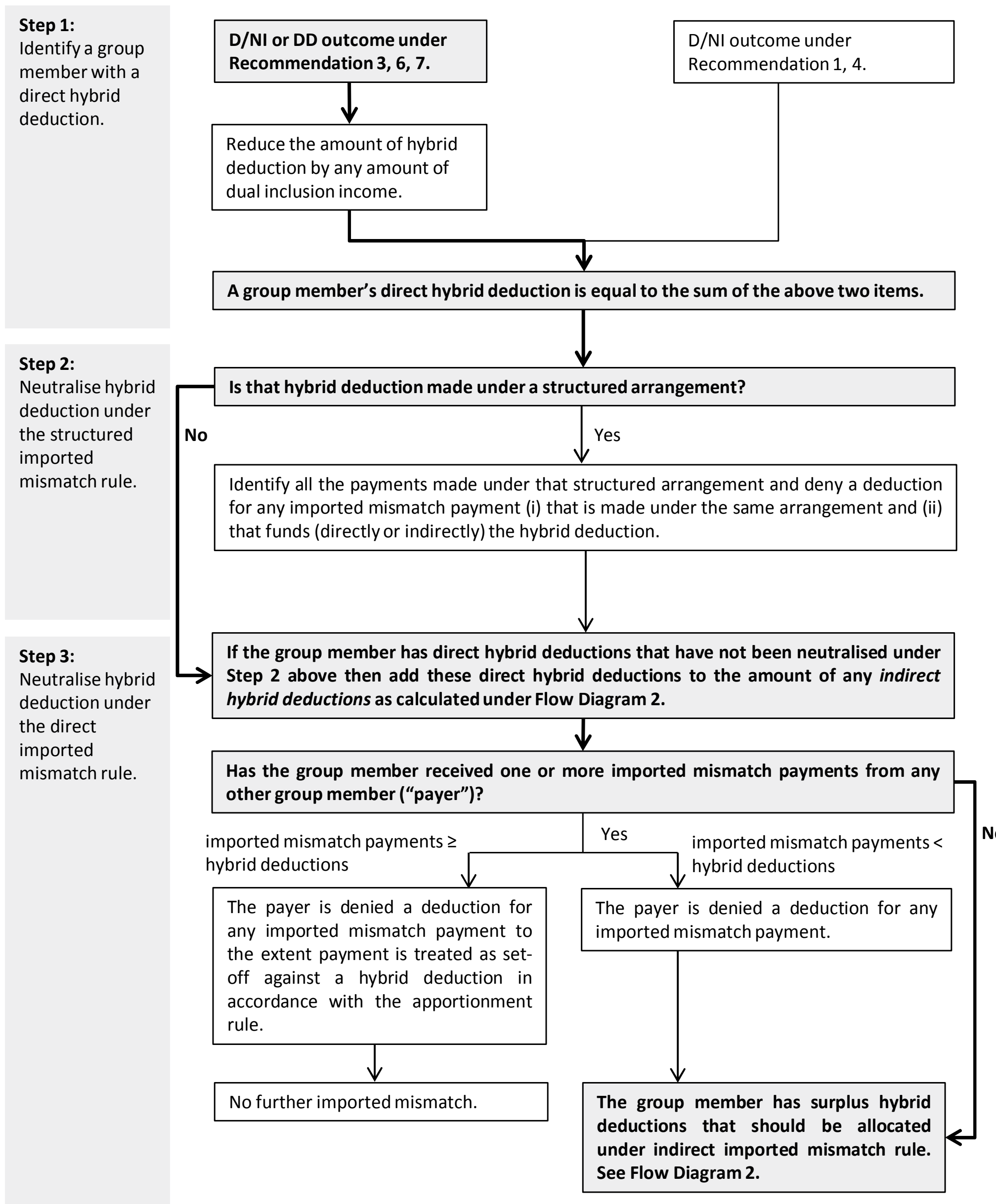
14. B Co 2 treats indirect hybrid deduction as being set-off against imported mismatch payments made by C Co. The amount of deduction that is treated as set-off against C Co's imported mismatch payment is calculated on the same basis as under the direct imported mismatch rule:

$$\text{Imported mismatch payments made by C Co} \times \frac{\text{B Co 2's hybrid deduction}}{\text{Imported mismatch payments received by B Co 2}} = 100 \times \frac{100}{100} = 100$$

C Co should therefore be denied a deduction of 100.

Flow Diagram 1 (Example 8.10)

Neutralising hybrid deduction under the structured and direct imported mismatch rule



Flow Diagram 2 (Example 8.10)
Allocating surplus hybrid deduction under the indirect imported mismatch rule

Step 1:
Identify a group member with a surplus hybrid deduction.

Identify those group members with surplus hybrid deductions. See Flow Diagram 1 for details.

Step 2:
Determine the extent to which surplus hybrid deduction has been surrendered to, or set-off against funded taxable payments from, other group members.

Has the group member surrendered any deduction to, or received a taxable payment from, another group member ("payer")?

No → No further imported mismatch.

Yes →

Should any of those surrenders to, or taxable payments from, the payer be treated as *funded taxable payments*?

No → (go to Step 3)

Yes →

funded taxable payments ≥ surplus hybrid deductions

Treat the surplus hybrid deduction as surrendered or set-off against funded taxable payments on a pro-rata basis to calculate each payer's indirect hybrid deduction. Apply Step 4 below.

funded taxable payments < surplus hybrid deductions

Treat the surplus hybrid deduction as fully surrendered or set-off against all funded taxable payments to calculate each payer's indirect hybrid deduction. Apply **Step 4 below**.

Step 3:
Allocate the remaining surplus hybrid deduction against any remaining taxable payments.

Treat the (remaining) surplus hybrid deduction as surrendered to or set-off against any (remaining) taxable payments made by any group member ("payer").

The payer has an indirect hybrid deduction equal to the lesser of: (i) the amount of taxable payments by that payer; or (ii) the remaining surplus hybrid deduction as calculated above. Apply **Step 4 below**.

Any allocation should ensure that a surplus hybrid deduction is not directly or indirectly set-off against more than one imported mismatch payment.

Step 4:
Neutralise indirect hybrid deduction under the direct imported mismatch rule.

The payer's indirect hybrid deduction should be neutralised in accordance with the procedure set out in Step 3 of Flow Diagram 1.

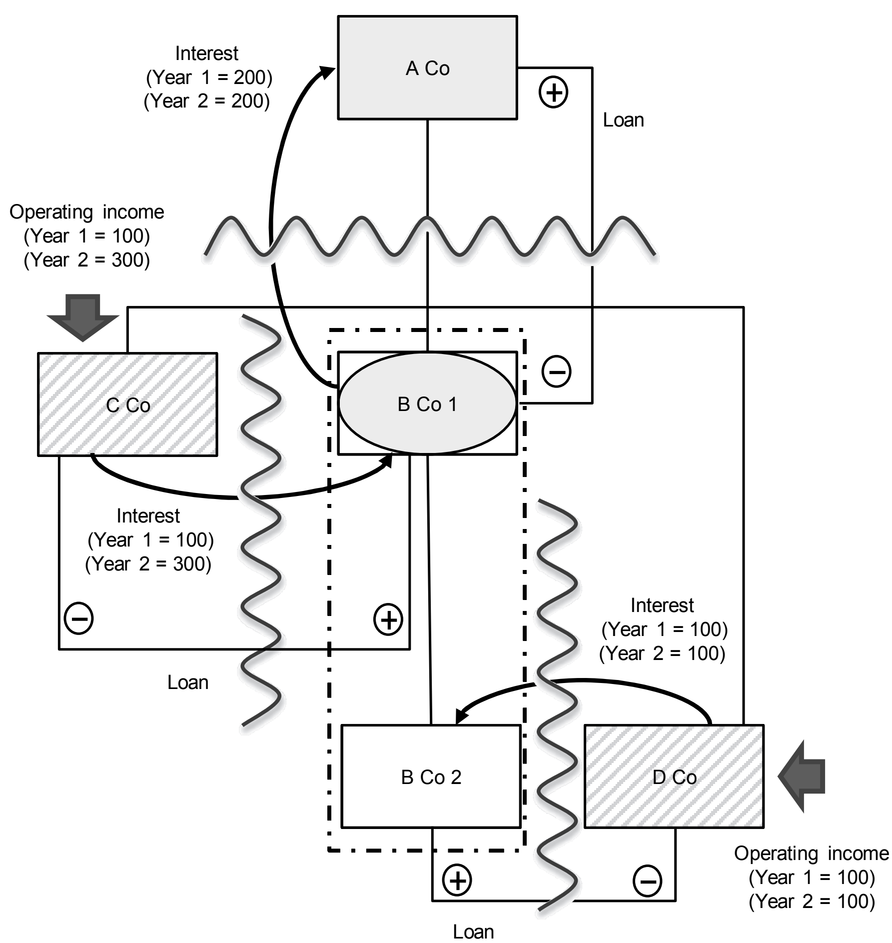
Example 8.11

Payment of dual inclusion income not subject to adjustment under imported mismatch rule

Facts

1. The figure below sets out the financing arrangements for companies that are members of the ABCD group. A Co is resident in Country A and is the parent company of the group. B Co 1, C Co and D Co are all direct subsidiaries of A Co and are resident in Country B, Country C and Country D respectively. B Co 2 is a wholly-owned subsidiary of B Co 1 and is also resident in Country B.

2. All companies are treated as separate tax entities in all jurisdictions, except that B Co 1 is a hybrid entity (i.e. an entity that is treated as a separate entity for tax purposes in Country B but as a disregarded entity under Country A law).



3. A Co has lent money to B Co 1. B Co 1 has lent money to C Co and B Co 2 has lent money to D Co. Each of these financing arrangements are entered into independently and do not form part of single scheme, plan or understanding.

4. Because B Co 1 is a hybrid entity, the interest payments it makes to A Co are deductible under Country B law, but not recognised as income by A Co under Country A law. For the same reason, interest payments by C Co to B Co 1 are included in the income of both A Co and B Co 1 under the laws of Country A and Country B respectively (i.e. the interest payment gives rise to dual inclusion income). B Co 1 and B Co 2 are members of the same tax group for tax purposes under Country B law, which means that the net loss of B Co 1 can be set-off against any net income of B Co 2. All jurisdictions impose corporate tax at the rule of 30%.

Tax position before applying the imported mismatch rule

5. The tables below set out the tax position in respect of the ABCD group under this structure as at the end of the first year.

	Country A A Co			Country B B Co 1		
Year 1		**Tax**	**Book**		**Tax**	**Book**
	<u>Income</u>			<u>Income</u>		
	Interest paid by B Co 1	-	200	Interest paid by C Co	100	100
	Interest paid by C Co to B Co 1	100	-			
				<u>Expenditure</u>		
				Interest paid to A Co	(200)	(200)
				Net return		**(100)**
				Taxable income	(100)	
				Loss surrender to B Co 2	100	
				Loss carry-forward	**0**	
				B Co 2		
				<u>Income</u>		
				Interest paid by D Co	100	100
				<u>Expenditure</u>		
				Loss surrender	(100)	-
	Net return		**200**	**Net return**		**100**
	Taxable income	**100**		**Taxable income**	**0**	

Year 1	Country C Law C Co	Tax	Book	Country D Law D Co	Tax	Book
	Income			Income		
	Operating income	100	100	Operating income	100	100
	Expenditure			Expenditure		
	Interest paid to B Co 1	(100)	(100)	Interest paid to B Co 2	(100)	(100)
	Net return		**0**	**Net return**		**0**
	Taxable income	**0**		**Taxable income**	**0**	

6. The tables below set out the tax position in respect of the ABCD Group under this structure as at the end of the second year.

Year 2	Country A A Co	Tax	Book	Country B B Co 1	Tax	Book
	Income			Income		
	Interest paid by B Co 1	-	200	Interest paid by C Co	300	300
	Interest paid by C Co to B Co 1	300	-			
				Expenditure		
				Interest paid to A Co	(200)	(200)
	Net return		**200**	**Net return**		**100**
	Taxable income	**300**		**Taxable income**	**100**	
	Tax on income (30%)	(90)		Tax on income (30%)	(30)	
	Credit for tax paid in Country B	30				
	Tax to pay		(60)	Tax to pay		(30)
	After-tax return		**140**	**After-tax return**		**70**
				B Co 2		
				Income		
				Interest paid by D Co	100	100
				Net return		**100**
				Taxable income	**100**	

Year 2	Country C Law C Co	Tax	Book	Country D Law D Co	Tax	Book
	Income			Income		
	Operating income	300	300	Operating income	100	100
	Expenditure			Expenditure		
	Interest paid to B Co 1	(300)	(300)	Interest paid to B Co 2	(100)	(100)
	Net return		**0**	**Net return**		**0**
	Taxable income	**0**		**Taxable income**	**0**	

Result under Country A law

7. A Co has taxable income of 100 and 300 in Years 1 and 2 respectively. Under Country A law, A Co is entitled to a foreign tax credit in Year 2 for taxes paid by B Co 1 in Country B so that the amount of ordinary income derived by A Co is 200.

Result under Country B law

8. In Year 1, B Co 1 has a net loss of 100 while B Co 2 has net income of 100. B Co 1's net loss is surrendered through Country B's tax grouping regime and applied against B Co 2's net income so that the group is treated, under Country B law, as having net income of zero for that year. In Year 2, B Co 1 has net income of 100 (interest income of 300 and a deduction of 200) and B Co 2 has net income of 100.

Result under Country C and D law

9. Country C and D have income that is equal to their expenses and therefore have no net income in either of the two years.

Mismatch in tax outcomes

10. In aggregate the ABCD Group generates a net return of 600 over the two years. The total amounts of taxable income recognised in each jurisdiction is also 600, but 100 of this is income that is sheltered by foreign tax credits. Accordingly, the total amount of ordinary income recognised under the structure is 500.

Question

11. Whether the interest payments made by C Co and D Co are subject to adjustment under the imported mismatch rule and, if so, the amount of the adjustment required under the rule.

Answer

12. As the interest payments made by C Co to B Co 1 are dual inclusion income, they are not treated as set-off against a hybrid deduction and therefore no adjustment is required for the payments made by C Co under the imported mismatch rule.

13. Indirect imported mismatch rule applies to interest payments from D Co to B Co 2. Country D should therefore deny D Co a deduction for all (100) of the interest paid to B Co 2 in Year 1 but no adjustment is required in Year 2. See the flow diagrams at the end of this example which outline the steps to be taken in applying the imported mismatch rule.

Analysis

Interest payments made by B Co 1 are not made under a structured arrangement

14. The loan between A Co and B Co 1 is independent of the other intra-group financing arrangements. Unless such loan was entered into as part of wider scheme, plan or understanding that was intended to import the effect of a mismatch in tax outcomes into Country C or D, then the interest payment made by B Co 1 to A Co should not be treated as made under a structured imported mismatch arrangement.

The interest payments by C Co to B Co 1 are not offset against a hybrid deduction

15. As explained in the facts above, the interest payments made by B Co 1 to A Co give rise to a D/NI outcome under the disregarded payments rule. However, a hybrid mismatch does not arise under the disregarded hybrid payments rule to the extent the deductions attributable to such payment are set-off against dual inclusion income. In this case, C Co's interest payments to B Co 1 are dual inclusion income and therefore cannot be treated as giving rise to an imported mismatch. Hence, no adjustment is required for the payments made by C Co in either year under the imported mismatch rule.

B Co 1's hybrid deduction is not set-off against an imported mismatch payment under the structured or direct imported mismatch rule

Step 1 – B Co 1's disregarded hybrid payment gives rise to a direct hybrid deduction

16. The interest payment B Co 1 makes to A Co is a disregarded hybrid payment. Any deduction claimed for that payment will be a direct hybrid deduction to the extent it exceeds the payer's dual inclusion income. In this case, the disregarded interest payment made by B Co 1 in Year 1 (200) exceeds Co 1's dual inclusion for that year (100) and accordingly B Co 1 has a hybrid deduction in Year 1 of 100.

Step 2 – the structured imported mismatch rule does not apply

17. The facts of this example assume that the disregarded hybrid payment is not made under a wider structured imported mismatch arrangement. Therefore the structured imported mismatch rule does not apply.

Step 3 – the direct imported mismatch rule does not apply

18. In this case the direct imported mismatch rule does not apply as B Co 1 does not directly receive any imported mismatch payments from another group member.

The interest payment made by D Co in Year 1 should be subject to adjustment under the indirect imported mismatch rule

19. As B Co 1's hybrid deduction has not been neutralised under the structured or direct imported mismatch rule, the indirect imported mismatch rule applies to determine the extent to which B Co 1's surplus hybrid deduction should be treated as giving rise to an indirect hybrid deduction for another group member.

Step 1 –B Co 1 has surplus hybrid deductions of 100

20. In this case B Co 1's surplus hybrid deduction will be the amount of hybrid deduction that arises under the hybrid mismatch arrangement (100) minus any amount that has been neutralised under either the structured or direct hybrid mismatch rules (0).

Step 2 –B Co 1's surplus hybrid deduction are treated as fully set-off against funded taxable payments

21. B Co 1 has surrendered a loss of 100 to B Co 2. This loss surrender is treated in the same way as a funded taxable payment because the surrendered hybrid deduction is set-off against an imported mismatch payment. In this case the amount of the loss surrender is equal to the imported mismatch payment and so 100% of the amount surrendered should be treated as set-off against a funded taxable payment under the indirect imported mismatch rule.

Step 3 – B Co 1 has no remaining surplus hybrid deduction

22. B Co 1's surplus hybrid deduction is fully set-off against funded taxable payments and B Co 1 therefore has no remaining surplus hybrid deduction to be set-off against other taxable payments.

Step 4 – B Co 2's indirect hybrid deduction is neutralised in accordance with the direct imported mismatch rule

23. B Co 2 treats the indirect hybrid deduction as being set-off against imported mismatch payments made by C Co. The amount of deduction that is treated as set-off against C Co's imported mismatch payment is calculated on the same basis as under the direct imported mismatch rule:

$$\text{Imported mismatch payments made by D Co} \times \frac{\text{B Co 2's hybrid deduction}}{\text{Imported mismatch payments received by B Co 2}} = 100 \times \frac{100}{100} = 100$$

C Co should therefore be denied a deduction of 100.

Tax position after applying the imported mismatch rule

24. The effect of the adjustment under the imported mismatch rule is to deny D Co a deduction for the entire amount of the interest payment in Year 1. This brings the total ordinary income under the structure into line with the aggregate income under the

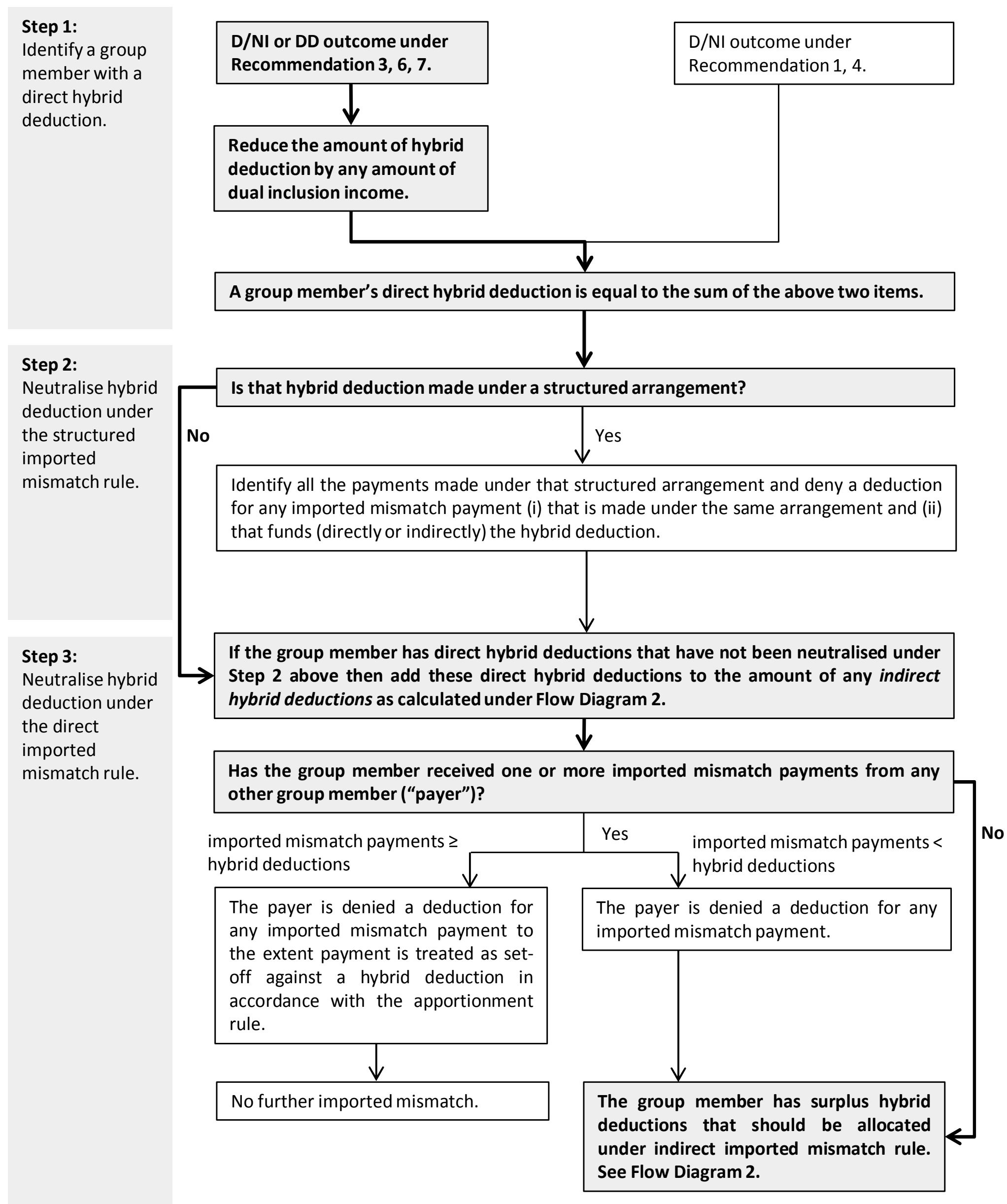
arrangement. The tables below sets out the tax position of the ABCD Group, as at the end of the first year, after applying the imported mismatch rule.

Year 1	Country A A Co			Country B B Co 1		
		Tax	Book		Tax	Book
	Income			Income		
	Interest paid by B Co 1	-	200	Interest paid by C Co	100	100
	Interest paid by C Co to B Co 1	100	-			
				Expenditure		
				Interest paid to A Co	(200)	(200)
				Net return		**(100)**
				Taxable income	(100)	
				Loss surrender to B Co 2	100	
				Loss carry-forward	**0**	
				B Co 2		
				Income		
				Interest paid by D Co	100	100
				Expenditure		
				Loss surrender	(100)	-
	Net return		**200**	**Net return**		**100**
	Taxable income	**100**		**Taxable income**	**0**	

Year 1	Country C Law C Co			Country D Law D Co		
		Tax	Book		Tax	Book
	Income			Income		
	Operating income	100	100	Operating income	100	100
	Expenditure			Expenditure		
	Interest paid to B Co 1	(100)	(100)	Interest paid to B Co 2	-	(100)
	Net return		**0**	**Net return**		**0**
	Taxable income	**0**		**Taxable income**	**100**	

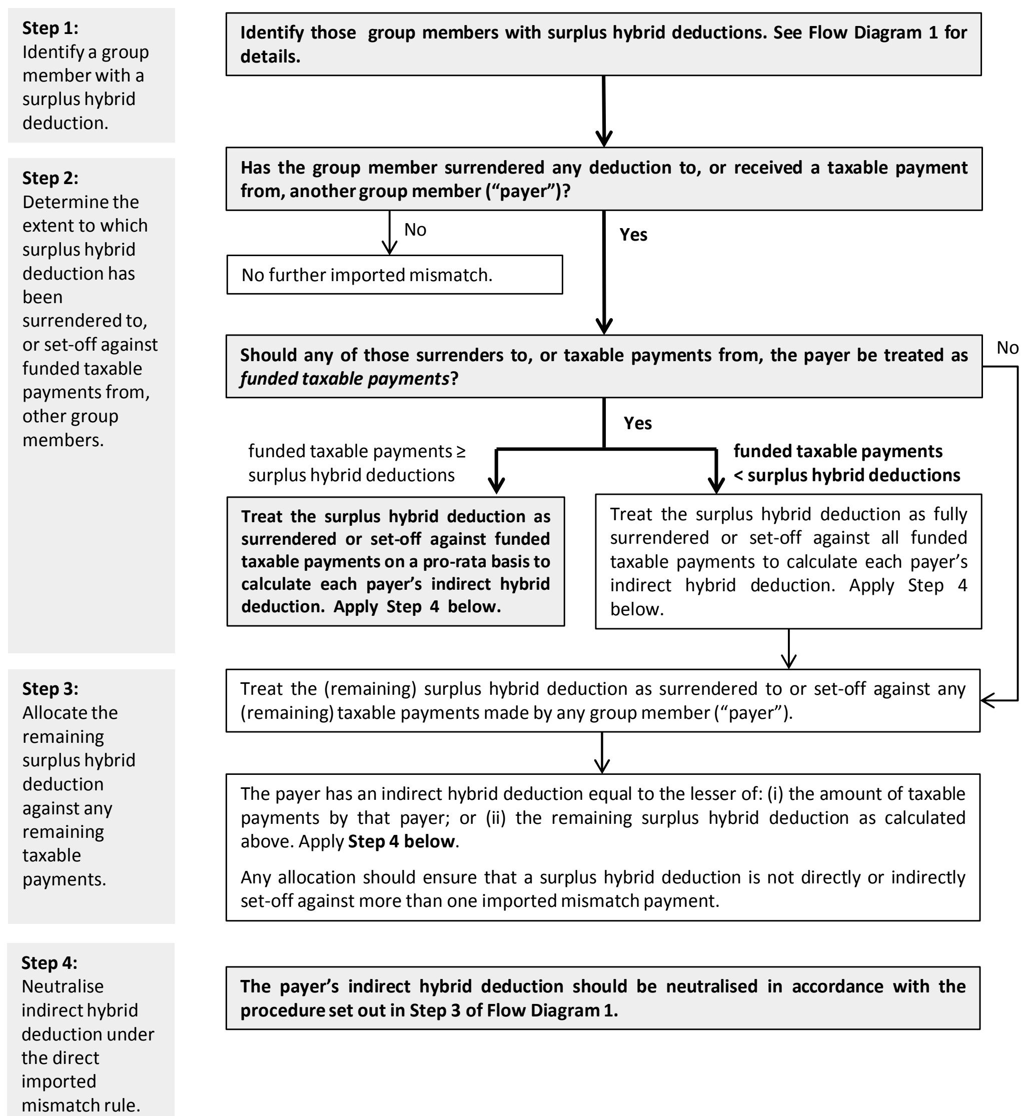
Flow Diagram 1 (Example 8.11)

Neutralising hybrid deduction under the structured and direct imported mismatch rule



Flow Diagram 2 (Example 8.11)

Allocating surplus hybrid deduction under the indirect imported mismatch rule



Example 8.12

Imported mismatch rule and carry-forward losses

Facts

1. The facts are the same as in **Example 8.11** except that B Co 1's net loss is not surrendered to B Co 2 in the first year. The tables below set out the tax position in respect of each member of the ABCD Group under this structure as at the end of the first year.

	Country A A Co	Tax	Book	Country B	Tax	Book
Year 1				**B Co 1**		
	Income			Income		
	Interest paid by B Co 1	-	200	Interest paid by C Co	100	100
	Interest paid by C Co to B Co 1	100	-			
				Expenditure		
				Interest paid to A Co	(200)	(200)
				Net return		**(100)**
				Taxable income (loss)	**(100)**	
				B Co 2		
				Income		
				Interest paid by D Co	100	100
	Net return		**200**	**Net return**		**100**
	Taxable income	**100**		**Taxable income**	**100**	

	Country C Law C Co	Tax	Book	Country D Law D Co	Tax	Book
Year 1	<u>Income</u>			<u>Income</u>		
	Operating income	100	100	Operating income	100	100
	<u>Expenditure</u>			<u>Expenditure</u>		
	Interest paid to B Co 1	(100)	(100)	Interest paid to B Co 2	(100)	(100)
	Net return		**0**	**Net return**		**0**
	Taxable income	**0**		**Taxable income**	**0**	

2. The tables below set out the tax position in respect of each member of the ABCD Group under this structure as at the end of the second year.

	Country A A Co	Tax	Book	Country B B Co 1	Tax	Book
Year 2	<u>Income</u>			<u>Income</u>		
	Interest paid by B Co 1	-	200	Interest paid by C Co	300	300
	Interest paid by C Co to B Co 1	300	-			
				<u>Expenditure</u>		
				Interest paid to A Co	(200)	(200)
	Net return		**200**	**Net return**		**100**
	Taxable income	**300**		Taxable income	100	
	Tax on income (30%)	(90)		Loss carry forward	(100)	
				Adjusted income	0	
	Tax to pay		(90)	Tax to pay		0
	After-tax return		**110**	**After-tax return**		**100**
				B Co 2		
				<u>Income</u>		
				Interest paid by D Co	100	100
				Net return		**100**
				Taxable income	**100**	

Year 2	Country C Law C Co	Tax	Book	Country D Law D Co	Tax	Book
	Income			Income		
	Operating income	300	300	Operating income	100	100
	Expenditure			Expenditure		
	Interest paid to B Co 1	(300)	(300)	Interest paid to B Co 2	(100)	(100)
	Net return		**0**	**Net return**		**0**
	Taxable income	**0**		**Taxable income**	**0**	

Result under Country A law

3. A Co has net income of 100 and 300 in Years 1 and 2 respectively. A treats these amounts as ordinary income.

Result under Country B law

4. In Year 1, B Co 1 has a net loss of 100 (interest income of 100 and a deduction of 200), while B Co 2 has net income of 100. B Co 1's net loss is carried-forward to the subsequent year and set-off against dual inclusion income in Year 2. Accordingly in Year 2, B Co 1 has an adjusted taxable income of 0 (interest income of 300, a deduction of 200 and a carry-forward loss of 100) and B Co 2 has net income of 100.

Result under Country C and D law

5. Country C and D have income that is equal to their expenses and therefore have no net income in either of the two years.

Question

6. Whether the interest payments made by D Co are subject to adjustment under the imported mismatch rule and, if so, the amount of the adjustment required under the rule.

Answer

7. Because B Co 1 does not surrender its Year 1 loss to B Co 2 under the tax grouping regime, B Co 2's income from the imported mismatch payment is not set-off against any hybrid deduction. Accordingly, no adjustment is required for the payments made by C Co or D Co under the indirect imported mismatch rule. See the flow diagrams at the end of this example which outline the steps to be taken in applying the imported mismatch rule.

Analysis

Interest payments made by B Co 1 are not made under a structured arrangement

8. The loan between A Co and B Co 1 is independent of the other intra-group financing arrangements. Unless such loan was entered into as part of wider scheme, plan or understanding that was intended to import the effect of a mismatch in tax outcomes into Country C or D, then the interest payment made by B Co 1 to A Co should not be treated as made under a structured imported mismatch arrangement.

B Co 1's hybrid deduction is not set-off against an imported mismatch payment under the structured or direct imported mismatch rule

Step 1 – B Co 1's disregarded hybrid payment gives rise to a direct hybrid deduction

9. The interest payment B Co 1 makes to A Co is a disregarded hybrid payment. Any deduction claimed for that payment will be a direct hybrid deduction to the extent it exceeds the payer's dual inclusion income. In this case, the disregarded interest payments made by B Co 1 in Year 1 (200) exceed B Co 1's dual inclusion for that year (100) and accordingly B Co 1 has a hybrid deduction in Year 1 of 100.

Step 2 – the structured imported mismatch rule does not apply

10. The facts of this example assume that the disregarded hybrid payment is not made under a wider structured imported mismatch arrangement. Therefore the structured imported mismatch rule does not apply.

Step 3 – the direct imported mismatch rules does not apply

11. In this case the *direct imported mismatch rule* does not apply as B Co 1 does not directly receive any imported mismatch payments from another group member.

The interest payment made by D Co in Year 1 should be subject to adjustment under the indirect imported mismatch rule

12. As B Co 1's hybrid deduction has not been neutralised under the structured or direct imported mismatch rule, the indirect imported mismatch rule applies to determine the extent to which B Co 1's surplus hybrid deduction should be treated as giving rise to an indirect hybrid deduction for another group member.

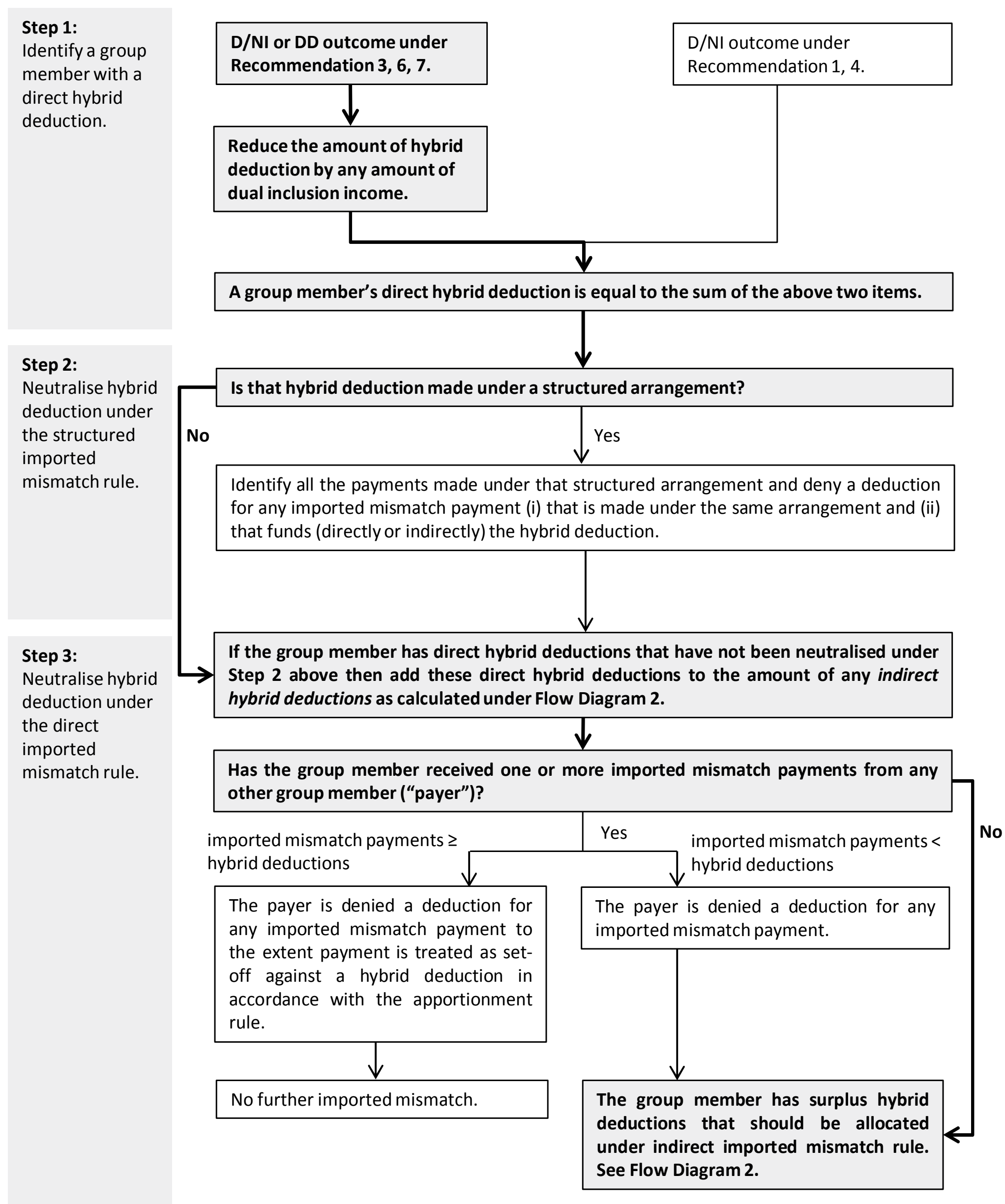
Step 1 –B Co 1 has surplus hybrid deductions of 100

13. In this case B Co 1's surplus hybrid deduction will be the amount of hybrid deduction that arises under the hybrid mismatch arrangement (100) minus any amount of hybrid deduction that has been neutralised under either the structured or direct imported mismatch rules (0).

Step 2 –B Co 1's surplus hybrid deduction is not surrendered or set-off against a taxable payment from any group member

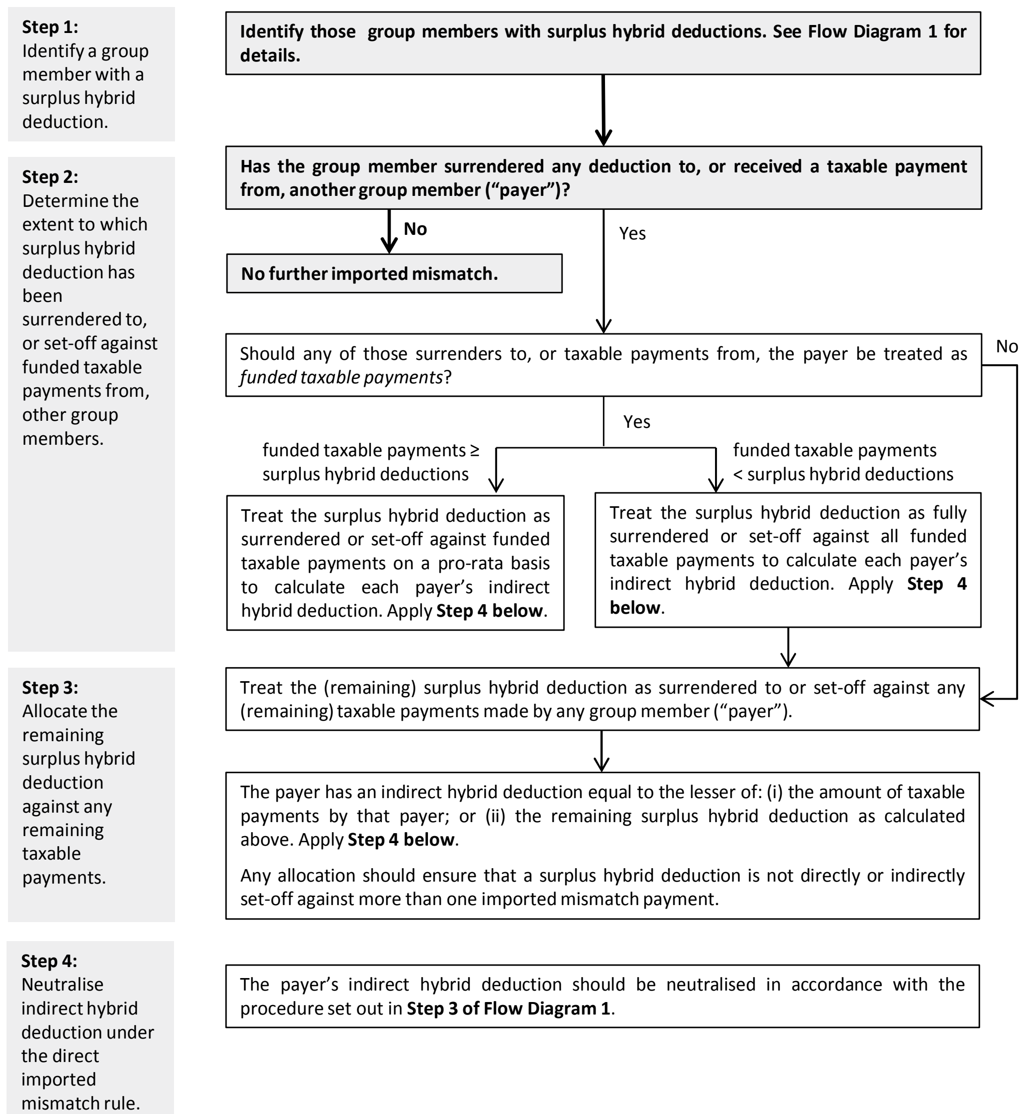
14. B Co 1's surplus hybrid deduction is not surrendered under the tax grouping regime or set-off against the taxable payment of any group member. Therefore the hybrid deduction is not treated as giving rise to any indirect hybrid deduction for any other group member. B Co 1, however, has a surplus hybrid deduction that is converted into a net loss that is carried-forward into the subsequent period. The carried-forward loss should be treated as giving rise to a hybrid deduction in that period (see the analysis in **Example 8.15**). In this case, however, because the hybrid deduction has arisen in respect of a disregarded payment and is offset against dual inclusion income in the following year the net effect of the hybrid deduction is neutralised and no imported mismatch arises in Year 2. The carry-forward of the net loss eliminates the foreign tax credit that would otherwise be available to A Co in Year 2, bringing the aggregate amount of ordinary income under the structure into line with the overall group profit.

Flow Diagram 1 (Example 8.12)
Neutralising hybrid deduction under the structured and direct imported mismatch rule



Flow Diagram 2 (Example 8.12)

Allocating surplus hybrid deduction under the indirect imported mismatch rule

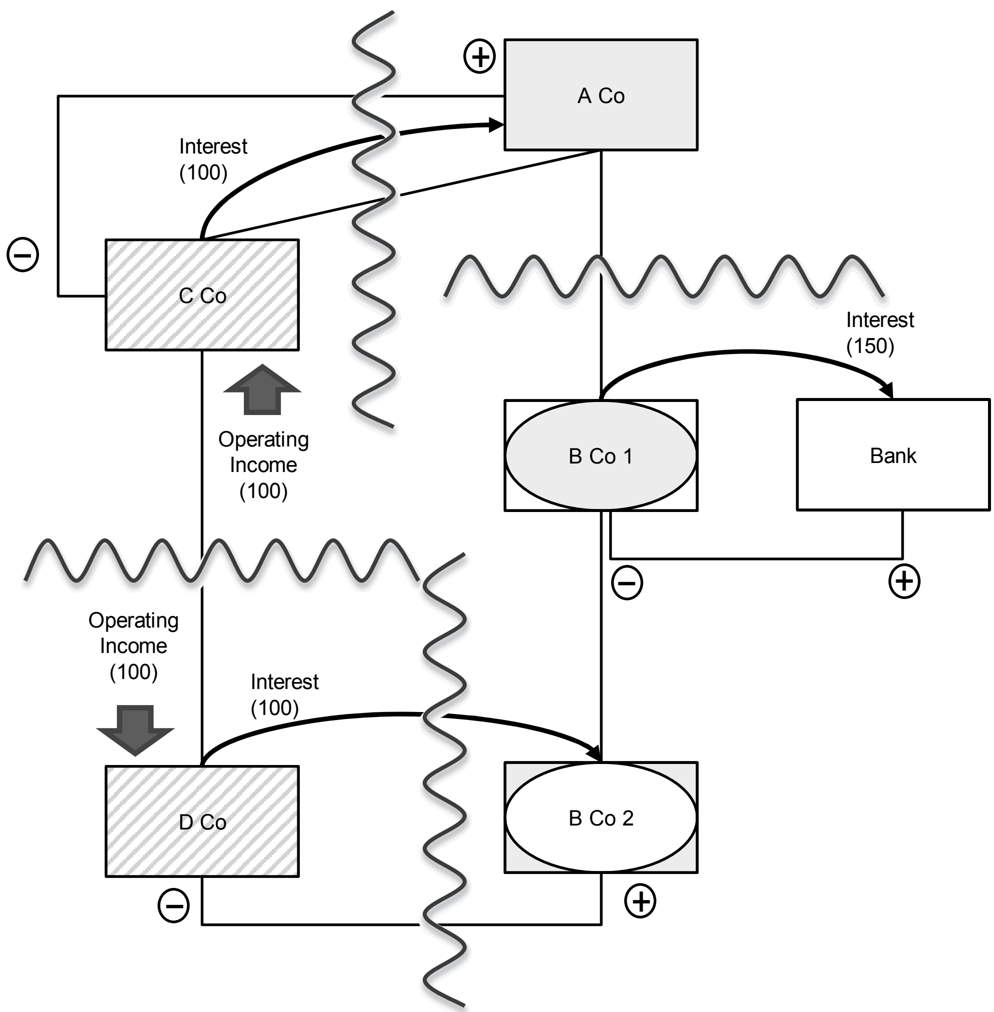


Example 8.13

Deductible hybrid payments, reverse hybrids and the imported hybrid mismatch rule

Facts

1. The figure below sets out the intra-group financing arrangements for companies that are members of the ABCD group. A Co is the parent of the group and is resident in Country A. B Co 1 and C Co are both direct subsidiaries of A Co and are resident in Country B and C respectively. B Co 2, a company resident in Country B, is a wholly-owned subsidiary of B Co 1 and D Co, a company resident in Country D, is a subsidiary of C Co.



2. B Co 1 is a hybrid entity, i.e. an entity that is treated as a separate entity for tax purposes in Country B and as a disregarded entity in Country A. B Co 2 is a reverse hybrid entity, which means that it is treated as a separate entity under the tax laws of both Country A and D but as a disregarded entity for the purposes of Country B law.

3. The funding arrangements for the group are illustrated in the figure above. Each of these financing arrangements are entered into independently and do not form part of single scheme, plan or understanding. C Co pays interest of 100 on the loan from A Co and D Co pays interest of 100 on the loan from B Co 2. B Co 1 pays interest of 150 on the loan funding it receives from Bank. The table below illustrates the net income and expenditure of the entities in the group.

Country A A Co			**Country B B Co 1 and B Co 2 Combined**		
	Tax	**Book**		**Tax**	**Book**
<u>Income</u>			<u>Income</u>		
Interest paid by C Co	100	100	Interest paid by D Co	100	100
<u>Expenditure</u>			<u>Expenditure</u>		
Interest paid by B Co 1	(150)	-	Interest paid by B Co 1	(150)	(150)
Net return		**100**	**Net return**		**(50)**
Taxable income (loss)	**(50)**		**Taxable income**	**(50)**	

Country C Law C Co			**Country D Law D Co**		
	Tax	**Book**		**Tax**	**Book**
<u>Income</u>			<u>Income</u>		
Operating income	100	100	Operating income	100	100
<u>Expenditure</u>			<u>Expenditure</u>		
Interest paid to A Co	(100)	(100)	Interest paid to B Co 2	(100)	(100)
Net return		**0**	**Net return**		**0**
Taxable income	**0**		**Taxable income**	**0**	

4. Because B Co 1 is treated as a transparent entity for the purposes of Country A law, the tax positions of A Co and B Co 1 are combined. The combination of A Co and B Co 1 accounts mean that the payment of 150 made by B Co 1 to Bank is deductible in both Country A and Country B (a DD outcome). For the purposes of Country B law, the positions of B Co 1 and B Co 2 are combined, because B Co 2 is a reverse hybrid and thus the payment of 100 that B Co 2 receives from C Co is treated as if it was received directly by B Co 1. This payment is not, however, dual inclusion income.

5. Country C and Country D have implemented the full set of recommendations set out in the report. For the purposes of this example it is assumed that the structured imported mismatch rule does not apply.

Question

6. Whether the interest payments made by C Co and D Co are subject to adjustment under the imported mismatch rule, and, if so, the amount of the adjustment required under the rule.

Answer

7. Country C and Country D should apply the direct imported mismatch rule to deny a deduction for half the interest payments made by C Co and D Co respectively. See the flow diagram at the end of this example which outlines the steps to be taken in applying the imported mismatch rule.

Analysis

Interest payments made by B Co 1 are not made under a structured arrangement

8. B Co 1's loan from the Bank is independent of the intra-group financing arrangements. Unless such loan was entered into as part of wider scheme, plan or understanding that was intended to import the effect of a mismatch in tax outcomes into Country C or D, then the interest payment made by B Co 1 to the Bank should not be treated as made under a structured imported mismatch arrangement.

Payment of interest by C Co and D Co are offset against the same hybrid deduction

9. B Co 1 makes a deductible hybrid payment of 150 that gives rise to a DD outcome. The resulting hybrid deduction is automatically set-off against income on interest paid by C Co to A Co and on the interest paid by D Co to B Co 2. Because, however, this is a double deduction structure, the payments made by C Co and D Co are effectively set-off against the same hybrid deduction and both these payments should be taken into account when applying the apportionment approach under the direct imported mismatch rule.

The interest payments made by C Co and D Co should be subject to adjustment under the imported mismatch rule

Step 1 – B Co 1's deductible hybrid payment gives rise to a direct hybrid deduction under both Country A law and Country B law

10. The interest payment B Co 1 makes to the Bank is a deductible hybrid payment. Any deduction claimed for that payment will be a direct hybrid deduction to the extent it exceeds the payer's dual inclusion income. In this case the deductible payment is not reduced by any dual inclusion income so that B Co 1's interest payment gives rise to a direct hybrid deduction of 150 under both Country A and Country B law.

Step 2 – the structured imported mismatch rule does not apply

11. The facts of this example assume that the deductible hybrid payment is not made under a structured imported mismatch arrangement. Therefore the structured imported mismatch rule does not apply.

Step 3 – the imported mismatch payments made by C Co and D Co D Co should be treated as set-off against the same hybrid deduction under the direct imported mismatch rule

12. The direct imported mismatch rule should be applied in both Country C and Country D to deny C Co and D Co (respectively) deductions for the interest payments made to A Co and B Co 2 (respectively). Because Country C and Country D are applying the direct imported mismatch rule to the same hybrid deduction, those countries should apply an apportionment approach to determine the extent to which the imported mismatch payment has been set-off against the same hybrid deduction.

13. The guidance to the imported mismatch rule sets out an apportionment formula which can be used to determine the extent to which an imported mismatch payment has been directly set-off against a counterparty's hybrid deductions. The formula is as follows:

$$\text{Imported mismatch payment made by payer} \quad \times \quad \frac{\text{Total amount of remaining hybrid deductions incurred}}{\text{Total amount of imported mismatch payments received}}$$

14. As observed above, in this case the same hybrid deduction is set-off against two imported mismatch payments (from C Co and D Co) and the amount of those payments that should be treated as set-off against the hybrid deduction is calculated as follows:

$$\frac{\text{B Co 1's hybrid deduction}}{\text{Imported mismatch payments received by A Co and B Co 2}} = \frac{150}{100 + 100} = \frac{150}{200} = \frac{3}{4}$$

15. Applying this ratio under the imported mismatch rules of Country C and Country D, the amount of interest deduction denied under Country C law will be $75\ (\text{i.e.}\ 3/4 \times 100)$ and the amount of interest deduction denied under Country D law will be $75\ (\text{i.e.}\ 3/4 \times 100)$.

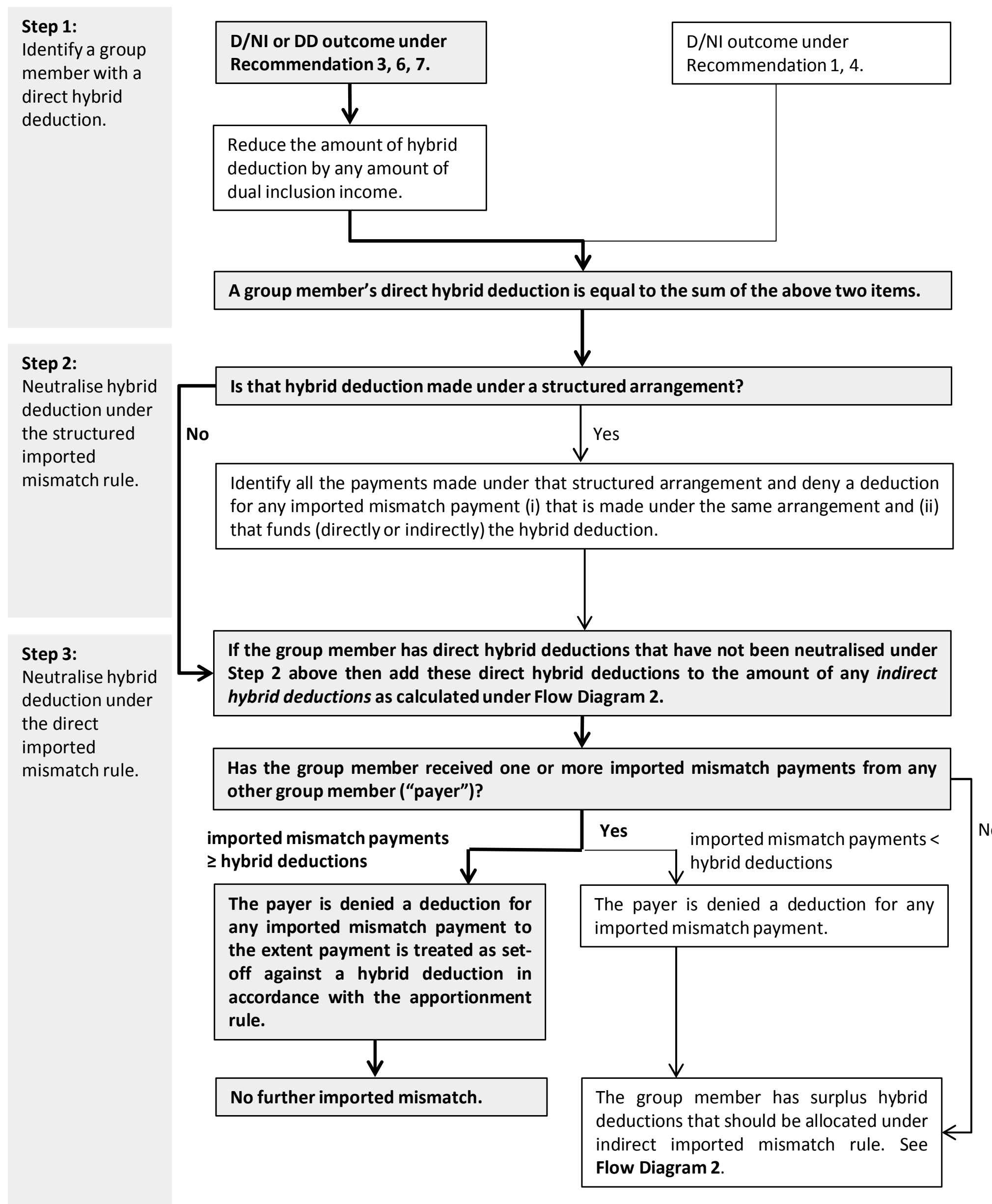
The net income of the companies in the group after application of the imported mismatch rule is presented in the table below.

Country A A Co			Country B B Co 1 and B Co 2 Combined		
	Tax	Book		Tax	Book
Income			Income		
Interest paid by C Co	100	100	Interest paid by D Co	100	100
Expenditure			Expenditure		
Interest paid by B Co 1	(150)	-	Interest paid by B Co 1	(150)	(150)-
Net return		**100**	**Net return**		**(50)**
Taxable income (loss)	**(50)**		**Taxable income**	**(50)**	

Country C Law C Co			Country D Law D Co		
	Tax	Book		Tax	Book
Income			Income		
Operating income	100	100	Operating income	100	100
Expenditure			Expenditure		
Interest paid to A Co	(25)	(100)	Interest paid to B Co 2	(25)	(100)
Net return		**0**	**Net return**		**0**
Taxable income	**75**		**Taxable income**	**75**	

Flow Diagram 1 (Example 8.13)

Neutralising hybrid deduction under the structured and direct imported mismatch rule

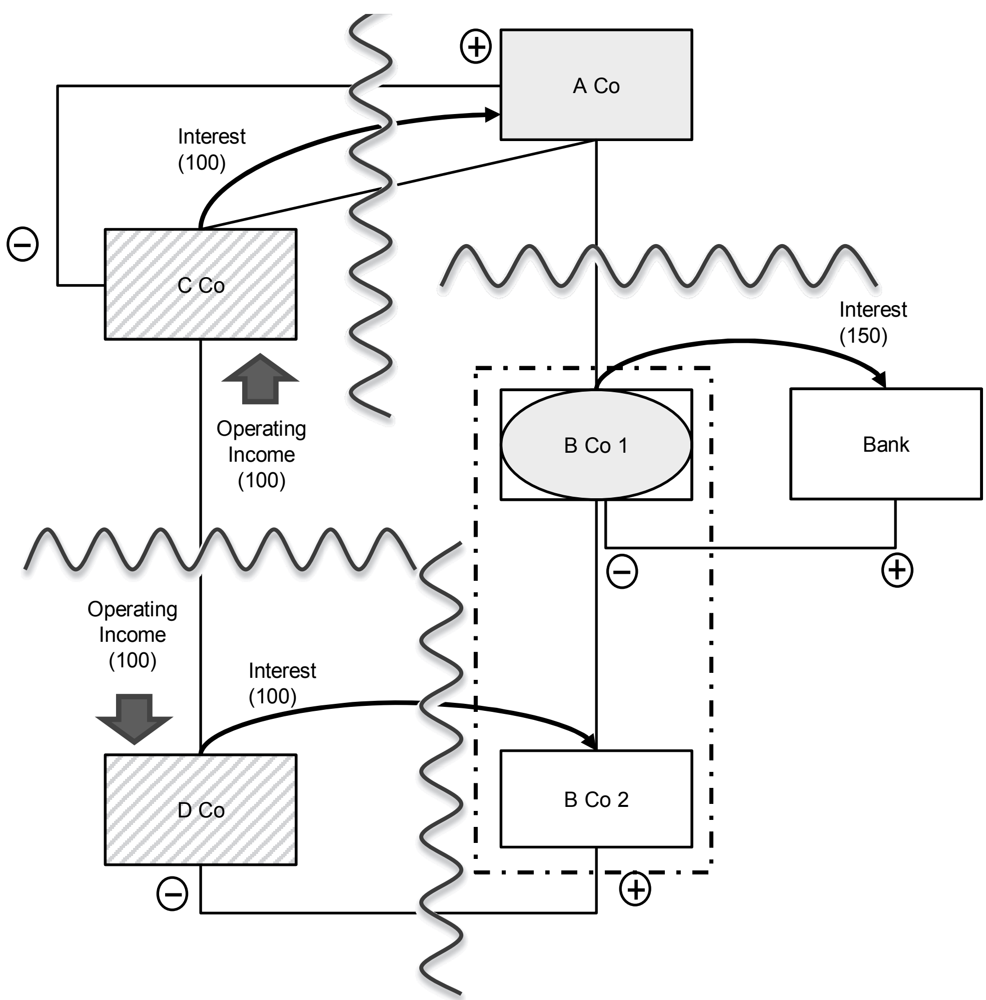


Example 8.14

Deductible hybrid payments, tax grouping and imported hybrid mismatch rules

Facts

1. The facts illustrated in the figure below are the same as **Example 8.13** except that B Co 2 is not a reverse hybrid but a member of the same tax group for the purposes of Country B tax law. Members of a tax group calculate their income (or loss) on a separate entity basis but are able to surrender any net loss to another group member and set it off against that group member's income arising in the same accounting period. The group structure and financing arrangements are illustrated in the figure below.



2. The net income accounts of the entities in the ABCD group are the same as in **Example 8.13** and are set out in the table below. Unlike in the example above, B Co 1 and B Co 2 accounts are not combined.

Country A – A Co	**Tax**	**Book**
Income		
Interest paid by C Co	100	100
Expenditure		
Interest paid by B Co 1	(150)	-
Net return		**100**
Taxable income (loss)	**(50)**	

Country B – B Co 1	**Tax**	**Book**
Expenditure		
Interest paid by B Co 1	(150)	(150)-
Net return		**(150)**
Taxable income (loss)	(150)	
Loss surrender to B Co 2	100	
Loss carry forward	**(50)**	

Country B – B Co 2	**Tax**	**Book**
Income		
Interest paid by D Co	100	100
Expenditure		
Loss surrender	(100)	
Net return		**100**
Taxable income	**0**	

Country C Law – C Co	**Tax**	**Book**
Income		
Operating income	100	100
Expenditure		
Interest paid to A Co	(100)	(100)
Net return		**0**
Taxable income	**0**	

Country D Law – D Co	**Tax**	**Book**
Income		
Operating income	100	100
Expenditure		
Interest paid to B Co 2	(100)	(100)
Net return		**0**
Taxable income	**0**	

Question

3. Whether the interest payments made by C Co and D Co are subject to adjustment under the imported mismatch rule, and, if so, the amount of the adjustment required under the rule.

Answer

4. Country C should apply the direct imported mismatch rule to deny a deduction for all of the interest payments made by C Co. Country D should apply the indirect imported mismatch rule to deny a deduction for half the interest payment made by D Co. See the flow diagram at the end of this example which outlines the steps to be taken in applying the imported mismatch rule.

Analysis

5. B Co 1's loan from the Bank is independent of the other group financing arrangements. Unless such loan was entered into as part of wider scheme, plan or understanding that was intended to import the effect of a mismatch in tax outcomes into Country C or D, then the interest payment made by B Co 1 to the Bank should not be treated as made under a structured imported mismatch arrangement.

Payments of interest by C Co and D Co are offset against the same hybrid deduction.

6. B Co 1 makes a deductible hybrid payment of 150 that gives rise to a DD outcome. The resulting hybrid deduction is set-off against income on interest paid by C Co to A Co and on the interest paid by D Co to B Co 2 (after having been surrendered under the tax grouping regime in Country B). Because, however, this is a double deduction structure, the payments made by C Co and D Co are effectively set-off against the same hybrid deduction. Accordingly, the tax consequences attaching to the imported mismatch payment in Country C should be taken into account when applying the indirect imported mismatch rule in Country D.

The interest payment made by C Co should be subject to adjustment under the direct imported mismatch rule

Step 1 – B Co 1's deductible hybrid payment gives rise to a direct hybrid deduction under both Country A law and Country B law

7. The interest payment B Co 1 makes to the Bank is a deductible hybrid payment. Any deduction claimed for that payment will be a direct hybrid deduction to the extent it exceeds the payer's dual inclusion income. In this case the deductible payment is not reduced by any dual inclusion income so that B Co 1's interest payment gives rise to a direct hybrid deduction of 150 under both Country A and Country B law.

Step 2 – the structured imported mismatch rule does not apply

8. The facts of this example assume that the deductible hybrid payment is not made under a structured imported mismatch arrangement. Therefore the structured imported mismatch rule does not apply.

Step 3 – B Co 1's hybrid deductions should be treated as set-off against the imported mismatch payment made by C Co

9. This hybrid deduction is automatically set-off against income on the interest C Co pays to A Co (see the analysis in Example 8.13). In this case the amount of A Co's hybrid deduction (150) is greater than the imported mismatch payment made by C Co (100). Therefore, the whole of the deduction claimed by C Co should be denied under the direct imported mismatch rule leaving a surplus hybrid deduction of 50.

The interest payment made by D Co should be subject to adjustment under the indirect imported mismatch rule

Step 1 –B Co 1 has surplus hybrid deductions of 50

10. In this case B Co 1's surplus hybrid deduction will be the amount of hybrid deduction that is attributable to the deductible hybrid payment (150) minus any amount of hybrid deduction that has been neutralised under either the structured or direct imported mismatch rules (100).

Step 2 –B Co 1's surplus hybrid deduction are set-off against funded taxable payments

11. B Co 1 has surrendered a loss of 100 to B Co 2. This loss surrender is treated in the same way as a funded taxable payment because B Co 2 is a direct recipient of an imported mismatch payment. In this case B Co 1 does not receive any other taxable payments so the remaining surplus hybrid deduction should therefore be treated as fully surrendered to B Co 2.

Step 3 – B Co 1 has no remaining surplus hybrid deduction

12. As B Co 1's surplus hybrid deduction is set-off against an imported mismatch payment, B Co 1 has no remaining surplus hybrid deductions

Step 4 – B Co 2's indirect hybrid deduction is neutralised in accordance with the direct imported mismatch rule

13. B Co 2 should treat the resulting indirect hybrid deduction as being set-off against imported mismatch payments made by D Co. The calculation is the same as under the direct imported mismatch rule and the proportion of the deduction for the interest payment that should be denied is calculated as follows:

$$\frac{\text{B Co 2's hybrid deduction}}{\text{Imported mismatch payments received by B Co 2}} = \frac{50}{100} = \frac{1}{2}$$

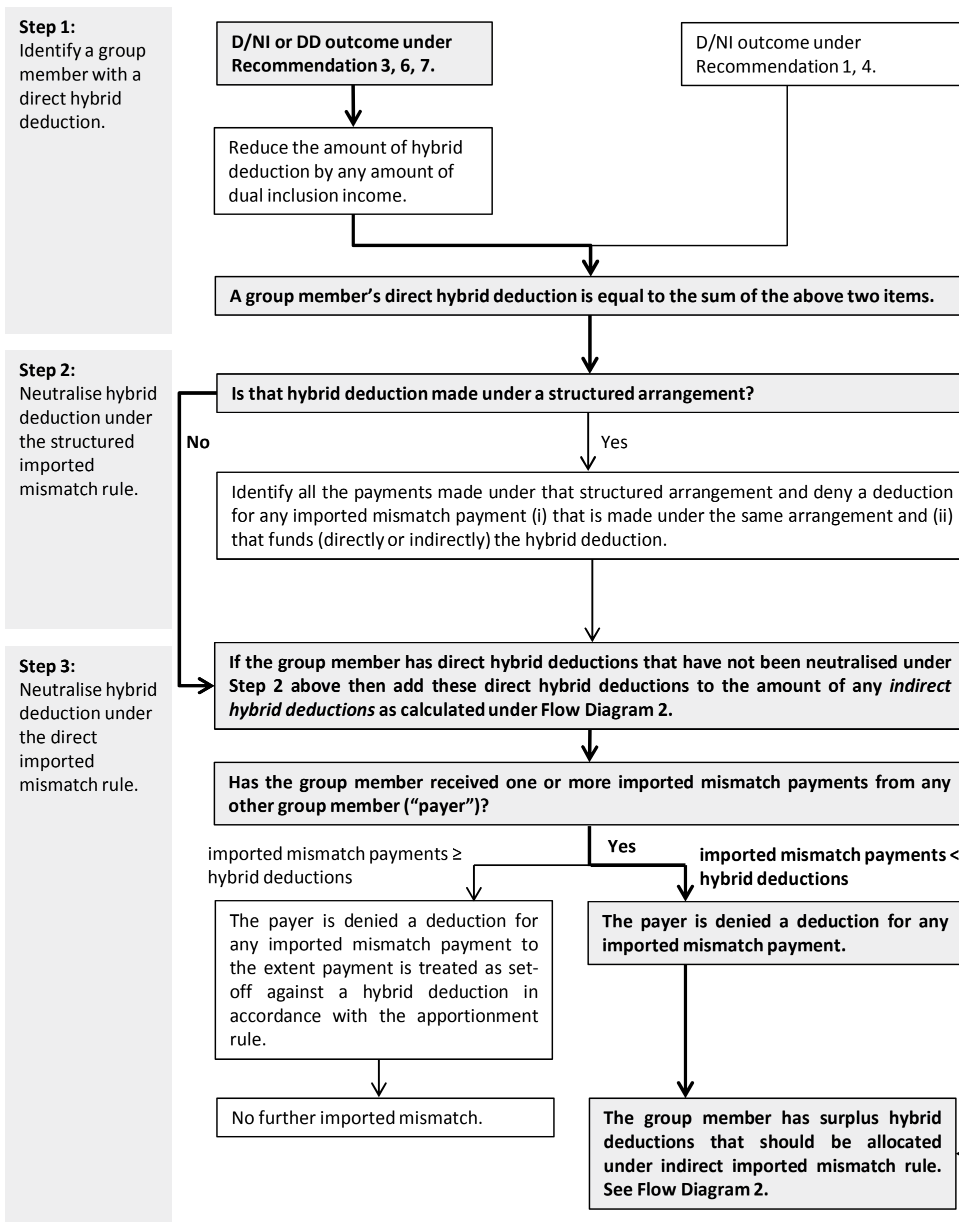
Therefore half the interest payment made by D Co should be subject to adjustment under the imported mismatch rule. The tables below illustrate the net income accounts of the group entities after application of the imported mismatch rules.

Country A A Co	Tax	Book	Country B B Co 1	Tax	Book
Income					
Interest paid by C Co	100	100			
Expenditure			Expenditure		
Interest paid by B Co 1	(150)	-	Interest paid by B Co 1	(150)	(150)
Net return		**100**	**Net return**		**(150)**
Taxable income (loss)	**(50)**		Taxable income (loss)	(150)	
			Loss surrender to B Co 2	100	
			Loss carry forward	**(50)**	
			B Co 2		
			Income		
			Interest paid by D Co	100	100
			Expenditure		
			Loss surrender	(100)	
			Net return		**100**
			Taxable income	**0**	

Country C Law C Co	Tax	Book	Country D Law D Co	Tax	Book
Income			Income		
Operating income	100	100	Operating income	100	100
Expenditure			Expenditure		
Interest paid to A Co	0	(100)	Interest paid to B Co 2	(50)	(100)
Net return		**0**	**Net return**		**0**
Taxable income	**100**		**Taxable income**	**50**	

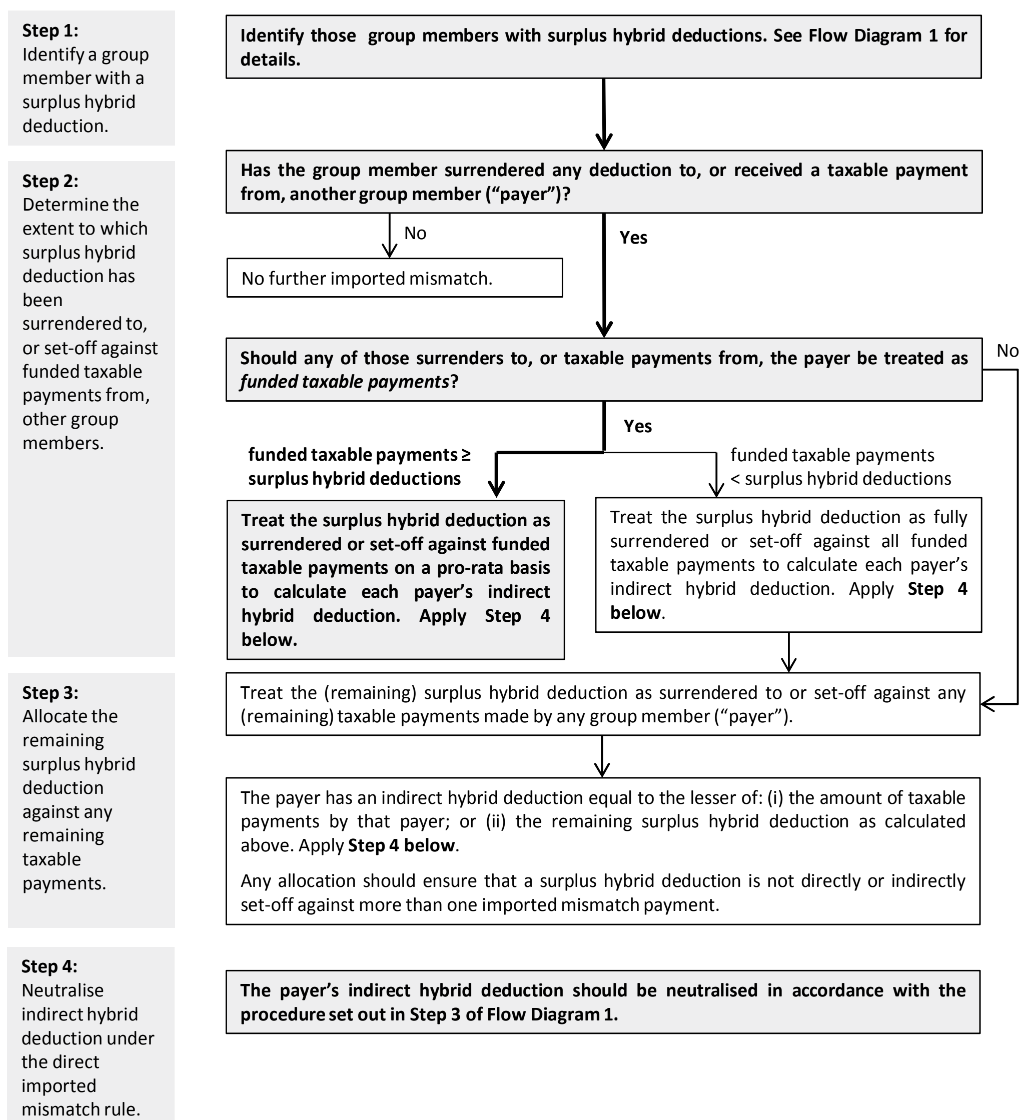
Flow Diagram 1 (Example 8.14)

Neutralising hybrid deduction under the structured and direct imported mismatch rule



Flow Diagram 2 (Example 8.14)

Allocating surplus hybrid deduction under the indirect imported mismatch rule

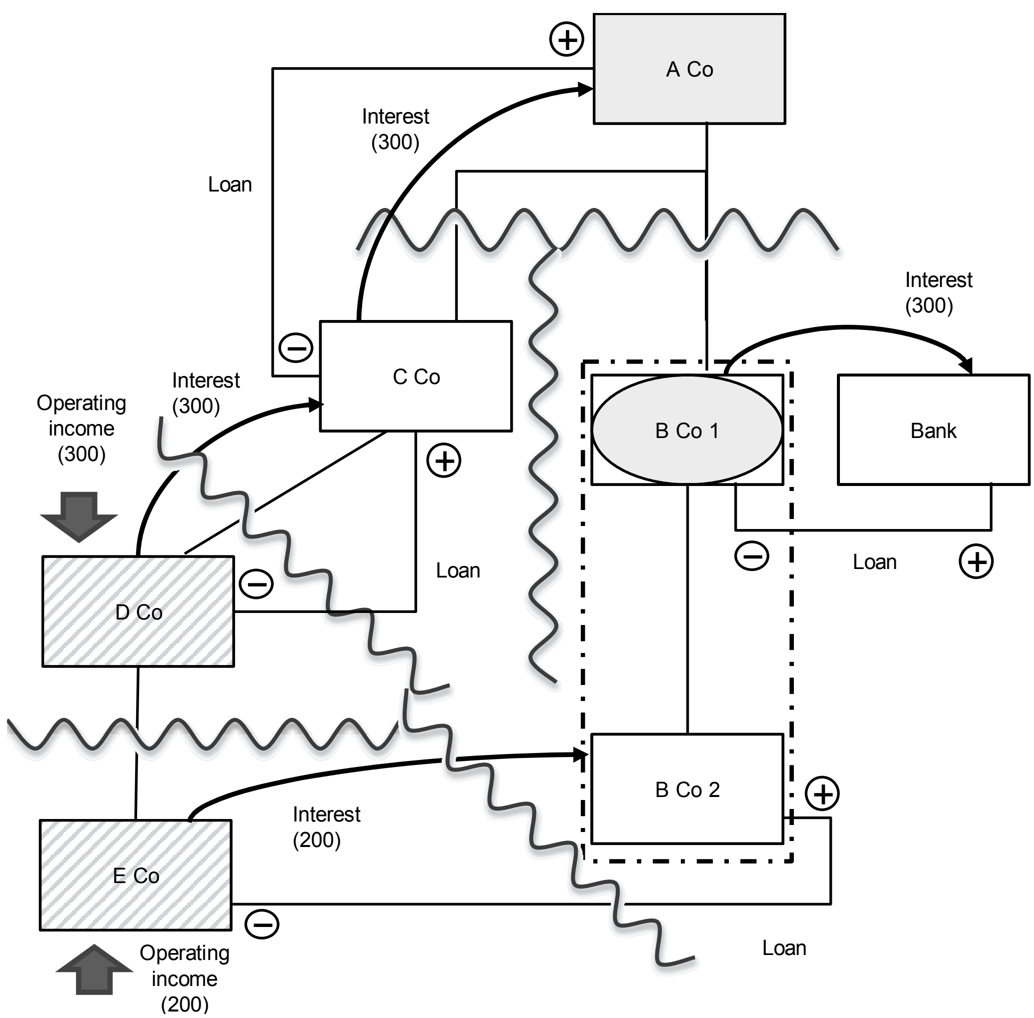


Example 8.15

Interaction between double deduction and imported mismatch rule

Facts

1. The figure below sets out the intra-group financing arrangements for companies that are members of the ABCDE Group. A Co is the parent of the group and is resident in Country A. B Co 1 and C Co are direct subsidiaries of A Co and are resident in Country B and Country C respectively. D Co (a company resident in Country D) is a direct subsidiary of C Co and E Co (a company resident in Country E) is a direct subsidiary of E Co. B Co 2 is a wholly-owned subsidiary of B Co 1 and is also resident in Country B.



2. All companies are treated as separate tax entities in all jurisdictions, except that B Co 1 is a hybrid entity (i.e. an entity that is treated as a separate entity for tax purposes in Country B but as a disregarded entity under Country A law).

3. A Co has lent money to C Co, and C Co has on-lent that money to D Co. B Co 1 borrowed money from a local bank. B Co 2 lent money to E Co. Each of D Co and E Co receives operating income. Each of these financing arrangements are entered into independently and do not form part of single scheme, plan or understanding. The figure above illustrates the operating income and the total gross interest payments for each group entity.

4. Because B Co 1 is a hybrid entity, the interest payments made to the local bank are deductible by both A Co and B Co 1 under the laws of Country A and Country B respectively. B Co 1 and B Co 2 are members of the same tax group for tax purposes under Country B law, which means that the net loss of B Co 1 can be surrendered to set-off against any net income of B Co 2.

Tax position before applying the imported mismatch rule

5. Below is a table setting out the tax position in respect of the ABCDE group (before the application of any imported mismatch rule).

Country A A Co			**Country B B Co 1**		
	Tax	**Book**		**Tax**	**Book**
Income					
Interest paid by C Co	300	300			
Expenditure			Expenditure		
Interest paid by B Co 1	(300)	-	Interest paid by B Co 1	(300)	(300)
Net return		**300**	**Net return**		**(300)**
Taxable income	**0**		Taxable income (loss)	(300)	
			Loss surrender to B Co 2	200	
			Loss carry forward	**(100)**	
			B Co 2		
			Income		
			Interest paid by D Co	200	200
			Expenditure		
			Loss surrender	(200)	
			Net return		**200**
			Taxable income	**0**	

Country C Law C Co			Country D Law D Co		
	Tax	Book		Tax	Book
Income			Income		
Interest paid by D Co	300	300	Operating income	300	300
Expenditure			Expenditure		
Interest paid to A Co	(300)	(300)	Interest paid to B Co 2	(300)	(300)
Net return		**0**	**Net return**		**0**
Taxable income	**0**		**Taxable income**	**0**	

Country E Law E Co		
	Tax	Cash
Income		
Operating income	200	200
Expenditure		
Interest paid to B Co 1	(200)	(200)
Net return		**0**
Taxable income	**0**	

Result under Country A law

6. A Co has net taxable income of zero (interest income of 300 and a deduction of 300).

Result under Country B law

7. B Co 1 has a net loss for tax purposes of 300 (a deduction of 300), while B Co 2 has net income of 200. B Co 1's net loss is surrendered through the tax grouping regime and applied against, and to the extent of, B Co 2's net income.

Result under Country C, D and E law

8. C Co, D Co and E Co have income that is equal to their expenses and therefore have no net income in either of the two years.

Mismatch in tax outcomes

9. In aggregate the arrangement generates a net return for the ABCDE Group of 200, however the total net taxable income recognised under this structure is nil. Country D and Country E have implemented the recommendations set out in this report.

Question

10. Whether the interest payments made by D Co and E Co are subject to adjustment under the imported mismatch rule and, if so, the amount of the adjustment required under the rule.

Answer

11. Indirect imported mismatch rule applies to the interest payment of 200 from E Co to B Co 2, and the interest payment of 300 from D Co to C Co. As a result of apportionment of surplus hybrid deduction of 300 between those payments, Country D should deny D Co a deduction for 180 of the interest paid to C Co, and Country E should deny E Co a deduction for 120 of the interest paid to B Co 2. See the flow diagrams at the end of this example which outline the steps to be taken in applying the imported mismatch rule.

Analysis

Interest payments made by B Co 1 are not made under a structured arrangement

12. B Co 1's loan from the Bank is independent of the intra-group financing arrangements. Unless such loan was entered into as part of wider scheme, plan or understanding that was intended to import the effect of a mismatch in tax outcomes into Country C or D, then the interest payment made by B Co 1 to the Bank should not be treated as made under a structured imported mismatch arrangement.

The hybrid deduction is not set-off against an imported mismatch payment under the structured or direct imported mismatch rule

Step 1 – B Co 1's deductible hybrid payment gives rise to a direct hybrid deduction under both Country A law and Country B law

13. The interest payment B Co 1 makes to the Bank is a deductible hybrid payment. Any deduction claimed for that payment will be a direct hybrid deduction to the extent it exceeds the payer's dual inclusion income. In this case the deductible payment is not reduced by any dual inclusion income so that B Co 1's interest payment gives rise to a direct hybrid deduction of 300 under both Country A and Country B laws.

Step 2 – the structured imported mismatch rule does not apply

14. The facts of this example assume that the deductible hybrid payment is not made under a structured imported mismatch arrangement. Therefore the structured imported mismatch rule does not apply.

Step 3 – the direct imported mismatch rules does not apply

15. In this case the direct imported mismatch rule does not apply as the group entities that are recipients of the loss surrender or that are directly funding the hybrid deduction (i.e. B Co 2 and C Co) are resident in jurisdictions that have not implemented the imported mismatch rules.

The interest payments made by D Co and E Co should be subject to adjustment under the indirect imported mismatch rule

16. As B Co 1's hybrid deduction has not been neutralised under the structured or direct imported mismatch rule, the indirect imported mismatch rule applies to determine the extent to which B Co 1's surplus hybrid deduction should be treated as giving rise to an indirect hybrid deduction for another group member.

Step 1 –B Co 1 and A Co have surplus hybrid deductions of 300

17. A group member's surplus hybrid deduction will be the amount of hybrid deduction that is attributable to deductible hybrid payment (300) minus any amount of hybrid deduction that has been neutralised under either the structured or direct imported mismatch rules (0).

Step 2 –Surplus hybrid deduction is set-off against funded taxable payments

18. Both B Co 1 and A Co must first treat the surplus hybrid deduction as being surrendered or offset against funded taxable payments received from group entities calculated as follows:

(a) A taxable payment will be treated as a funded taxable payment to the extent the payment is directly funded out of imported mismatch payments made by other group entities. In this case the interest payments of 300 that A Co receives from C Co constitute funded taxable payments.

(b) B Co 1 has surrendered a loss of 200 to B Co 2. This loss surrender is treated in the same way as a funded taxable payment because B Co 2 is a direct recipient of an imported mismatch payment.

Accordingly the total amount of funded taxable payments is equal to 500.

19. In this case the amount of funded taxable payments (500) exceeds the amount of the surplus hybrid deduction (300). Both A Co and B Co 1 should therefore treat the surplus hybrid deduction as set-off pro rata against the funded taxable payments and the loss surrendered to B Co 2 under the tax grouping regime. Therefore:

(a) B Co 2 has indirect hybrid deduction of 120 (i.e. 300/500 x 200).

(b) C Co has indirect hybrid deduction of 180 (i.e. 300/500 x 300).

Step 3 – C Co has no remaining surplus hybrid deduction

20. C Co's surplus hybrid deduction has been surrendered or fully set-off against funded taxable payments and C Co therefore has no remaining surplus hybrid deduction to be set-off against other taxable payments.

Step 4 – B Co 2 and C Co's indirect hybrid deductions are neutralised in accordance with the direct imported mismatch rule

21. B Co 2 should treat the resulting indirect hybrid deduction as being set-off against imported mismatch payments made by D Co. The calculation is the same as under the direct imported mismatch rule and the proportion of the deduction for the interest payment that should be denied is calculated as follows:

$$\frac{\text{B Co 2's hybrid deduction}}{\text{Imported mismatch payments received by B Co 2}} = \frac{120}{200} = \frac{3}{5}$$

Therefore D Co should be denied a deduction for (3/5 x 200) = 120 under the imported mismatch rule.

22. The calculation with respect to E Co is the same. C Co treats indirect hybrid deduction as being set-off against imported mismatch payments made by E Co. Calculation is the same as under the direct imported mismatch rule and the proportion of deduction that G Co should be denied on its IM payments is calculated as follows:

$$\frac{\text{C Co's hybrid deduction}}{\text{Imported mismatch payments received by C Co}} = \frac{180}{300} = \frac{3}{5}$$

Therefore D Co should be denied a deduction for (3/5 x 300) = 180 under the imported mismatch rule.

23. The table below sets out tax position in respect of the ABCDE group (after the application of any imported mismatch rule).

Country A **A Co**			**Country B** **B Co 1**		
	Tax	**Book**		**Tax**	**Book**
Income					
Interest paid by C Co	300	300			
Expenditure			Expenditure		
Interest paid by B Co 1	(300)	-	Interest paid by B Co 1	(300)	(300)-
Net return		**300**	**Net return**		**(300)**
Taxable income	**0**		Taxable income (loss)	(300)	
			Loss surrender to B Co 2	200	
			Loss carry forward	**(100)**	
			B Co 2		
			Income		
			Interest paid by D Co	200	200
			Expenditure		
			Loss surrender	(200)	
			Net return		**100**
			Taxable income	**0**	

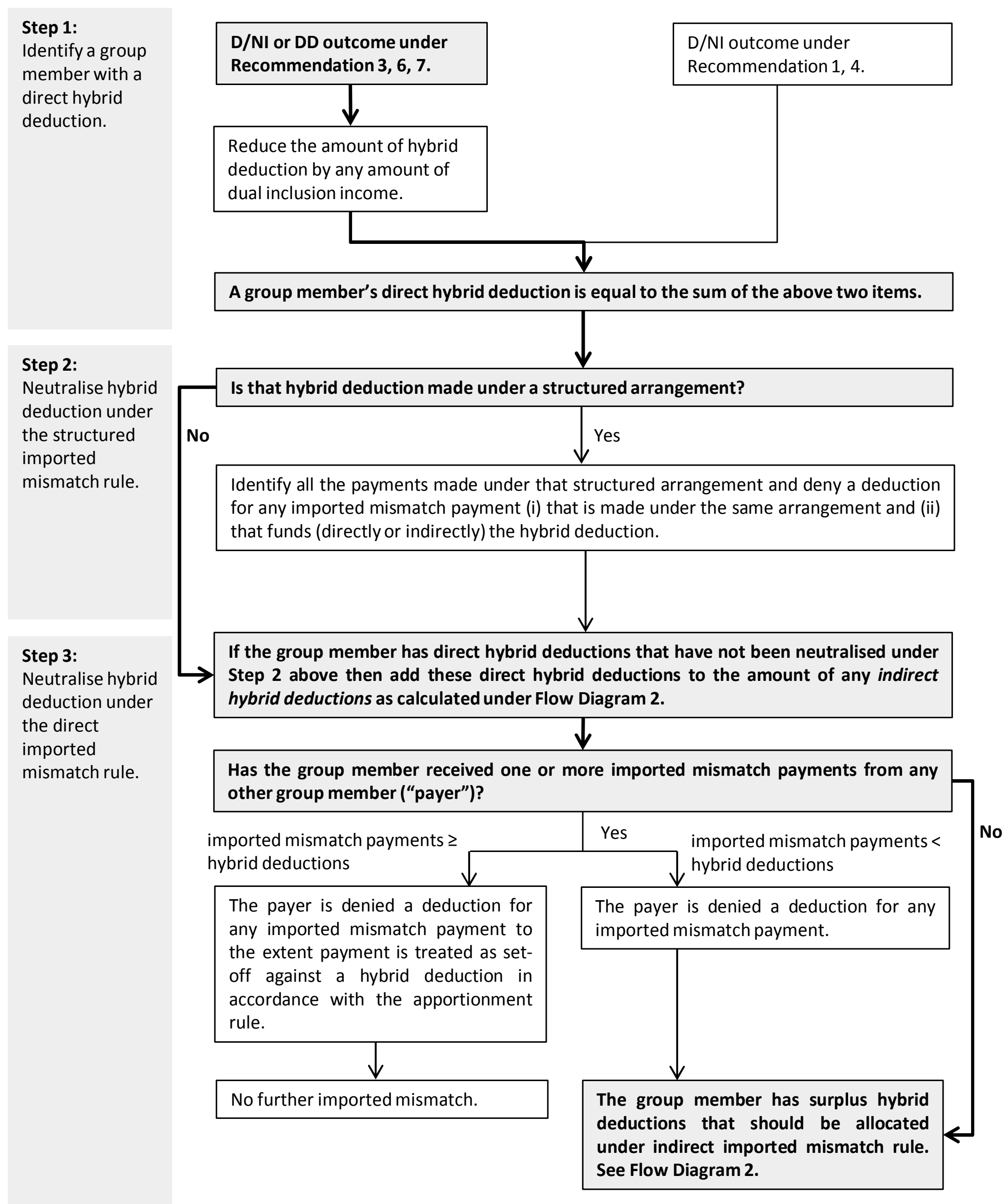
Country C Law C Co		
	Tax	Book
Income		
Interest paid by D Co	300	300
Expenditure		
Interest paid to A Co	(300)	(300)
Net return		**0**
Taxable income	**0**	

Country D Law D Co		
	Tax	Book
Income		
Operating income	300	300
Expenditure		
Interest paid to B Co 2	(120)	(300)
Net return		**300**
Taxable income	**180**	

Country E Law E Co		
	Tax	Cash
Income		
Operating income	200	200
Expenditure		
Interest paid to B Co 1	(80)	(200)
Net return		**0**
Taxable income	**120**	

Flow Diagram 1 (Example 8.15)

Neutralising hybrid deduction under the structured and direct imported mismatch rule



Flow Diagram 2 (Example 8.15)

Allocating surplus hybrid deduction under the indirect imported mismatch rule

Step 1:
Identify a group member with a surplus hybrid deduction.

Identify those group members with surplus hybrid deductions. See Flow Diagram 1 for details.

Step 2:
Determine the extent to which surplus hybrid deduction has been surrendered to, or set-off against funded taxable payments from, other group members.

Has the group member surrendered any deduction to, or received a taxable payment from, another group member ("payer")?

No

No further imported mismatch.

Yes

Should any of those surrenders to, or taxable payments from, the payer be treated as *funded taxable payments*?

No

Yes

funded taxable payments ≥ surplus hybrid deductions

Treat the surplus hybrid deduction as surrendered or set-off against funded taxable payments on a pro-rata basis to calculate each payer's indirect hybrid deduction. Apply Step 4 below.

funded taxable payments < surplus hybrid deductions

Treat the surplus hybrid deduction as fully surrendered or set-off against all funded taxable payments to calculate each payer's indirect hybrid deduction. Apply **Step 4 below**.

Step 3:
Allocate the remaining surplus hybrid deduction against any remaining taxable payments.

Treat the (remaining) surplus hybrid deduction as surrendered to or set-off against any (remaining) taxable payments made by any group member ("payer").

The payer has an indirect hybrid deduction equal to the lesser of: (i) the amount of taxable payments by that payer; or (ii) the remaining surplus hybrid deduction as calculated above. Apply **Step 4 below**.

Any allocation should ensure that a surplus hybrid deduction is not directly or indirectly set-off against more than one imported mismatch payment.

Step 4:
Neutralise indirect hybrid deduction under the direct imported mismatch rule.

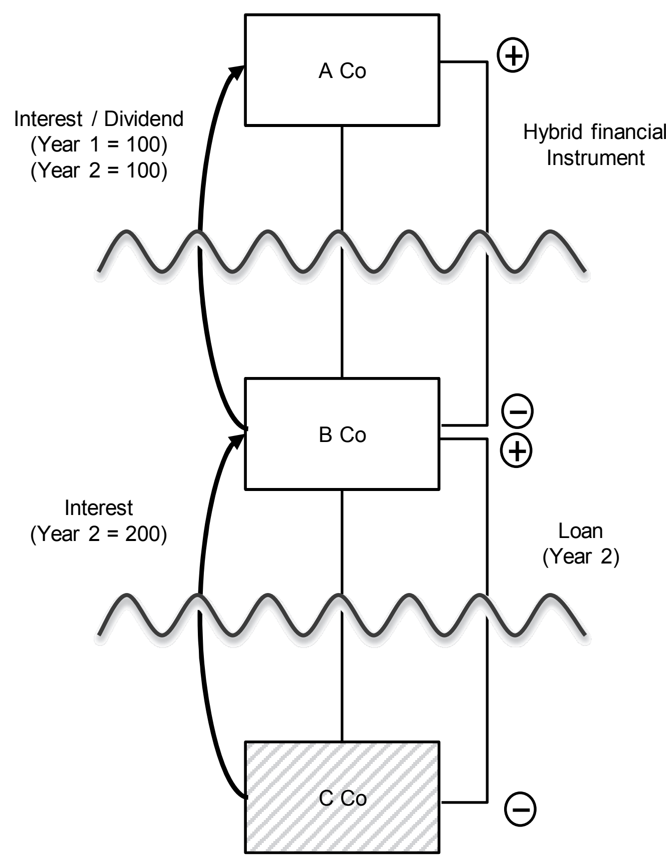
The payer's indirect hybrid deduction should be neutralised in accordance with the procedure set out in Step 3 of Flow Diagram 1.

Example 8.16

Carry-forward of hybrid deductions under imported mismatch rules

Facts

1. In the example illustrated in the figure below, A Co wholly owns B Co, which, in turn, wholly owns C Co. A Co, B Co and C Co are resident in Country A, Country B and Country C respectively.



2. In Year 1, A Co lends money to B Co under a hybrid financial instrument. Interest payments under the hybrid financial instrument are treated as deductible interest expenses under Country B law but treated as exempt dividends under Country A law. The payments are equal to 100 each year. At the end of the first year B Co has a net-loss carry-forward of 100.

3. In Year 2, B Co lends money to C Co under an ordinary loan. The interest payable under the loan in Year 2 is 200.

4. Only Country C has implemented the recommendations set out in the report.

Question

5. Whether the interest payments made by C Co are subject to adjustment under the imported mismatch rule and, if so, the amount of the adjustment required under the rule.

Answer

6. B Co carries over a hybrid deduction of 100 from Year 1. The direct imported mismatch rule applies to the interest payment of 200 from C Co to B Co and Country C should deny C Co a deduction for all the interest paid to B Co.

Analysis

Application of direct imported mismatch rule to interest payments from C Co to B Co

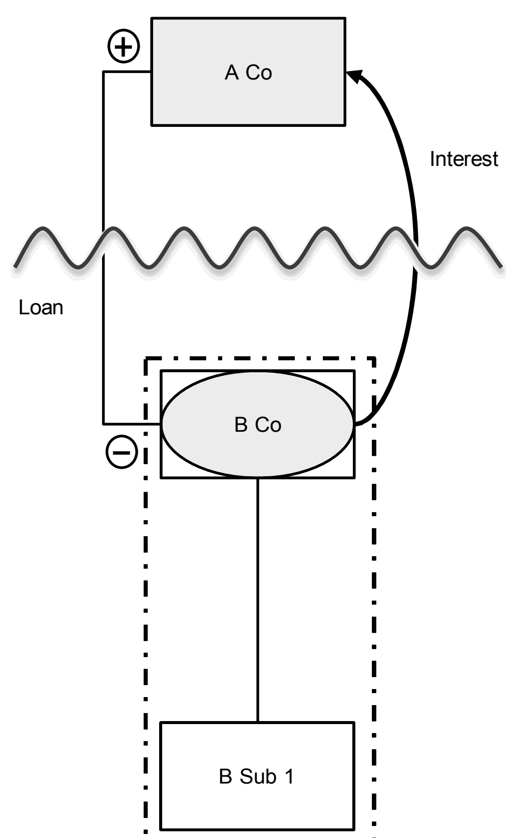
7. As explained in the facts above, the interest payments by B Co to A Co in Year 1 give rise to a D/NI outcome under a hybrid financial instrument. B Co's hybrid deduction is carried-forward to Year 2 and set-off against interest income paid by C Co in the following year. The direct imported mismatch rule applies to the full interest payment from C Co to B Co since this payment (of 200) is directly set-off against a deduction for the interest paid under the hybrid financial instrument in both Year 1 (100) and Year 2 (100).

Example 9.1

Co-ordination of primary/secondary rules

Facts

1. In the example illustrated in the figure below, A Co holds all the shares of a foreign subsidiary (B Co). B Co is a hybrid entity that is disregarded for Country A tax purposes. B Co borrows from A Co and pays interest on the 5 year loan. Interest is payable in arrears every 12 months on 1 October each year.



2. B Co is treated as transparent under the laws of Country A and (because A Co is the only shareholder in B Co) Country A simply disregards the separate existence of B Co. Disregarding B Co means that the loan (and by extension the interest on the loan) between A Co and B Co is ignored under the laws of Country A. Under the laws of Country B, B Co and B Sub 1 form part of the same tax group which allows B Co to

surrender the tax benefit of the interest deduction to B Sub 1 where it can be set-off against non-dual inclusion income.

3. In Year 2 of the arrangement, Country A implements the hybrid mismatch rules so that the interest payment is included in the income of A Co through the operation of the disregarded hybrid payments rule set out in Recommendation 3. This income in Country A is recognised on an accrual basis. In Year 3 of the arrangement, Country B also implements the hybrid mismatch rules to take effect from the beginning of Country B's tax year commencing in Year 4. The tax year for Country A is the calendar year (1 January to 31 December) while B Co's tax year runs from on 1 July to 30 June of the following year.

Question

4. What proportion of the payment is required to be brought into account under the hybrid mismatch rule by A Co and B Co in Years 3 to 5 of the arrangement?

Answer

5. A jurisdiction applying the secondary or defensive rule in a period when the counterparty jurisdiction introduces hybrid mismatch rules (the switch-over period), should cease to apply the defensive rule to the extent the mismatch is neutralised by the introduction of the primary rule in the counterparty jurisdiction. This should not affect the adjustments made under the secondary rule in periods prior to the switch-over period. Accordingly:

(a) Country A should:

- require A Co to include a payment in ordinary income to the extent it gives rise mismatch in an accounting period that begins on or after the introduction of the hybrid mismatch rules in Country A; and
- grant A Co relief for any payment made during the switch-over period to the extent the mismatch is neutralised due to the operation of the primary rule in Country B.

(b) Country B should apply the primary rule to the amount that is treated as paid, under its laws, after the commencement of hybrid mismatch rules in Country B while taking into account any payment that has previously been included in income under the laws of Country A in a prior accounting period.

Analysis

Defensive rule applies only where the mismatch is not neutralised in payer jurisdiction

6. Recommendation 3.1(b) provides that a disregarded payment made by a hybrid payer must be included in ordinary income to the extent it gives rise to a D/NI outcome. This rule only applies, however, to the extent the mismatch in tax outcomes has not been neutralised in the payer jurisdiction. Accordingly, if and when Country B introduces hybrid mismatch rules to deny a deduction for the disregarded hybrid payment, Country A should cease to apply the defensive rule.

Co-ordination of the primary and secondary rules

7. Complications in the application of the rule and a risk of double taxation could arise, however, in situations where the counterparty jurisdiction introduces hybrid mismatch rules from a date that is part way through the taxpayer's accounting period (the switch-over period). In order to ensure the primary and secondary rules are properly co-ordinated without causing undue disruption to the domestic rules of the counterparty, the payer and payee jurisdictions should apply the co-ordination rules as follows:

(a) The secondary or defensive rule will apply to any amount that is treated as paid, under the laws of the payee jurisdiction (Country A), in a period prior to the commencement of the switch-over period.

(b) The primary rule will apply to any amount that is treated as paid, under the laws of the payer jurisdiction (Country B), during the switch-over period (after taking into account any amounts caught by the secondary rule in accordance with paragraph (a) above).

(c) Any other payments that give rise to a hybrid mismatch and that are not captured by paragraph (b) above will be caught by the application of the secondary rule.

8. A table setting out the effect of these adjustments in Years 3 to 5 is set out below. The table shows the payments of accrued interest income or expense under the loan in each calendar year and the income tax consequences applying to payments made under the loan. In this table it is assumed that the interest payment is 100 each year. and that B Co and A Co have no other income or expenditure other than the disregarded hybrid payment. Both countries tax income and expenditure under a debt instrument on an accrual basis.

	Country A A Co			Country B B Co 1			Total
		Tax	**Book**		**Tax**	**Book**	
Year 2	Income			Income			
	Interest paid by B Co 1	100	100				
				Expenditure			
				Interest paid to A Co	(100)	(100)	
	Net return		**100**	**Net return**		**(100)**	**0**
	Taxable income	**100**		**Taxable income**	**(100)**		**0**

Year 3	Country A A Co	Tax	Book	Country B B Co 1	Tax	Book	Total
	Income			Income			
	Interest paid by B Co 1	50	100				
				Expenditure			
				Interest paid to A Co	(50)	(100)	
	Net return		**100**	**Net return**		**(100)**	**0**
	Taxable income	**50**		**Taxable income (loss)**	**(50)**		**0**

Year 4	Country A A Co	Tax	Book	Country B B Co	Tax	Book	Total
	Income			Income			
	Interest paid by B Co 1		75				
				Expenditure			
				Interest paid to A Co		(75)	
	Net return		**75**	**Net return**		**(75)**	**0**
	Taxable income	**0**		**Taxable income**	**0**		**0**

9. In Year 3, 100 of interest accrues on the loan. The primary rule has not yet been introduced into Country B law so the entire amount of accrued interest is included in income under Country A law (see para 7(a) above).

10. In Year 4, the primary rule is introduced in Country B and takes effect from the beginning of Country B's tax year (which commences on 1 July).

(a) In this case, Country B will apply the primary response under its own law with no adjustment (see para 7(b) above). Because Country B recognises expenditure under a financial instrument on an accrual basis for tax purposes:

- the interest that accrues after the commencement of the rules will be subject to the adjustment under the primary rule; and
- the portion of the interest payment that has accrued prior to the commencement of the hybrid mismatch rules (50) will be outside the application of the primary rule as it will be treated as derived in a prior tax year.

(b) Country A should apply the secondary rule to the extent the mismatch has not been eliminated by the primary rule in Country B (see para 7(c) above). This means that Country A should continue to apply the secondary rule for the switch-over period to the extent the deduction for the payment has not been denied under Country B law.

If, in practice, it would be unduly burdensome to require A Co to determine the actual amount of the payment that has been subject to adjustment under the primary rule, the amount of the payment falling within the scope of the secondary rule can be calculated based on the amount accrued under Country A law for the switch-over period where the primary rule will not apply (in this case 1 January to 30 June). This will result in only half the accrued interest payment being recognised as income in Country A under the hybrid mismatch rule.

11. In Year 5, the loan matures and the final payment of accrued interest on the loan is paid. The secondary rule does not apply in Country A as all the payments made under the instrument are caught by the primary rule in Country B.

Differences in the timing in the recognition of payments

12. The above table was calculated on the assumption that both Country A and B apply the same rules regarding the recognition of income and expenditure under a financial instrument. However differences between jurisdiction in the timing of the recognition of income and expenditure will impact on the amounts caught by the primary and secondary rules. The effect of these differences can be illustrated by changing the facts of this example so that, rather than granting deductions on an accrual basis, Country B only grants deductions for interest when such amounts are actually paid. A table setting out the effect of these adjustments in Years 3 to 5 based on this modified assumption is set out below.

	Country A A Co			Country B B Co 1			Total
Year 2		**Tax**	**Book**		**Tax**	**Book**	
	Income			Income			
	Interest paid by B Co 1	100	100				
				Expenditure			
				Interest paid to A Co	(100)	(100)	
	Net return		**100**	**Net return**		**(100)**	**0**
	Taxable income	**100**		**Taxable income**	**(100)**		**0**

Year 3	Country A A Co	Tax	Book	Country B B Co 1	Tax	Book	Total
	Income			Income			
	Interest paid by B Co 1	0	100				
				Expenditure			
				Interest paid to A Co	(25)	(100)	
	Net return		**100**	**Net return**		**(100)**	**0**
	Taxable income	**0**		**Taxable income (loss)**	**(25)**		**(25)**

Year 4	Country A A Co	Tax	Book	Country B B Co	Tax	Book	Total
	Income			Income			
	Interest paid by B Co 1		75				
				Expenditure			
				Interest paid to A Co	25	(75)	
	Net return		**75**	**Net return**		**(75)**	**0**
	Taxable income	**0**		**Taxable income**	**25**		**25**

13. As above, the table shows the payments of accrued interest under the loan in each calendar year and the income tax consequences applying to those payments for the same period. It is assumed that the interest payment is 100 each year (paid on 1 October of each year) and that B Co and A Co have no other income or expenditure other than the disregarded hybrid payment.

14. In Year 3 the primary rule has not yet been introduced into Country B law so that the entire amount of the payment is included in income under Country A law (see para 7(a) above).

15. In Year 4 the primary rule is introduced in Country B and takes effect from the beginning of Country B's tax year (which commences on 1 July).

(a) In this case, the amount of the deduction denied under the primary rule should not include a payment to the extent it has been already subject to adjustment under the secondary rule in a prior period. Because Country A recognises income under a financial instrument on an accrual basis, 25% of the interest payment has already been included in income in Year 3 (see para 7(b) above).

(b) Country A does not apply the secondary rule for the switch-over period as the entire amount of the payment for that period is caught by the primary rule under Country B law (see para 7(c) above).

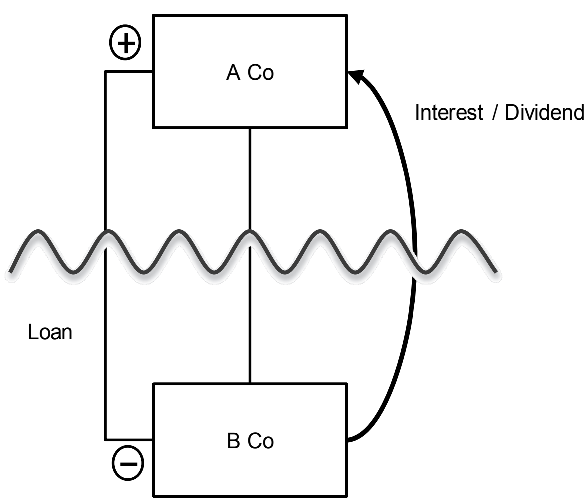
16. In Year 5 the loan matures and the final payment of accrued interest on the loan is paid. The secondary rule does not apply in Country A as all the payments made under the instrument are caught by the primary rule in Country B. The primary rule in country B denies a deduction for the full amount of the interest payment (100) effectively triggering an additional 25 of taxable income in the hands of B Co and reversing out the timing advantage that arose in the previous year due to the differences in the timing of the recognition of payments.

Example 9.2

Deduction for interest payment subject to a general limitation

Facts

1. In the example illustrated in the figure below, A Co (a company resident in Country A) owns all the shares in B Co (a company resident in Country B). A Co has invested 2.5 million by way of equity and 7.5 million by way of debt. The debt is in the form of two interest bearing loans that pay regular arm's length interest at an annual rate of 10% per year. The senior loan is for a principal amount of 5 million and the subordinated loan is for a principal amount of 2.5 million.



2. The subordinated loan is treated as an equity instrument (i.e. a share) under the laws of Country A and payments of interest are treated as dividends. Country A exempts foreign dividends under its domestic law and has not introduced a specific restriction on this exemption in accordance with Recommendation 2.1. The subordinated loan is treated as a debt instrument under the laws of Country B and interest payments on the loan are generally treated as deductible.

3. Country B has introduced a thin capitalisation rule which disallows interest deductions on debt to the extent the debt to equity ratio of the debtor exceeds 2:1. B Co has a debt to equity ratio of 3:1 accordingly one-third of the interest expenses incurred by B Co will be subject to limitation under the Country B thin capitalisation rule.

Question

4. Whether the interest payments under the subordinated loan fall within the scope of the hybrid financial instrument rule and, if so, what adjustments are required under the rule?

Answer

5. Payments of interest under the loan will give rise to a D/NI outcome that is a hybrid mismatch. This will be the case even if, as a technical matter, the deductibility of the interest is limited under the thin capitalisation rule.

6. The primary recommendation under the hybrid financial instrument rule is that Country B should deny a deduction for the payment to the extent it gives rise to a D/NI outcome. Accordingly B Co should be denied a deduction for the interest paid on the subordinated loan. The interaction between the interest limitation rule and the hybrid financial instrument rule is a matter for domestic law implementation however the interaction between these rules should not result in the hybrid financing instrument rule being used to deny a deduction for interest under a non-hybrid loan.

7. If Country B does not apply the recommended response, then Country A should treat the entire interest payment on the subordinated loan as ordinary income in order to neutralise the D/NI outcome.

Analysis

The arrangement is a financial instrument between related parties

8. Recommendation 1 only applies to payments made under a *financial instrument*. The loan meets the definition of a *financial instrument* because it is treated as an equity instrument in Country A and a debt instrument in Country B. B Co is a wholly-owned subsidiary of A Co and therefore A Co and B Co are related parties.

A payment made under the financial instrument will give rise to a hybrid mismatch

9. As with Example 1.1, the D/NI outcome that arises in this case is the result of B Co's entitlement to a deduction for the interest paid to A Co and the fact that the interest payment is treated as an exempt dividend in the hands of A Co. The hybrid financial instrument rule looks to the terms of the arrangement and its expected tax treatment and not to the detail of how the payments under a financial instrument have actually been taken into account by the parties to the arrangement. The fact that a taxpayer is subject to a general interest limitation, based on overall leverage or interest expense, will not, generally be relevant to a tax analysis based on the terms of the instrument. This will be the case even if it is the subordinated loan that triggered the interest limitation rule.

Primary recommendation – deny the deduction in the payer jurisdiction

10. In this case the interest payments made by B Co to A Co are treated as exempt dividends under the tax laws of Country A. A full denial of the deduction will therefore be required in order to neutralise the D/NI outcome.

11. The adjustment is limited to neutralising the mismatch in tax outcomes. In order to avoid double taxation under the hybrid financial instrument rule the interaction between the interest limitation rule and the hybrid financial instrument rule should be co-ordinated to achieve an overall outcome that is proportionate on an after-tax basis. The mechanism for co-ordinating the interaction between the two rules is a matter for domestic law however the interaction between these rules should not result in the hybrid financing instrument rule being used to deny a deduction for interest under a non-hybrid loan.

Defensive rule – require income to be included in the payee jurisdiction

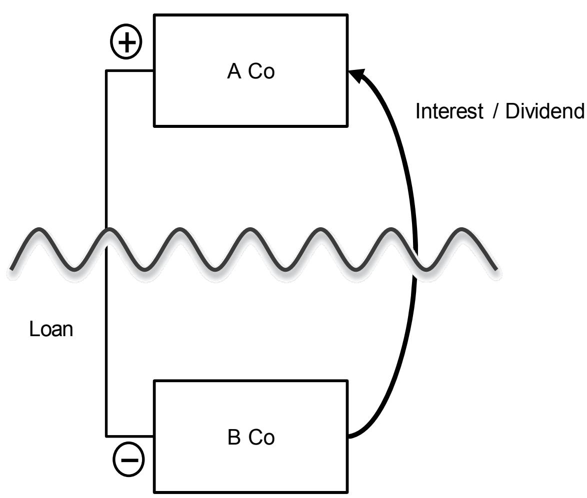
12. If Country B does not apply the recommended response, then A Co should treat the deductible payment as ordinary income under Country A law. Country A should not restrict the application of the rule to reflect the fact that a portion of the interest paid under the subordinated loan may be subject to the interest limitation rule unless it is Country B's general policy to permit taxpayers to re-characterise interest receipts that are treated as non-deductible under an interest limitation rule.

Example 10.1

Hybrid mismatch priced into the terms of the arrangement

Facts

1. In the example illustrated in the figure below, A Co (a company resident in Country A) and B Co (a company resident in Country B) are unrelated parties. A Co lends 0.3 million to B Co under a loan that pays annual interest. The bond is treated as a debt instrument under the laws of Country B but as an equity instrument (i.e. shares) under the laws of Country A. Under its domestic law Country A generally exempts foreign dividends. Hence, the payment results a D/NI outcome that is a hybrid mismatch.



2. Formula for calculating interest payment on the debt instrument provides for a discount to the market rate of interest which is calculated by reference to the corporation tax rate in Country A (i.e. the interest formula is equal to *market rate x (1 – tax rate)*). This means that while an expected market rate of interest on the loan might be 6% (i.e. 18 000 each year) the rate of interest on the hybrid financial instrument (assuming a corporate tax rate of 30% in Country A) would be 12 600 each year.

Question

3. Whether the parties have entered into a structured arrangement within the meaning of Recommendations 1 and 10?

Answer

4. The tax benefit is priced into the terms of the hybrid financial instrument and therefore the instrument is a structured arrangement.

Analysis

Tax outcome is priced into the terms of the instrument

5. Recommendation 10.1 explains that an arrangement will be treated as structured where the tax benefit arising from a hybrid mismatch is priced into the terms of the instrument. In this case, the terms of the instrument explicitly provide for a formula that discounts what would otherwise have been a market interest rate by the amount of the tax benefit under the loan.

Taxpayer is a party to the structured arrangement

6. A Co and B Co are parties to the arrangement because they are direct parties to the financial instrument. The fact that the tax benefit is priced into the calculation of the interest rate means that they can reasonably be expected to be aware of its tax consequences.

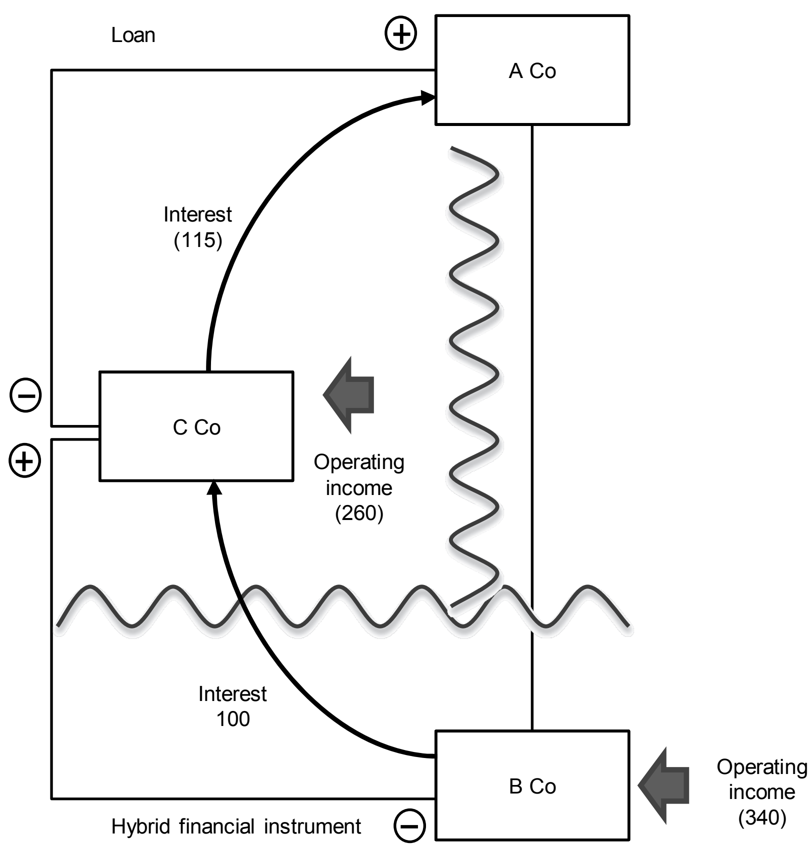
Example 10.2

Back-to-back loans structured through an unrelated intermediary

Facts

1. In the example illustrated in the figure below, B Co (a company resident in Country B) is a wholly-owned subsidiary of A Co (a company resident in Country A). A Co intends to provide subordinated debt financing to B Co, but is advised that this arrangement would be caught by the hybrid mismatch rules in Country B as A Co and B Co are related parties.

2. A Co is advised to organise the financing through C Co, an independent third party which is also resident in Country A. C Co's loan to B Co will be funded by a back-to-back loan arrangement. By structuring the financing in this way, the hybrid financial instrument is between unrelated parties. The domestic law of Country C treats the loan between C Co and B Co as equity, whereas the domestic law of Country B treats that loan as an ordinary debt instrument.



3. The table below illustrates the tax consequences to the parties of entering into the above arrangement.

Country A Law A Co	Tax	Book	Country B Law B Co	Tax	Book
Income			Income		
Interest paid by C Co	115	115	Operating income	340	340
			Expenditure		
			Payment to C Co under hybrid financial instrument	(100)	(100)
Net return		**115**	**Net return**		**240**
Taxable income	**115**		**Taxable income**	**240**	
Tax to pay (at 20%)		(23)	Tax to pay (at 20%)		(48)
After-tax return		**92**	**After-tax return**		**192**

Country C Law C Co	Tax	Book
Income		
Operating income	260	260
Payment from B Co under hybrid financial instrument	-	100
Expenditure		
Interest paid to A Co1	(115)	(115)
Net return		**245**
Taxable income	**145**	
Tax to pay (at 20%)		(29)
After-tax return		**216**

4. Under the arrangement B Co claims a deduction of 100 for a payment of interest under the hybrid financial instrument. This payment is treated as an exempt dividend under Country C law and is not brought into account as income by C Co. C Co pays a deductible amount of 115 of interest to A Co which is recognised as income under Country A law. The net effect of the payment under the hybrid financial instrument is to decrease the overall taxable income under the arrangement by the amount of the payment (100) with the value of the resulting tax benefit (20) being shared between C Co and A Co under the interest payable on the loan.

Question

5. Whether the payments under the hybrid financial instrument should be treated as entered into under a structured arrangement within the meaning of Recommendations 1 and 10.

Answer

6. The interest payments under the hybrid financial instrument should be treated as being made under a structured arrangement as:

(a) the tax benefit arising from the mismatch has been priced into the terms of the arrangement;

(b) the facts and circumstances indicate that the arrangement was designed to create a hybrid mismatch; and

(c) the parties have introduced an unnecessary step into the structure to create the mismatch.

7. Further, in cases such as this, it is likely that the terms of the arrangement will contain provisions that allow the arrangement to be unwound, at no cost to the terminating party, in the event the tax benefit under the structure is no longer available.

Analysis

The mismatch is priced into the terms of the instrument

8. The test of whether the mismatch is priced into the arrangement looks to the terms of the arrangement. This includes both the hybrid financial instrument and the loan from A Co to C Co.

9. In this case C Co appears to be paying an above-market rate of interest on the loan. This interest rate is intended to provide A Co with the benefit of the mismatch in tax outcomes. The pricing of the tax benefit arising from the mismatch into the arrangement would further be indicated by the fact that C Co's return on the arrangement is pre-tax negative and if there are terms that permit the structure to be unwound if the tax benefit is no longer available.

The facts and circumstances indicate that there is a structured arrangement

10. As stated in Recommendation 10.1, the determination of whether the hybrid mismatch was priced into the arrangement can be made on the basis of the terms of the underlying instrument or the facts and circumstances of the arrangement. This case contains a number of factors listed in Recommendation 10.2 that point to the existence of a structured arrangement.

The arrangement was designed to create a hybrid mismatch

11. In this scenario A Co was advised before the arrangement was entered into, to lend the money to its subsidiary through an unrelated intermediary in order to avoid the effect of the related party test under the hybrid financial instrument rule in Country B. Therefore, it can be said that the arrangement was designed in such a way as to allow

A Co to take advantage of the hybrid mismatch without implicating the hybrid mismatch rules.

The arrangement uses a step to create a hybrid mismatch

12. The arrangement contains an additional step or steps (i.e. the back-to-back loan arrangement) that have the effect of avoiding the related party rules and where there is no obvious business, commercial or other reason that could explain why the financing is routed through a third party.

Pre-tax negative return

13. C Co receives 100 of interest from B Co under the hybrid financial instrument but is required to pay an 115 of interest to A Co under the back to back loan entered into as part of the same arrangement. This structure only makes economic sense for C Co if the 20 of tax benefit from the hybrid mismatch is factored in to the overall return.

Change to the terms under the arrangement in the event the hybrid mismatch is no longer available

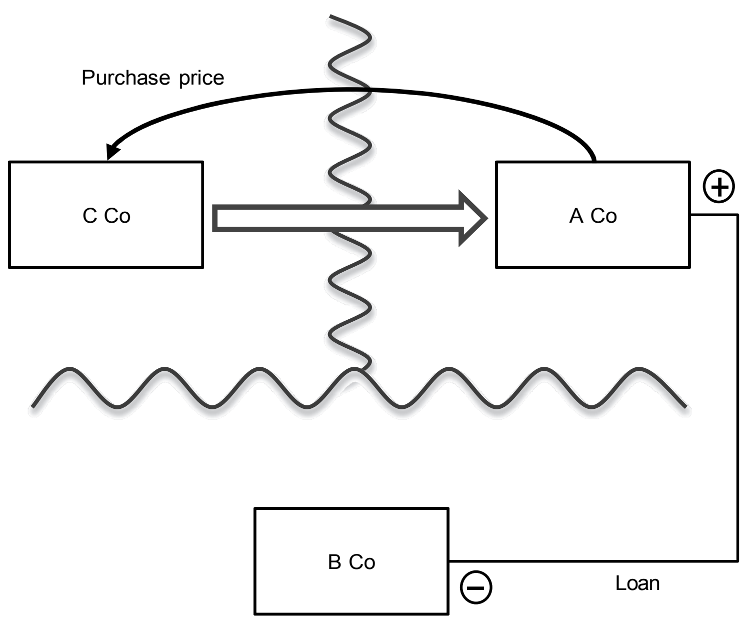
14. If the terms of the arrangement allow one or both parties to terminate the arrangement in the event the tax benefits of the transaction are no longer available, that will also be a strong indicator of the arrangement having structured to produce a D/NI outcome.

Example 10.3

Arrangement marketed as a tax-advantaged product

Facts

1. In the example illustrated in the figure below, C Co (a company resident in Country C) subscribes for bonds issued by B Co (an unrelated company resident in Country B). Due to the differences in treatment of the underlying instrument under the respective laws of Country A and Country B, the interest payments give rise to a hybrid mismatch resulting in a D/NI outcome.



2. C Co subscribed for these bonds after receiving an investment memorandum that included a summary of the expected tax treatment of the instrument (including the fact that payments on the instrument will be eligible for tax relief in Country A). A similar investment memorandum was sent to a number of other potential investors in Country A. Subsequently, C Co sells the bond to A Co, an unrelated company resident in Country A.

Question

3. Whether the payments under the hybrid financial instrument should be treated as made under a structured arrangement within the meaning of Recommendations 1 and 10, and whether A Co is a party to that structured arrangement.

Answer

4. The original issue of the bonds will give rise to a structured arrangement because the facts indicate that bond has been marketed as a tax-advantaged product and has been primarily marketed to persons who can benefit from the mismatch. C Co is a party to that arrangement because it acquires the bond on initial issuance. On the other hand, A Co may not be a party to the structured arrangement if it pays market value for the bond and could not reasonably have been expected to be aware of the mismatch in tax treatment.

Analysis

Marketed as a tax advantaged product

5. The investment memorandum includes a description of the expected tax consequences for the holder including a reference to the fact that payments on the instrument will be eligible for tax relief in Country A. This is evidence that the instrument has been marketed to investors as a tax advantaged product.

Marketed to a class of investors

6. In this case, in order to avoid the definition of a structured arrangement the issuer would further need to show that the instrument had not been primarily marketed to investors in jurisdictions that could benefit from the mismatch in tax outcomes. If the majority of the investors by both number and value are located in jurisdictions where the tax benefit does not arise, then this will be evidence that the arrangement has been widely-marketed to a diverse group of investors.

C Co is a party to the structured arrangement

7. C Co is a party to the structured arrangement because it can be reasonably expected to have been aware of the mismatch at the time it subscribed for the bonds.

A Co may not be a party to the structured arrangement

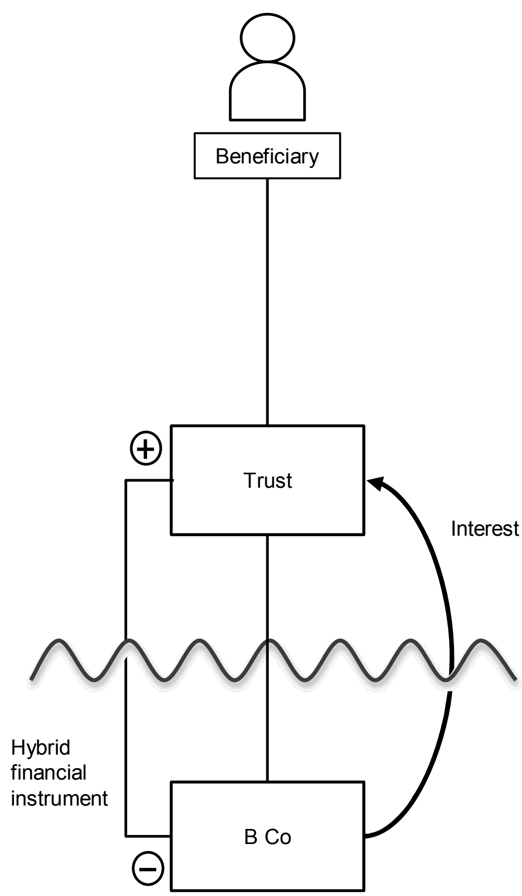
8. A Co may not be aware of the mismatch in tax outcomes if it acquires the bond from C Co on arms-length terms and at a market price.

Example 10.4

Beneficiary of a trust party to a structured arrangement

Facts

1. In the example illustrated in the figure below, a trust established in Country A subscribes for an investment that gives rise to a hybrid mismatch and has been marketed by the issuer as a tax advantaged product (see **Example 10.3**). The trust is transparent for tax purposes and allocates the payment to a beneficiary who is a resident of Country A. The beneficiary has no knowledge of the investment made by the trustee.



Question

2. Whether the beneficiary is a party to the structured arrangement within the meaning of Recommendation 10.3?

Answer

3. The beneficiary is a party to the arrangement because the tax consequences arising to the trust are attributed to its beneficiaries.

Analysis

4. Although the beneficiary is not a direct party to the arrangement tax consequences of the investment are imputed to the beneficiary under the laws of Country A. These tax consequences should include the fact that the trust subscribed for the investment under conditions that gave rise to a hybrid mismatch.

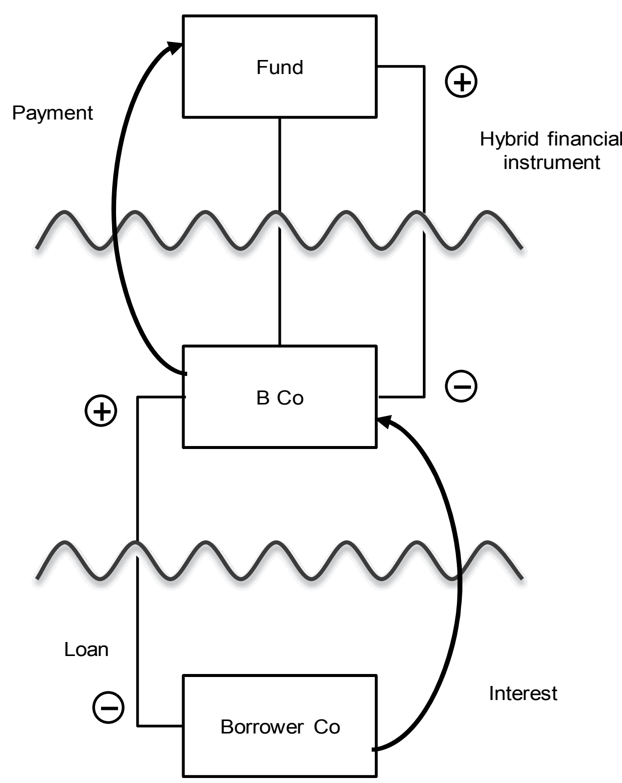
Example 10.5

Imported mismatch arrangement

Facts

1. In the example illustrated in the figure below, a fund resident in Country A, which is in the business of lending money to medium-sized enterprises (Fund), enters into negotiations to provide an unsecured loan to Borrower Co, a company resident in Country C, to fund Borrower Co's working capital requirements.

2. Once negotiations for the loan have commenced, C Co and the Fund receive tax advice that the subordinated terms of the loan mean that it will be treated as an equity instrument (i.e. a share) under Country A law, but as debt under Country C law. In order to avoid the negative effects of the hybrid mismatch rules in Country C, the Fund structures the loan through a back-to-back arrangement with a wholly-owned subsidiary in Country B. Country B also treats these types of subordinated loan as debt but it has not implemented the hybrid mismatch rules. The loan between the Fund and B Co therefore produces a mismatch in tax outcomes and the whole lending arrangement gives rise to an imported mismatch under Country C law.



Question

3. Whether Borrower Co is a party to the structured arrangement within the meaning of Recommendation 10.3?

Answer

4. Borrower Co should be treated as a party to the structured arrangement.

Analysis

5. Borrower Co should be treated as party to the structured financing arrangement if it has sufficient involvement in the design of the arrangement to understand its mechanics and anticipate its tax effects.

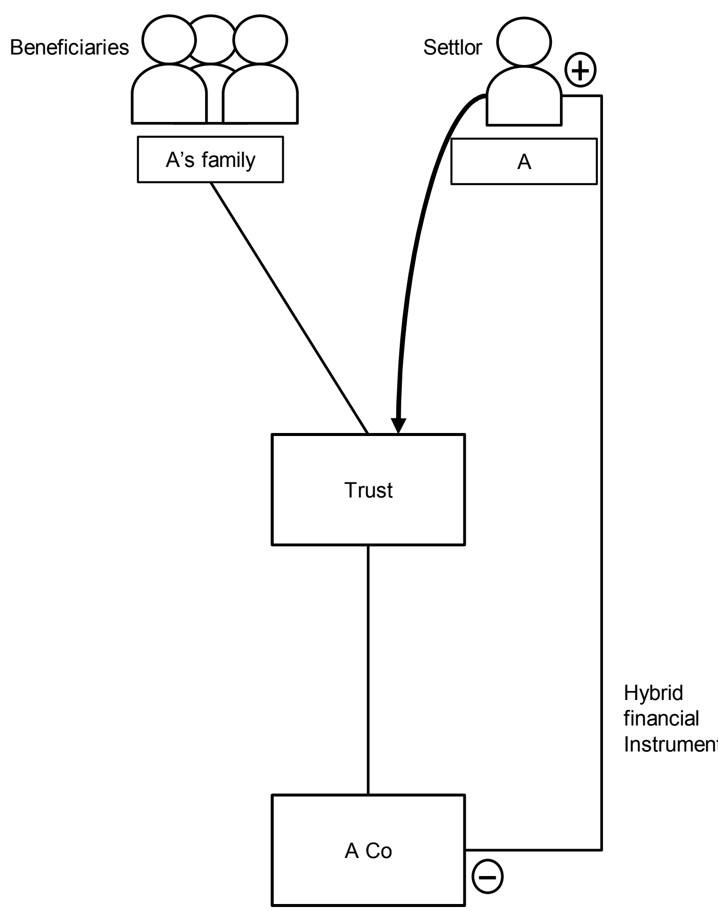
6. In contrast to the facts described in **Example 4.1**, Borrower Co is already engaged in financing discussion with A Co at the time the potential for hybrid tax treatment is identified by the parties. The potential impact of the hybrid financial instrument rule is then mitigated by introducing another entity (B Co) into the lending structure. While Borrower Co may not know the precise details of the financing arrangements between A Co and B Co, Borrower Co (or a member of Borrower Co's control group) can reasonably be expected to be aware of the fact that B Co and A Co are affiliates and that funding for the loan has come indirectly from A Co. Borrower Co is also aware that B Co has been inserted into the structure for tax reasons, notably to avoid Borrower Co losing its interest deduction under the hybrid financial instrument rule. Therefore, although Borrower Co has no direct involvement or knowledge of the hybrid financial instrument between A Co and B Co, it has sufficient involvement in the overall design of the arrangement to understand how the arrangement has been structured (as a back-to-back financing arrangement through an intermediary); and to anticipate what the tax outcomes will be for the parties to the arrangement (avoiding denial of the deduction in Country C while preserving the tax outcomes under Country A law).

Example 11.1

Application of related party rules to assets held in trust

Facts

1. In the example that is illustrated in the figure below, Individual A is the settlor of a trust that is established for the benefit of A's immediate family. Under the trust deed, the settlor has no vested or contingent beneficial entitlement to the income or assets of the trust or the power to amend the trust deed but the settlor is entitled to appoint trustees to the trust. A appoints an independent bank to act as a trustee of the trust. The trust owns all of the ordinary shares in A Co. A enters into a hybrid financial instrument with A Co.



Question

2. Is A related to A Co for the purposes of Recommendation 11?

Answer

3. The trust holds all the voting and equity interests in A Co and A is either treated as having an *indirect voting interest in A Co* (through A's right to appoint trustees to the trust) or is deemed to hold *an indirect equity interest in A Co* (because the beneficiaries of the trust are A Co's immediate family). Further A may be considered related to A Co if the facts of the case indicate that trust is under the effective control of A.

Analysis

The trust owns all the voting and equity interests in A Co.

4. Although the trust may be transparent for tax purposes, it is treated as a person under the related party rules in Recommendation 11. The trust holds all the ordinary shares in A Co which will give the trust 100% of the voting and equity interests in the company.

A is treated as having 100% of the voting interests in the trust

5. As settlor of the trust, A has the sole right, under the terms of the trust deed, to appoint trustees, which is one of the enumerated voting rights described in the related party rules. The fact that the constitutional documents (in this case the trust deed) do not give A the power to authorise distributions or alter the terms of the trust, does not affect the conclusion that A holds 100% of the voting interests in the trust.

A's family are treated as holding 100% of the equity interests in the trust

6. As the named beneficiaries of the trust, A's family are treated as the holders of the equity interests in the trust. Under the "acting together" test in Recommendation 11.3. A is deemed to hold any equity interests that are held by his family.

A is the indirect holder of the voting and equity interests in A Co

7. The measurement of a person's voting and value interests in another person includes interests that are held indirectly through others. As the holder (or deemed holder) of the voting and equity interests in the trust A is deemed to hold, indirectly, all of the voting and equity interests in A Co.

A could be treated as holding a direct voting or equity interest if A and the trustee can be shown to be acting together.

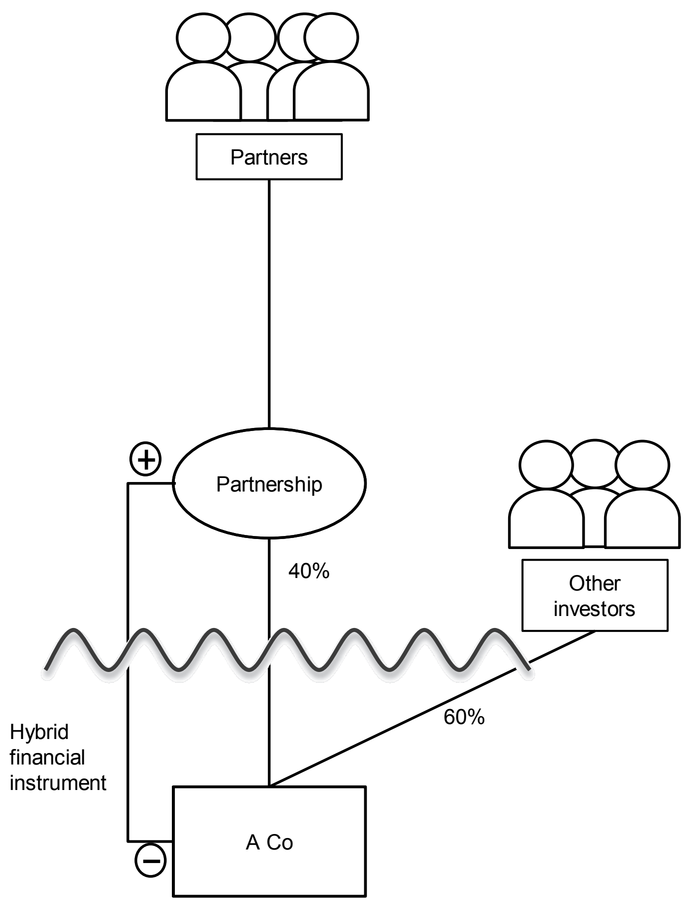
8. Subject to more precise facts, A can also be considered to be directly related to A Co if it can be shown that the trustee effectively acts in accordance to A's instructions.

Example 11.2

Related parties and control groups - partners in a partnership

Facts

1. In the example illustrated in the figure below A, B, C and D are four partners in a partnership resident in Country B. All the decision in the partnership require unanimous vote. All the partners have the same voting rights and equal share in the profits of the partnership. The partnership is treated as tax transparent under the laws of Country B.



2. The partnership has a substantial shareholding in a company resident in Country A (A Co). The partnership lends money to A Co. The way this loan is taxed under Country A and B laws gives rise to a mismatch in tax outcomes.

Question

3. Whether the partners are related to A Co for the purposes of Recommendation 11?

Answer

4. The partners are treated as directly related to A Co because, in this case, each partner is treated as acting together with the other partners in respect of the partnership's substantial shareholding in A Co.

Analysis

The partner's indirect holding in A Co is insufficient to bring that partner within the related party rule

5. Although the partnership is transparent for tax purposes, it is treated as a person under the related party rules in Recommendation 11. The partnership holds 40% of the ordinary shares in A Co which will give the partnership 40% of the voting and equity interests in the company. This holding will be attributed equally to the partners in the partnership in proportion to their voting and value interest in the partnership. In this case, however, this leaves each partner with only a 10% indirect holding in A Co which is insufficient to bring that partner within the related party rules.

Each partner is treated as having a direct holding in A Co under the acting together test

6. In this case, the shares in A Co are held by a person that is treated as transparent under Country B law so that the shares in A Co, and the payments made under the financial instrument, are treated as made directly to the partners in accordance with their interest in the partnership. In this case where the ownership or control of the shares in A Co are managed by the partnership and where that management or control has a connection with the arrangement that has given rise to the mismatch (because both the equity interest and the financial instrument are held by the same person) each partner will be treated as holding the shares of the other partners under the acting together test in Recommendation 11.3(d) and accordingly will be treated as holding sufficient shares in A Co to bring that partner within the scope of the related party rule.

The partners are not related to each other

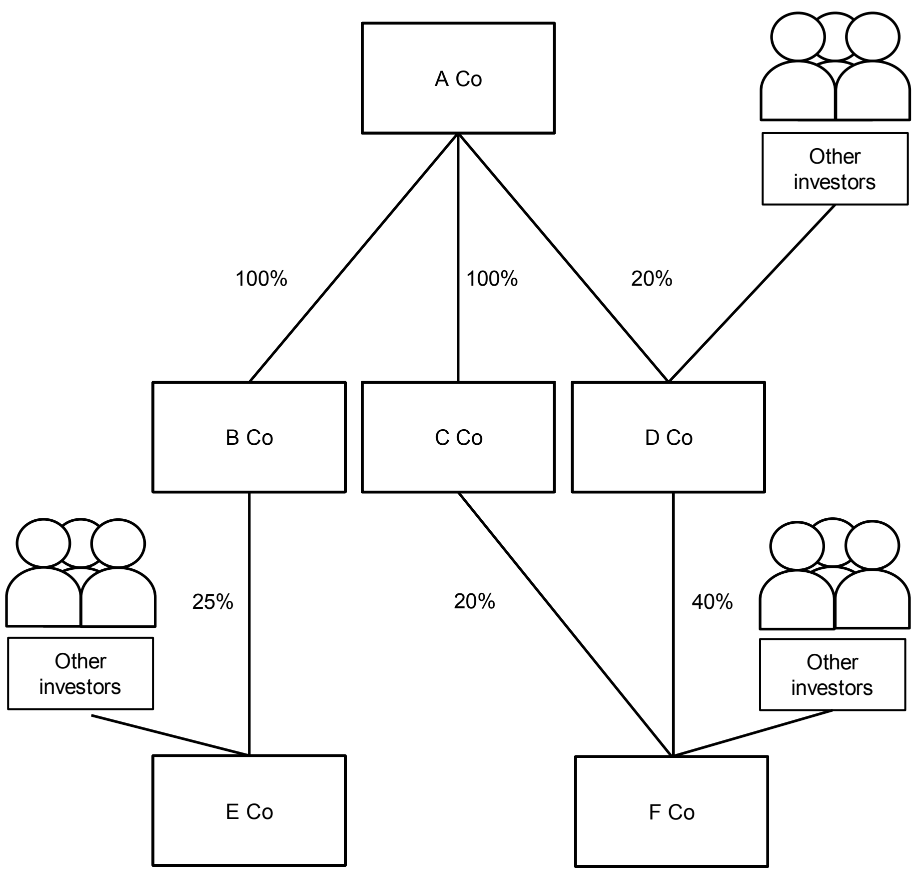
7. Although the partners are related to the partnership and to A Co they are not related to each other. There is no third person who holds at least a 25% investment in two or more partners nor can they be said to be in the same control group within the meaning of Recommendation 11.1(b).

Example 11.3

Related parties and control groups - calculating vote and value interests

Facts

1. In this example illustrated in the figure below, A Co is the ultimate parent of a group. It has two wholly-owned subsidiaries B Co and C Co and has a holding of 20% of the ordinary shares in D Co. B Co has a holding of 25% of the ordinary shares in E Co. C Co and D Co have a 20% and 40% holding in F Co (respectively).



Question

2. Which entities in this group structure are related within the meaning of Recommendation 11?

Answer

3. A Co, B Co, C Co, E Co and F Co are related parties. D Co is related to F Co but not to any other group member (unless, for example, D Co's other ordinary shares are widely-held).

Analysis

Related parties through direct shareholding

4. A Co is related to B Co and C Co through its 100% direct holding of shares. On the same basis D Co is related to F Co.

Related parties through indirect holding

5. A Co is related to E Co through an indirect holding of 25% of E Co's voting and value interests. A Co is also related to F Co as it holds an indirect 28% investment in F Co.

Related parties due to membership in the same control group

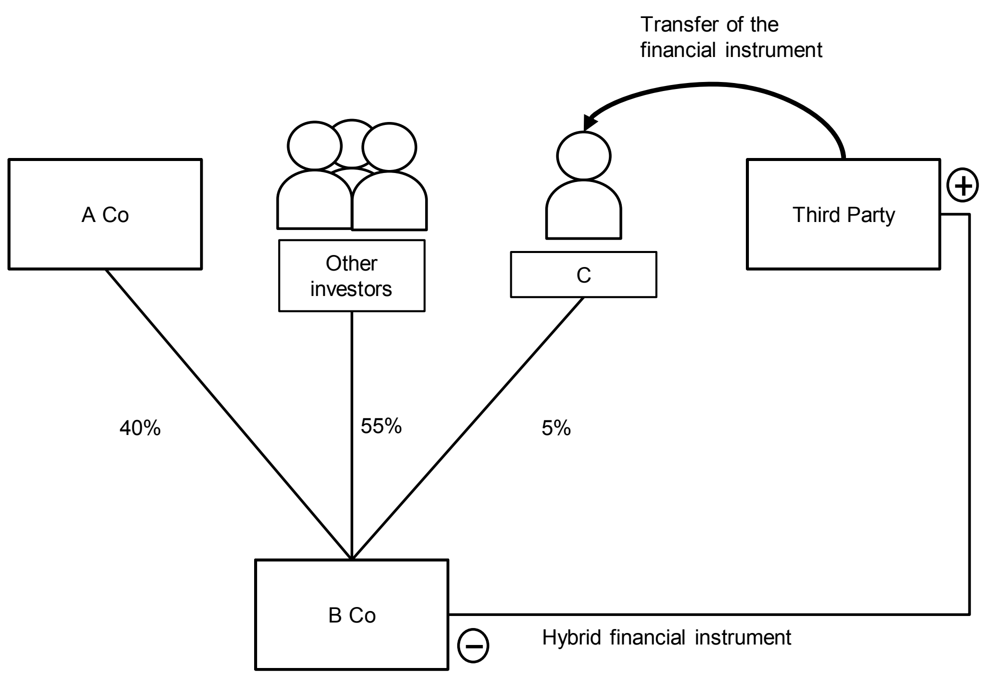
6. A Co does not hold, directly or indirectly, more than 25% of the voting or value interests in D Co. But A Co may be related to D Co if they are both found to be in the same control group. This particular case could fall within the second test in Recommendation 11.1(b) if A Co holds an investment that gives it an effective control over D Co. If, for example, the shareholding of D Co is otherwise widely-held, except for the 20% holding by A Co, then A Co may have effective control of D Co even with a minority stake.

Example 11.4

Acting together - aggregation of interests under a shareholders' agreement

Facts

1. In the example illustrated in the figure below A Co and a number of other investors, including C, hold together 100% of equity and voting rights in B Co. A Co is a majority shareholder with 40% holding and the other investors each own 5% of shares in B Co. The shareholders entered into a shareholders' agreement that provides the majority shareholder with a first right of refusal on any disposal of the shares and drag-along and tag-along provisions in the event that an offer is made for a majority of the shares in the company.



2. B Co issues a financial instrument that is purchased from an unrelated third party by C (one of the minority shareholders). This instrument results in a hybrid mismatch giving rise to a D/NI outcome.

Question

3. Whether the investors in B Co are acting together, within the sense of Recommendation 11.3(c) such that C should be treated as related to B Co.

Answer

4. Provisions that are commonly found in a shareholders agreement and that do not have a material impact on the value or control of the interests held by a shareholder will not be treated as common control agreements within the meaning of Recommendation 11.3(c).

5. If the shareholder's agreement does have a material impact on the value of C's shareholding, C will be treated as a related party under the acting together test in respect of the acquisition of the financial instrument even if there is no link or connection between the shareholders' agreement and the transaction that gave rise to the hybrid mismatch.

Analysis

Shareholders' agreement is on standard terms

6. The right to buy C Co's shares at market value, as well as the drag along and tag along rights are relatively standard terms in a shareholders' agreement for a closely-held company. These types of provisions will not generally have a material impact on the value of the holder's equity interest and therefore should not be taken into account for the purposes of the acting together requirement.

No nexus required between transactions giving rise to the mismatch and the common control arrangement

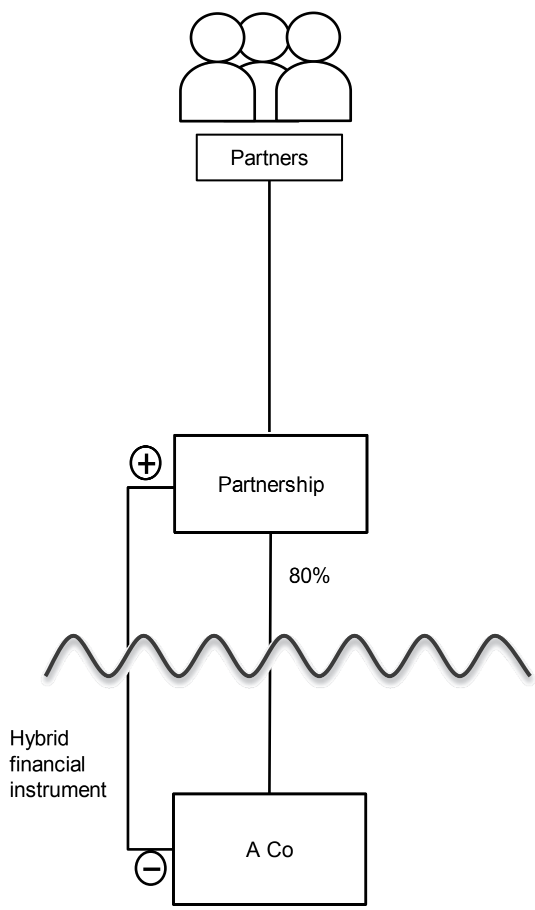
7. The acting together test does not impose any definitional limits on the content of the common control arrangement and the acting together test can capture transactions between otherwise unrelated taxpayers even if the common control arrangement has not played any role in the transaction that has given rise to the mismatch. Thus, if the shareholders' agreement does have a material impact on the value of C's shareholding, C will be treated as a related party under the acting together test in respect of the acquisition of the financial instrument even if there is no link or connection between the shareholders' agreement and the transaction that gave rise to the hybrid mismatch.

Example 11.5

Acting together - rights or interests managed together by the same person/s

Facts

1. In the example illustrated in the figure below, a widely-held investment partnership provides additional financing to A Co, a company in which it already has an 80% holding. The terms of this loan agreement result in a mismatch in tax outcomes for one investor in that partnership.



2. The terms of the partnership agreement give the general partner the primary right to decide on the investments of the partnership. The general partner when making its decisions must act in good faith and in the best interest of all the partners.

Question

3. Whether the partner is related to A Co through the aggregation of interests rule under Recommendation 11.3?

Answer

4. In this instance the partner that is a party to a hybrid financial instrument will be treated as related to A Co through the aggregation of interest rule in Recommendation 11.3(d). This will be the case even where it cannot be said that the partnership is acting together with all the other partners in respect of the mismatch in tax outcomes.

Analysis

5. Consistent with the analysis in **Example 11.2**, where the shares and debt are held by the same investment partnership the joint management or control of the equity interest will result in each partner being treated as holding the shares of the other partners under the acting together test in Recommendation 11.3(d).

6. The fact that the partnership is widely-held and otherwise meets the test for a CIV does not permit the partnership to rely on the exclusion to Recommendation 11.3(d) because that exception only applies to investors that are CIVs and not investors in a CIV.

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ISBN 978-92-64-24108-4
23 2015 29 1 P

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Report No. 1411
February 26, 2019

The Honorable David J. Kautter
Assistant Secretary (Tax Policy)
Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

The Honorable Charles P. Rettig
Commissioner
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

The Honorable William M. Paul
Acting Chief Counsel and Deputy
Chief Counsel (Technical)
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

Re: *Report No. 1411 – Report on Proposed Regulations under Sections 267A, 245A(e) and 1503(d)*

Dear Messrs. Kautter, Rettig, and Paul:

I am pleased to submit Report No. 1411, commenting on the proposed regulations issued by the Internal Revenue Service and the Department of the Treasury under Sections 267A, 245A(e) and 1503(d) of the Internal Revenue Code.

We commend the Internal Revenue Service and the Department of the Treasury for issuing thoughtful and timely guidance on the treatment of hybrid transactions and arrangements under the new statutory provisions. This Report is intended to highlight significant issues under the Proposed

Regulations that we have identified and, where appropriate, make recommendations intended to improve the operation of the rules thereunder.

We appreciate your consideration of our Report. If you have any questions or comments, please feel free to contact us and we will be glad to assist in any way.

Respectfully submitted,

Deborah L. Paul
Chair

Enclosure

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NEW YORK STATE BAR ASSOCIATION TAX SECTION

REPORT ON PROPOSED REGULATIONS UNDER SECTIONS 267A, 245A(e), AND 1503(d)

February 26, 2019

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I. INTRODUCTION

This Report[1] comments on proposed regulations (the "**Proposed Regulations**")[2] issued by the Internal Revenue Service (the "**IRS**") and the Department of the Treasury (collectively with the IRS, the "**Treasury**") under Sections 267A, 245A(e), and 1503(d).[3] Sections 267A and 245A(e) were added by Public Law No. 115-97, informally known as the "Tax Cuts and Jobs Act of 2017" (the "**Act**" or the "**TCJA**").[4]

We commend Treasury for issuing thoughtful and timely guidance on the treatment of hybrid transactions and arrangements under the new TCJA rules. This Report is intended to highlight significant issues under the Proposed Regulations that we have identified and, where appropriate, make recommendations intended to improve the operation of the rules thereunder. Part II of this Report contains a summary of our principal recommendations. Part III provides a summary of the Proposed Regulations and Sections 267A, 245A(e), and 1503(d). Part IV contains our comments and recommendations.

II. SUMMARY OF PRINCIPAL RECOMMENDATIONS[5]

A. Section 267A

1. Multiple Specified Recipients Rule

We recommend that final regulations replace the Multiple Specified Recipients Rule with a rule, consistent with the OECD Recommendations, that an Inclusion by any specified recipient is sufficient to avoid a NI outcome. We have also set out alternative approaches that we do not favor, but which represent a middle-ground between the two approaches.

2. Structured Arrangements Rule

We recommend that the Structured Arrangements Rule be revised to more closely align with the OECD Recommendations. In particular, we recommend that the rule should ask whether,

[1] The principal authors of this report are Lawrence Garrett, Stuart Leblang, and Diana Wollman, with substantial assistance from Menachem Danishefsky, Arlene Fitzpatrick, Julie Geng, Andrew Herman, Lee Holt, Ron Nardini, Armita Sobhi, Deborah Tarwasokono, Tuvia Tendler, and Kristie Withrow. Helpful comments were received from Kimberly Blanchard, Andy Braiterman, Robert Cassanos, Patrick Cox, Daniel Dunn, Kevin Glenn, Stephen Land, Jiyeon Lee-Lim, Erika Nijenhuis, Richard Nugent, Deborah Paul, Robert Scarborough, Michael Schler, Karen Sowell, Joseph Tootle, and Michael Yaghmour. This report reflects solely the views of the Tax Section of the New York State Bar Association (**"NYSBA"**) and not those of the NYSBA Executive Committee or the House of Delegates.

[2] REG-104352-18**,** 83 FR 67612-01 (Dec. 28, 2018).

[3] Unless otherwise stated, all "Code" and "Section" references are to the Internal Revenue Code of 1986, as amended. References to "Reg." or "Regulations" are to the Treasury Regulations promulgated under the Code.

[4] P.L. 115-97.

[5] Capitalized terms used, but not defined, in this summary are defined in the corresponding sections of the Summary of Proposed Regulations or the Discussion and Recommendations parts of the Report below.

based upon all the facts and circumstances, the payor actually knows or should have known that the arrangement results in a hybrid mismatch that produces a more than minor benefit or benefits (in the aggregate) for (i) the payor (including a benefit in the form of more favorable pricing and including a benefit that is realized by the payor or a related party through a separate transaction with one or more investors or their related parties), or (ii) one or more investors.

3. Imported Mismatches

We recommend adjusting the Imported Mismatch Rule in a number of ways to coordinate better with other jurisdictions' imported mismatch rules as well as other portions of the Proposed Regulations. These changes are needed to avoid imposing double disallowances on taxpayers and to avoid allowing taxpayers to avoid the application of the Imported Mismatch Rule.

4. Determining Existence and Extent of D/NI Outcomes

a. Structured Payments

The Proposed Regulations create a separate category of "structured payments" as distinct from interest. Treasury and the Service should consider including structured payments within the definition of interest or otherwise clarifying whether the relevant rules apply to all specified payments or only to interest and royalties.

b. US Inclusion Kick-Out Rule for PFICs

The Proposed Regulations provide that, if a specified payment is taken into account for tax purposes, deductions for interest and royalties are not subject to disallowance under Section 267A. We recommend that Treasury and the Service consider expanding the US Inclusion Kick-out Rule to scenarios in which the corresponding income is included in the US as a result of an election to be treated as a qualified electing fund with respect to a passive foreign investment company under Section 1295 of the Code.

c. Treatment of US and Foreign Withholding Taxes

Although the Proposed Regulations provide exceptions to Section 267A disallowance for amounts included in income as GILTI or subpart F, or included in the income of a US taxable branch, no such exception applies in the case of gross-basis withholding. We recommend that Treasury provide that a specified payment is not a disqualified hybrid amount to the extent that the US imposes a withholding tax on the specified payment. To the extent that an income tax treaty reduces the amount of withholding imposed on a specified payment, such amount should be treated as a disqualified hybrid amount on a proportionate basis under rules similar to those in Section 163(j)(5)(B) as in effect before the TJCA.

d. Treatment of Specified Payments to Reverse Hybrids

We recommend adjusting the Reverse Hybrid Rule to take into account the treatment of the recipient entity in its jurisdiction of tax residency in addition to its jurisdiction of incorporation or organization.

e. Timing Mismatches

We generally support the 36-month rule as consistent with the OECD Recommendations and necessary to address long-term deferral that, as a practical matter, creates a NI result. However, where a timing mismatch extends beyond the 36-month period, we recommend that the interest or royalty deduction be deferred until the Inclusion occurs, rather than disallowed.

f. Base Differences

We recommend clarifying that an Inclusion is tested on an aggregate basis taking into account all related payments in the transaction.

g. Treatment of Foreign Currency Gain or Loss

We agree with the Proposed Regulations' treatment of foreign currency gain or loss; however, there appears to be a drafting error in the definition of "proportionate amount," which should be corrected to include the proper fraction as a multiplier.

h. Treatment of Special Exemption Regimes

We request clarification regarding how dual inclusion income is calculated when a recipient jurisdiction has other special exemption regimes, e.g., a participation exemption or patent box regime.

i. Treatment of Deemed Branch Payments

At this time we have no specific recommendation with regard to deemed branch payments, but we set out various issues that we believe should be carefully considered.

5. Anti-Avoidance Rule

We do not object to the inclusion of a broad purpose-based Anti-Avoidance Rule in regulations under Section 267A. We do believe that Treasury and the Service may want to give further attention to the role that it plays. An argument can be made that the Anti-Avoidance Rule should not be used to supplant the careful balance struck by the other avoidance-focused provisions, such as the Structured Arrangements Rule, the Imported Mismatch Rule, and the Multiple Specified Recipients Rule. On the other hand, an argument can be made that a broad purpose-based rule remains appropriate, even when layered on top of targeted anti-avoidance rules.

6. Other Rules

a. De Minimis Exception

The *de minimis* exception in the Proposed Regulations exempts taxpayers who have less than $50,000 in the aggregate of interest and royalty deductions, without regard to whether such deductions arise from hybrid arrangements. We recommend the *de minimis* threshold apply only to deductions associated with hybrid arrangements. We do not view such a revised rule as significantly increasing taxpayer burden.

b. Effect of Disallowance on Earnings and Profits

It is appropriate that the Proposed Regulations provide that the Section 267A deduction disallowance rule will not affect E&P of a US corporation or a foreign corporation with a US branch. However, reducing earnings and profits of a CFC for disallowed specified payments may allow 10% US shareholders of the CFC to reduce subpart F inclusions, because the CFC's earnings and profits cap the potential amount of any subpart F inclusion by a 10% US shareholder. Accordingly, Treasury and the Service may wish to consider adding an anti-avoidance rule that would prevent the use of disqualified hybrid amounts to lower the earnings and profits cap on subpart F income under Section 952(c)(1).

c. Coordination with Section 163(j)

As currently drafted, there is a potential inconsistency between the coordination rules in the proposed Section 163(j) regulations and the coordination rules in the Proposed Regulations under Section 267A. Final regulations should clarify that Section 267A applies prior to the application of Section 163(j).

7. Areas that Final Regulations Should Reserve On

a. Notional Interest and Deemed Interest Deductions

Because the OECD Recommendations only address actual payments, we recommend regulations reserve on notional interest deductions and deemed interest deductions in order to determine whether an acceptable solution can be achieved on a multilateral basis.

b. Distributions from Reverse Hybrids

We recommend that current year distributions from a reverse hybrid that are taxable to an investor reduce a NI result, and that regulations reserve for additional guidance on this issue.

B. Section 245A

1. Scope of the Hybrid Deduction Account

Treasury and the Service should consider providing that to the extent that a taxpayer can demonstrate that there is a legal obligation to make the payment giving rise to a hybrid deduction within 36 months of the accrual of the deduction under foreign tax law and the parties expect the payment to be timely made, such deduction should not increase the CFC's hybrid deduction account (consistent with the 36-month rule proposed in Section 267A); rather, Section 245A(e) should apply to such payment when made.

2. Effective Date of the Hybrid Deduction Account

Treasury and the Service should consider changing the effective date of the hybrid dividends account rule to distributions occurring after December 31, 2018 (with a possible tracing regime applying for distributions made in 2017), in order to give taxpayers sufficient notice for compliance with the hybrid deduction account rules.

3. Consideration of Tiered Hybrid Dividends under Relevant Foreign Tax Law

Treasury and the Service should consider revising the tiered hybrid deduction rules of Section 245A(e) to take into account the relevant foreign tax law's treatment of the receipt of a distribution by the intermediary CFC (including applicable withholding taxes).

4. Maintenance of Hybrid Deduction Account

a. Certain Adjustments to the Hybrid Deduction Account

Treasury and the Service should consider and adopt (unless determined to be too difficult to administer) an arithmetic convention (such as a pro ration approach) to identify if and to what extent subpart F income or GILTI earned in a taxable year funds a hybrid deduction in the same year. Once it is determined whether and the extent to which subpart F income or GILTI funded a hybrid deduction in the same year, hybrid deduction accounts could be adjusted in respect of distributions of subpart F income or GILTI, but reducing the adjustment to reflect deemed paid foreign tax credits or Section 250 benefits obtained in that year.

b. Carryover of Hybrid Deduction Account in Certain Nonrecognition Transactions

With respect to the carryover of hybrid deduction accounts in certain reorganizations and liquidations to which Section 381 applies, Treasury and the Service should consider precluding the duplication of the hybrid deduction account of a lower-tier CFC at an upper-tier CFC, to the extent such upper-tier CFC has already accounted for such hybrid deductions in the upper-tier

CFC's hybrid deduction account (i.e., in the case of back-to-back arrangements). With respect to the carryover of hybrid deduction accounts in spin-offs, it would appear that the shareholder's hybrid dividend accounts for the controlled corporation following the spin-off generally should equal the sum of (i) the allocable share of its hybrid dividend account for the distributing corporation's stock prior to the spin-off and (ii) the distributing corporation's hybrid dividend account of the controlled corporation to which the shareholder succeeds, subject to the anti-duplication rule mentioned above.

C. Section 1503(d)

1. Domestic Reverse Hybrids

Losses of a DRH should be treated as DCLs, provided that, if Treasury and the Service do not believe they have authority to issue Regulations directly subjecting losses of a DRH to the DCL rules (without using the CTB regime), we recommend that Treasury and the Service seek a legislative amendment to provide for such authority, instead of conditioning a CTB election on such treatment.

2. Disregarded Items

Treasury and the Service should consider redefining the net loss attributable to a separate unit by taking into account disregarded items to the extent they can offset regarded items of the separate unit, but we caution against affirmatively creating notional items by disaggregating items that are generally disregarded into a regarded deduction and a regarded item of income.

3. Intercompany Transactions

Intercompany transactions generally should be taken into account for purposes of determining the DCL or positive register. If disregarded transactions continue to be ignored in calculating the DCL or positive register, then Treasury should consider requiring consistency to prevent a consolidated group from structuring certain transactions as disregarded payments and others as regarded intercompany payments.

4. All-or-Nothing Rule

Treasury should redefine foreign use such that a partial use of a DCL results in only a partial foreign use, provided that appropriate evidentiary standards are met.

III. SUMMARY OF PROPOSED REGULATIONS

A. Proposed Regulations under Section 267A

Section 267A was added to the Code by the Act. Section 267A addresses hybridity-based deduction/no-inclusion ("**D/NI**") outcomes where a deduction is available for the payor with no corresponding income inclusion for the recipient. An inclusion means an amount included in taxable income that is taxed at the full marginal rate imposed on ordinary income *and* is not offset by an exemption, exclusion, deduction, or credit that is particular to that type of payment (an "**Inclusion**").[6]

Section 267A includes a broad grant of regulatory authority to "issue such regulations or other guidance as may be necessary or appropriate to carry out the purposes of [Section 267A]", including regulations or other guidance on a number of listed issues.[7] The listed issues include conduit arrangements, structured transactions, the tax residence of a foreign entity, and exceptions from Section 267A.[8]

The preamble to the Proposed Regulations (the "**Preamble**") notes that the Proposed Regulations under Section 267A generally address D/NI outcomes that are the result of hybridity,[9] and do not address transactions that produce double-deduction outcomes.[10] The Preamble also notes that Section 267A is intended to be consistent with the approaches taken to address hybrid arrangements in the Code,[11] the Organisation for Economic Co-operation and Development

[6] Prop. Reg. §1.267A-3(a).

[7] Section 267A(e).

[8] *Id.*

[9] *See* Preamble at 67612-67624.

[10] The Preamble states that transactions resulting in double-deduction outcomes are addressed through other provisions, such as the dual consolidated loss rules under Section 1503(d). *See* Preamble at 67615.

[11] E.g., Section 894(c) and the Regulations thereunder. For additional specific US proposals on hybrid-based double non-taxation, see Notice 98-11; Notice 98-35; former Reg. §1.954-9T; Prop. Reg. §1.954-9. For an early broad US proposal on hybrid-based double non-taxation, *see General Explanation of Administration's Revenue Proposals*, February 1998, (the 1998 Green Book) "Prescribe Regulatory Directive to Address Tax Avoidance Through the Use of Hybrids" at 144. The proper response to hybridity and double nontaxation has been a matter of public debate in the United States for over two decades. *See* Leblang, SE. "International Double Nontaxation," *Tax Analysts*, July 14, 1998 (addressing international tax impact of hybrid arrangements); *Cf.* Collins, J., and Shackelford, D. "Writers challenge claim of favorable cross-border taxation." 82 *Tax Notes*, January 4, 1999, at 131 – 34.

("**OECD**") Base Erosion and Profit Shifting ("**BEPS**") project (the "**OECD Recommendations**"),[12] bilateral income tax treaties, and provisions in foreign law.[13]

1. Overview of Categories of Specified Payments Subject To Disallowance

The Proposed Regulations identify the category of deductible payments that are potentially subject to disallowance under Section 267A. These payments are defined in the Proposed Regulations as "**specified payments**" made by a "**specified party**". Specified payments are payments of interest or royalties[14] and what the Proposed Regulations refer to as "**structured payments**", which are certain payments that are presumably considered to be in the nature of interest or royalties, but are not necessarily interest or royalties for other purposes of the Code.[15] A specified party is a US person, a controlled foreign corporation ("**CFC**"), or a US taxable branch.

Prop. Reg. §1.267A-1(b) provides that a deduction by a specified party is disallowed for any specified payment *to the extent that* the specified payment is within any of the following seven

[12] Action 2 of the OECD's BEPS project and two reports issued in connection with Action 2 address and provide recommendations for hybrid and branch mismatch arrangements. *See OECD/G20, Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2: 2015 Final Report* (2015) ("**OECD Hybrid Mismatch Report**") and *OECD/G20, Neutralising the Effects of Branch Mismatch Arrangements, Action 2: Inclusive Framework on BEPS* (2017) ("**OECD Branch Mismatch Report**").

[13] *See* Preamble at 67612 (citing Senate Committee on Finance, Explanation of the Bill, at 384 (November 22, 2017).)).

The Preamble (at 67612) provides:

> The Act's legislative history explains that section 267A is intended to be 'consistent with many of the approaches to the same or similar problems [regarding hybrid arrangements] taken in the Code, the OECD, base erosion and profit shifting projects ("BEPS"), bilateral income tax treaties, and provisions or rules of other countries.' *See* Senate Committee on Finance, Explanation of the Bill, at 384 (November 22, 2017). The types of hybrid arrangements of concern are arrangements that 'exploit differences in the tax treatment of a transaction or entity under the laws of two or more tax jurisdictions to achieve double non-taxation, including long-term deferral.' *Id.* Hybrid arrangements targeted by these provisions are those that rely on a hybrid element to produce such outcomes.

The Senate Finance Committee Explanation referred to (Senate Committee on Finance, Explanation of the Bill, at 384 (November 22, 2017)) reads as follows:

> The Committee believes that hybrid arrangements exploit differences in the tax treatment of a transaction or entity under the laws of two or more tax jurisdictions to achieve double non-taxation, including long-term deferral. The Committee further believes that these types of hybrid arrangements have an overall negative impact on competition, efficiency, transparency and fairness.
>
> The provision matches items of income and expense by denying the deductibility of certain interest and royalty payments or accruals to a hybrid transaction or by, or to, a hybrid entity. The Committee believes that the provision is consistent with many of the approaches to the same or similar problems taken in the Code, the OECD base erosion and profit shifting project, bilateral income tax treaties, and provisions or rules of other countries.

[14] The OECD Recommendations, by contrast, apply to any deductible payment under any arrangement treated as debt, equity or a derivate contract under local law (a "**financial instrument**"), including any transfer of a financial instrument.

[15] Prop. Reg. §1.267A.

categories.[16] Each of the first five categories discussed below is a type of "disqualified hybrid amount" described in Prop. Reg. §1.267A-1(b)(1) and set out in Prop. Reg. §1.267A-2 (the "**Hybrid Payment Rule**"). The next two categories are the remaining categories of specified payments listed in Prop. Reg. §1.267A-1(b).

i. ***Hybrid transaction payment*****:** any specified recipient has a no-inclusion ("**NI**") outcome and that NI results from the specified recipient's tax law not treating the payment as interest or royalty or from the specified recipient's tax law not treating the payment as recognized within 36 months after the taxable year of the payor's deduction.[17] Hybrid element: the transaction is not treated as generating interest or royalty under the recipient's tax law.

ii. ***Disregarded payment:*** the tax resident or taxable branch to which the payment was made has a NI outcome and that NI results from that recipient's tax law disregarding the payment.[18] The NI outcome is taken into account only to the extent that the disregarded deduction exceeds the specified party's "dual inclusion income", or net income of the specified party that is subject to dual inclusion in both the US and in the recipient's jurisdiction.[19] Hybrid element: the transaction is disregarded under the recipient's tax law.

iii. ***Deemed branch payment***: the specified party claiming the deduction is a US taxable branch of a non-US person and the specified payment is a deemed payment of interest or royalties from the branch to the home office which is deemed to be paid pursuant to an applicable tax treaty's provision for computing the branch's US taxable business profits; the non-inclusion results from the fact that the home office does not have a corresponding inclusion under its tax law. Hybrid element: the deemed payment from the branch to the home office is disregarded or otherwise not taken into account under the home office's tax law.

iv. ***Payment to reverse hybrid:*** the recipient is a "reverse hybrid" and any investor in that reverse hybrid has a NI outcome that results from the payment being made to the reverse

[16] Prop. Reg. §1.267A-1(b) provides that a deduction is disallowed for any specified payment to the extent it is (1) a disqualified hybrid amount (there are five categories of these, all defined in Prop. Reg. §1.267A-2), (2) a disqualified imported mismatch amount (defined in Prop. Reg. §1.267A-4), or (3) a specified payment that satisfies the requirements of the anti-avoidance rule of Prop. Reg. §1.267A-5(b)(6).

[17] Prop. Reg. §1.267A-2(a)(1) and (2). For each of the five types of disqualified hybrid amounts, the Proposed Regulations employ a counterfactual test to determine if the NI results from the hybridity. For a hybrid transaction payment, the applicable counterfactual test to determine whether the NI results from hybridity is whether, if the recipient's tax law treated the payment as interest or royalty, there would be an Inclusion.

[18] The tax resident or taxable branch to which payment is made is determined by looking through entities that are fiscally transparent to their owner. Prop. Reg. 1.267A-2(b)(4).

[19] Prop. Reg. §1.267A-2(b). The applicable counterfactual test is whether the NI would not occur if the recipient's tax law regarded the payment.

hybrid.[20] Hybrid element: recipient is transparent where it is organized (i.e., causing NI in that jurisdiction) and opaque to an investor (i.e., causing NI in the investor's jurisdiction).

v. ***Branch mismatch payment:*** the recipient is a branch and both the home office and the branch have NI outcomes that result from the home office, under its tax law, treating the income as attributable to the branch and the branch, under its tax law, not having a taxable presence in its jurisdiction or the income not being treated as attributable to the branch.[21] Hybrid element: the income is taxed in neither the branch nor the home office due to inconsistent rules regarding whether the income is attributable to the branch or home office.

vi. ***Disqualified imported mismatch amount*** (the "**Imported Mismatch Rule**")*:* the recipient has a full inclusion of the interest or royalties but that recipient (or a subsequent recipient of a payment connected through a chain of payments) has a deduction under its tax law that would be denied if that tax law had Section 267A rules.[22] Hybrid element: any of the above hybrid elements.

vii. ***Payment that satisfies the requirements of the anti-avoidance rule of Prop. Reg. §1.267A-5(b)(6):*** a payment or income attributable to a payment is not included in the income of the recipient (without regard to the *de minimis* and full inclusion rules in Prop. Reg. §1.267A-3(a)(4)[23]), and a principal purpose of the plan or arrangement is to avoid the purposes of the Section 267A regulations.[24] Hybrid element: none required.

[20] Prop. Reg. §1.267A-2(d). The applicable counterfactual test is whether the NI would not occur were the investor's tax law to treat the reverse hybrid as fiscally transparent and treat the payment as interest or royalty, as applicable. Prop. Reg. §1.267A-2(d)(1).

"Investor" means a tax resident or taxable branch that directly or indirectly (applying the attribution rules of Section 958(a) but without regard to an entity being foreign or domestic) owns an interest in the entity. Prop. Reg. §1.267A-5(a)(13). The Section 958(a) attribution rule attributes ownership proportionately to shareholders, partners and beneficiaries, with no threshold. Therefore, the "investors" who are tested here are all owners, all the way up the chain, regardless of size of interest and regardless of distance from the payor.

[21] Prop. Reg. §1.267A-2(e). The applicable counterfactual test is to what extent the NI would not occur if the home office's tax law treated the payment as income not attributable to the branch.

[22] Prop. Reg. §1.267A-4.

[23] A preferential rate, exemption, exclusion, deduction, credit, or similar relief that reduces or offsets (i) 10% or less of the payment is considered to reduce or offset none of the payment, or (ii) 90% or more of the payment is considered to reduce or offset 100% of the payment. We note that the Proposed Regulations cite to Prop. Reg. §1.267A-3(a)(3). However, Prop. Reg. §1.267A-3(a)(4) appears to be the correct cross-reference.

[24] Prop. Reg. §1.267A-5(b)(6).

2. Other Significant Rules

a. Taxpayers Excluded From the Rules Under the De Minimis Specified Payments Exception of Prop. Reg. §1.267A-1(c)

The *de minimis* exception exempts taxpayers from the application of Section 267A if the total amount of such taxpayer's interest and royalty deductions by the specified party, in the aggregate, is less than $50,000, without regard to whether the deductions involve hybrid arrangements. For this rule, related specified parties are treated as "a single specified party." A tax resident or taxable branch is related to a specified party within the meaning of Section 954(d)(3) (*i.e.*, generally if such person owns, or is owned by the specified party more than 50% by vote or value),[25] but without the application of downward attribution principles described in Section 318(a)(3) and Reg. §1.958-2(d).[26]

b. Rules Defining What Constitutes an "Inclusion" in Income and a "Non-Inclusion"

As discussed above, an Inclusion means included in taxable income and taxed at the full marginal rate imposed on ordinary income and not offset by an exemption, exclusion, deduction or credit that is particular to that type of payment.[27] A credit for a withholding tax imposed by the source jurisdiction is not considered an offset, but a credit for underlying taxes paid by the corporation from which a dividend is received is. The Inclusion must occur within 36 months after the end of the specified party payor's tax year in order to be considered an Inclusion.[28] A partial

[25] Prop. Reg. §1.267A-5(a)(14) provides: "A tax resident or taxable branch is related to a specified party if the tax resident or taxable branch is a related person within the meaning of section 954(d)(3), determined by treating the specified party as the 'controlled foreign corporation' referred to in that section and the tax resident or taxable branch as the 'person' referred to in that section." Under Section 954(d)(3), a person is a related person with respect to a controlled foreign corporation, if such person is an individual, corporation, partnership, trust, or estate which controls, or is controlled by, the controlled foreign corporation, or such person is a corporation, partnership, trust, or estate which is controlled by the same person or persons which control the controlled foreign corporation." Control is the ownership, directly or indirectly, of stock with more than 50% of the total vote or value of such corporation, or in the case of a partnership, more than 50% by value of such partnership.

[26] In addition, while not specifically pertinent to the *de minimis* exception analysis due to the aggregation of specified parties, a tax resident that is disregarded as separate from its owner pursuant to the Section 7701 regulations is treated as a corporation for purposes of the Section 267A related party rule generally.

[27] Prop. Reg. §1.267A-3(a).

[28] Prop. Reg. § 1.267A-3(a)(i).

Other timing differences, though, may provide a significant and long-term deferral benefit. Moreover, taxpayers may structure transactions that exploit these differences to achieve long-term deferral benefits. Timing differences that result in long-term deferral have an economic effect similar to a permanent exclusion and therefore give rise to policy concerns that Section 267A is intended to address. *See* Senate Explanation, at 384 (expressing concern with hybrid arrangements that "achieve double non-taxation, including long-term deferral."). Accordingly, proposed §1.267A-3(a)(1) provides that short-term deferral, meaning inclusion during a taxable year that ends no more than 36 months after the end of the specified party's taxable year, does not give rise to a D/NI outcome; inclusions outside of the 36-month timeframe, however, are treated as giving rise to a D/NI outcome.

exclusion or taxation at a reduced rate is treated as an Inclusion in part to the extent of the included portion. A *de minimis* and full inclusion rule rounds down for 10% or less and rounds up for 90% or more.[29]

The Proposed Regulations include a kick-out (the "**US Inclusion Kick-out Rule**") reducing the disqualified hybrid amount when a US tax resident or taxable branch takes the payment into income[30] or when a US shareholder[31] of a CFC includes a specified payment in income under either Sections 951 or 951A.[32] The determination of whether a recipient has an Inclusion is determined without regard to any foreign law hybrid mismatch "defensive" income-inclusion rule (i.e., a provision requiring the recipient to include an amount in income if a hybrid deduction is not disallowed under the payor's tax law).[33] An investor's Inclusion with respect to a reverse hybrid is determined without regard to distributions by the reverse hybrid to the investor.[34]

B. Proposed Regulations under Section 245A(e)

Section 245A was added to the Code by the Act. In general, Section 245A provides for a 100% dividends received deduction (the "**participation exemption**") with respect to the "foreign-source portion" of any dividend received from a "specified 10-percent owned foreign corporation" ("**STFC**") by a domestic corporation that is a US shareholder with respect to such STFC. Section 245A is a critical component of the Act's new modified territorial tax system for income earned by foreign subsidiaries of domestic corporations. The participation exemption is disallowed in the case of "hybrid dividends," which generally are amounts received from a CFC that would otherwise qualify for the participation exemption and for which the CFC received a deduction (or other tax benefit) with respect to any taxes imposed by any foreign country.[35] The rule is intended

[29] Prop. Reg. §1.267A-3(a)(4).

[30] For example, if the US tax resident is a partner in a specified recipient that is treated as a partnership for US tax purposes.

[31] A "US shareholder" means, with respect to any foreign corporation, a US person (as defined in Section 957(c)) who owns (within the meaning of Section 958(a)), or is considered as owning by applying the rules of ownership of Section 958(b), 10% or more of the total combined voting power of all classes of stock entitled to vote of such foreign corporation, or 10% or more of the total value of shares of all classes of stock of such foreign corporation. *See* Section 951(b).

[32] Prop. Reg. §1.267A-3(b). Unlike the Inclusion rule with respect to multiple foreign recipients, an inclusion by a US taxpayer is sufficient to prevent application of the disallowance rule without regard to whether there is a NI result in the specified recipients' jurisdiction(s).

[33] Prop. Reg. §1.267A-3(a)(2).

[34] Prop. Reg. §1.267A-3(a)(3).

[35] Section 245A(e)(4). This approach to hybrid dividends is consistent with the recommendation made under the OECD Hybrid Mismatch Report. The OECD proposes that, in the case of a hybrid dividend (i.e., a payment that is deductible in the payor jurisdiction but treated as an exempt dividend in the payee jurisdiction) the primary rule be that the payee jurisdiction should not grant an exemption for the dividend. *See id.*, Recommendation 2, Example 1.1. If the payee jurisdiction does grant an exemption, the payor jurisdiction may invoke the "defensive rule" and deny the

to prevent the "double non-inclusion"[36] of income in both the payor and payee jurisdictions.[37] In addition, a hybrid dividend received by one CFC from another CFC (where a domestic corporation is a US shareholder with respect to both CFCs)—so-called "tiered corporations"—is treated as subpart F income of the receiving CFC, resulting in a pro-rata income inclusion for the US shareholder.[38] Foreign tax credits and deductions are disallowed for foreign taxes paid or accrued with respect to (i) any dividend qualifying for the participation exemption,[39] or (ii) hybrid dividends and amounts included in gross income as tiered hybrid dividends.[40] Finally, Section 245A(g) gives the Secretary broad authority to prescribe regulations or other guidance that are necessary or appropriate to carry out the provisions of Section 245A, including regulations related to hybrid dividends. This grant of authority is in addition to the Secretary's general authority[41] and gives Treasury and the IRS broad latitude to provide guidance and clarification with respect to Section 245A.[42]

As mentioned, the Proposed Regulations provide that if a domestic corporation that is a US shareholder of a CFC receives a ''hybrid dividend'' from the CFC, then the US shareholder is not allowed the participation exemption for the hybrid dividend and no credit is allowed for any foreign taxes paid or accrued with respect to the hybrid dividend.[43] For this purpose, a hybrid dividend is an amount received by a US shareholder from a CFC for which the US shareholder would otherwise be allowed the participation exemption, but only to the extent of the sum of the US shareholder's "hybrid deduction accounts" with respect to each share of stock of the CFC.[44] The Proposed Regulations provide certain rules related to the maintenance of such hybrid deduction accounts.[45]

deduction. *See id.*, Recommendation 1, Example 1.1. The aim of these two rules is to achieve inclusion of the amount at least once and to prevent the shifting of profits from one jurisdiction to another. *See id.*, Recommendation 1.

[36] *See id.*, Recommendation 3; Nicolaus McBee & Ken Brewer, *U.S. International Tax Reform: The Good, the Bad, and the GILTI*, 159 TAX NOTES 839, 840 (2017) (noting that the design "clearly applies to traditional stock instruments when the payor is a resident of a country that allows a deduction for dividends paid").

[37] *See* H.R. Rep. No. 115-466 at 600 (2017) (Conf. Rep.) [hereinafter "**Conference Committee Report**"].

[38] Section 245A(e)(2).

[39] Section 245A(d).

[40] Section 245A(e)(3).

[41] *See* Section 7805(a) ("the Secretary shall prescribe all needful rules and regulations for the enforcement of this title").

[42] The explicit grant of authority has been deemed to grant Treasury broad discretion to act within the delegation of rulemaking authority. *See, e.g.*, *Hardy Wilson Memorial Hosp. v. Sebelius*, 616 F.3d 449, 457-58 (5th Cir. 2010); *Lantz v. Comm'r*, 607 F.3d 479, 486 (7th Cir. 2010); *Rowan Cos., Inc. v. United States*, 452 U.S. 247, 253 (1981).

[43] Prop. Reg. §1.245A(e)-1(b)(1).

[44] Prop. Reg. §1.245A(e)-1(b)(2).

[45] *See generally* Prop. Reg. §1.245A(e)-1(d)(4).

A hybrid deduction account with respect to a CFC reflects the amount of "hybrid deductions" of the CFC that are allocated to the shares of such CFC held, directly or indirectly, by the US shareholder.[46] A hybrid deduction is a deduction or other tax benefit (such as an exemption, exclusion, or credit, to the extent equivalent to a deduction) for which: (i) the deduction or other tax benefit is allowed to the CFC (or a person related to the CFC) under a relevant foreign tax law; and (ii) the deduction or other tax benefit relates to or results from an amount paid, accrued, or distributed with respect to an instrument issued by the CFC and treated as stock for US tax purposes.[47] In this regard, the Proposed Regulations provide that examples of such deductions or other tax benefit include an interest deduction, a dividends paid deduction, and a deduction with respect to equity (such as a notional interest deduction).[48] However, a deduction or other tax benefit relating to or resulting from a distribution by the CFC with respect to an instrument treated as stock for purposes of the relevant foreign tax law is considered a hybrid deduction only to the extent it has the effect of causing the earnings that funded the distribution to not be included in income or otherwise subject to tax under the CFC's tax law.[49]

In addition, as mentioned, if a CFC receives a hybrid dividend from another CFC—a "tiered hybrid dividend"—and a domestic corporation is a US shareholder of both CFCs, then (i) the gross amount of the tiered hybrid dividend is treated as subpart F income of the receiving CFC (notwithstanding any other provision, such as Section 954(c)(6)), (ii) the US shareholder must include in gross income its pro rata share of that subpart F income, and (iii) no credit or deduction is allowed for any foreign taxes paid or accrued with respect the tiered hybrid dividend.[50] A tiered hybrid dividend means an amount received by a receiving CFC from another CFC to the extent that the amount would be a hybrid dividend described in the Proposed Regulations if the receiving CFC were a domestic corporation.[51] Notably, even though distributions of amounts described in Section 959(b) ("**PTI distributions**") received by a CFC still appear to be dividends for US federal tax purposes (i.e., Section 959(d) provides that a PTI distribution is not a dividend if it is made to a US shareholder), PTI distributions are not considered tiered hybrid dividends.

The Proposed Regulations apply to distributions after December 31, 2017.[52] A deduction or other tax benefit allowed to a CFC (or a person related to the CFC) under a relevant foreign tax

[46] Prop. Reg. §1.245A(e)-1(d)(1).

[47] Prop. Reg. §1.245A(e)-1(d)(2)(i).

[48] *Id.*

[49] *Id.*

[50] Prop. Reg. §1.245A(e)-1(c)(1).

[51] Prop. Reg. §1.245A(e)-1(c)(2).

[52] Prop. Reg. §1.245A(e)-1(h).

law is taken into account as a hybrid deduction only if it was allowed with respect to a taxable year under the relevant foreign tax law beginning after December 31, 2017.[53]

C. Proposed Regulations under Section 1503(d)

The dual consolidated loss ("**DCL**") rules of Section 1503(d) were enacted as part of the Tax Reform Act of 1986.[54] The policy goal of the DCL rules is to prevent losses used to reduce foreign tax on income not taxed in the US from also being used to reduce US tax (i.e., a double-deduction outcome).[55] The following example demonstrates the double-deduction outcome that the DCL rules are designed to mitigate:

Example 1:

USP, a domestic corporation, is the parent of a US consolidated group. USP wholly owns FDRE, a foreign entity that is treated as a corporation in its jurisdiction of incorporation but is disregarded as an entity separate from USP for US federal income tax purposes. FDRE owns foreign corporation CFC, and FDRE and CFC are members of a foreign consolidated group. During the taxable year, USP and CFC each earn $100 of income, and FDRE generates ($100) of loss.

Without the DCL regime, the ($100) of loss generated by FDRE reduces USP's income to zero for US tax purposes, and also reduces CFC's income to zero for foreign tax purposes. Thus, as described below, the DCL rules generally prohibit the domestic use of FDRE's DCL of ($100), and thus require FDRE to earn $100 of income to unlock the ($100) loss.

In 2007, Treasury issued final DCL regulations (the "**2007 DCL Regulations**")[56] under Section 1503(d), which were the subject of a previous NYSBA report (the "**Final DCL Regulations Report**").[57] The 2007 DCL Regulations finalized, with changes, proposed regulations released in May 2005 (the "**2005 Proposed DCL Regulations**").[58] The 2005 Proposed DCL Regulations also were the subject of a previous NYSBA report (the "**Proposed DCL Regulations Report**").[59]

[53] Prop. Reg. §1.245A(e)-1(d)(2)(ii).

[54] P.L. 99-514, section 1249(a).

[55] S. Rep. 313, 99th Cong., 2d Sess., at 419-20 (1986).

[56] TD 9315, 72 FR 12902-01 (Mar. 19, 2007).

[57] New York State Bar Association Tax Section Report No. 1144, *Report on Final Dual Consolidated Loss Regulations* (January 23, 2008).

[58] 70 FR 29868-01 (May 24, 2005).

[59] *See* New York State Bar Association Tax Section Report No. 1100, *Report on Proposed Dual Consolidated Loss Regulations* (December 21, 2005). DCL issues were also addressed in New York State Bar Association Tax Section

Fundamentally, the DCL rules restrict double utilization of a loss (i.e., "double-dipping") to reduce both US tax on US income of a US corporation and foreign tax on foreign income of a foreign corporation. The rules thus prevent a single economic loss from offsetting two separate streams of economic income. Section 1503(d) and the Regulations thereunder generally provide that, unless an exception applies, a DCL of a hybrid entity or dual resident corporation cannot reduce the taxable income of the direct or indirect US owners (or consolidated group members) of the entity incurring the DCL (other than attributable to income of the entity that incurred the DCL) (such reduction, a "**domestic use**",[60] and the prohibition of using the DCL, the "**domestic use limitation**").[61]

A DCL is defined as a net operating loss of a dual resident corporation or the net loss attributable to a separate unit.[62] A separate unit is generally defined as a foreign branch or an interest in a hybrid entity.[63] Under Reg. §1.1503(d)-3(b)(3), a hybrid entity for purposes of Section 1503(d) is an entity that is not taxable as a corporation for US federal income tax purposes but is taxable as a corporation (or at the entity level) under foreign law.

If a DCL is subject to the domestic use limitation, the DCL is treated as a loss incurred in a separate return limitation year ("**SRLY**").[64] The DCL is subject to the SRLY rules of Reg. §1.1502-21(c), as modified by Reg. §1.1503(d)-4,[65] and may be carried forward or back for use in other taxable years. For this purpose, a separate unit is treated as a separate domestic corporation.[66] In general, the SRLY rules of Reg. §1.1502-21(c) provide that the aggregate amount of a member's SRLY net operating loss absorbed by a consolidated group may not exceed the member's cumulative contribution to the consolidated group's consolidated taxable income (i.e., the positive balance of the member's cumulative SRLY register). The cumulative SRLY register concept from Reg. §1.1502-21(c) applies to DCLs subject to the domestic use limitation.[67]

There are a number of exceptions to the domestic use limitation. One of the primary exceptions is if a domestic use election agreement is filed pursuant to Reg. §1.1503(d)-6(d). Generally, in making a domestic use election, the owner of the dual resident corporation or separate

Report No. 1004 (January 15, 2002), *Report on Proposed Regulations Under Section 894 Regarding Payments Made by Reverse Hybrid Entities* (the "**2002 Report**").

[60] Reg. §1.1503(d)-2.

[61] Reg. §1.1503(d)-4(b).

[62] Reg. §1.1503(d)-1(b)(5).

[63] Reg. §1.1503(d)-1(b)(4).

[64] Reg. §1503(d)-4(c)(3).

[65] *Id.*; Reg. §1.1503(d)-4(c)(1) and (2).

[66] Reg. §1.1503(d)-4(c)(2). As discussed below in Part IV.C., there may be some limits on the extent to which the separate unit is treated as a separate corporation.

[67] *See* AM 2011-002 (Aug. 1, 2011).

unit certifies that there has not been and will not be a “foreign use” of the DCL during a certification period (i.e., that no double-deduction result has occurred or will occur).[68] A foreign use of a DCL occurs when *any portion* (this reference to “any portion” is discussed below) of the DCL is made available under foreign tax laws to offset or reduce, directly or indirectly, income or gain of a foreign corporation (or certain hybrid entities).[69] Foreign use also includes “indirect use”, which is considered to occur if, with a principal purpose of avoiding the DCL rules, one or more items are taken into account as deductions or losses for foreign tax purposes but do not give rise to corresponding items of income or gain for US tax purposes, and such foreign tax deduction has the effect of making an item of deduction or loss composing the DCL available for a foreign use.[70]

A foreign use during the certification period is a triggering event with respect to a DCL,[71] and requires the US owner to recapture the DCL and report it as ordinary income.[72] Furthermore, the domestic use election is unavailable if there is a triggering event in the year the DCL is incurred.

The fact that a foreign use, and thus a DCL triggering event, arises when “any portion” of a DCL is made available under foreign tax law, is often referred to as the “**All-or-Nothing Rule**”. Under the All-or-Nothing Rule, if foreign tax law makes available even a small fraction of the DCL, this constitutes a foreign use of (and triggering event with respect to) the entire DCL. The triggering event results in the inability to make a domestic use election (i.e., the entire DCL is subject to the domestic use limitation and thus the SRLY limitation) or, in the case a domestic use election was previously made with respect to the DCL, the recapture of the entire DCL as ordinary income.

IV. Discussion and Recommendations

A. Section 267A

The Proposed Regulations adopt an expansive approach to the scope of Section 267A by covering a series of hybrid arrangements that are not specifically covered by the language of Section 267A(a) through (d). Sections 267A(a) through (d) by their terms only describe two (a “hybrid transaction payment” and a “payment to a reverse hybrid”) of the seven categories of specified payments discussed above.

[68] The certification period is the period of time up to and including the fifth taxable year following the year in which the DCL that is the subject of a domestic use agreement was incurred. Reg. §1.1503(d)-1(b)(20).

[69] Reg. §1.1503(d)-3(a)(1).

[70] Reg. §1.1503(d)-3(a)(2).

[71] Reg. §1.1503(d)-6(e)(i).

[72] Reg. §1.1503(d)-6(e).

The expansive approach of the Proposed Regulations appears to reflect the approach taken by the OECD in the OECD Recommendations. In addition, the approach seems to reflect the scope envisioned by Congress as evidenced by the arrangements referred to in the grant of regulatory authority under Section 267A(e) and the legislative history to Section 267A.[73] Each of the five additional categories of specified payments discussed above are rooted therein.

We acknowledge that there are reasonable policy arguments that can be made for a narrower approach to the anti-hybrid rules.[74] However, we also acknowledge that, with the enactment of Section 267A (including its broad grant of regulatory authority in Section 267A(e) and the broad scope of the Regulations to be issued thereunder envisioned under the commentary in the "Blue Book" prepared by the Joint Committee on Taxation[75]), as well as the broad approach taken in the Proposed Regulations themselves, the time to debate whether a significantly more limited approach is appropriate probably has passed. Accordingly, this Report proceeds on the basis that the overall scope of the Proposed Regulations as a policy matter has been settled as a general matter, and will instead focus on whether and how the specific rules in the Proposed Regulations can be improved.

1. The Multiple Specified Recipients Rule Applicable to Hybrid Transaction Payments

Under the Proposed Regulations, a hybrid transaction payment exists to the extent that *any* "specified recipient" has a NI outcome. This results in a rule that we are calling the "Multiple Specified Recipients Rule" (defined more specifically below).[76]

[73] As discussed above in Part III.A, Section 267A is intended to be consistent with many of the approaches taken to address hybrid arrangements, such as provisions already in the Code, the OECD Recommendations, bilateral income tax treaties, and foreign law. *See* Senate Committee on Finance, Explanation of the Bill, at 384 (November 22, 2017).

[74] For example, it could be argued that anti-hybrid Regulations should be narrowly circumscribed because they are an exception to the general rule of clear reflection of income of taxpayers subject to US taxation, applying US tax principles. Another argument in favor of a more limited scope could stem from a concern that broad new rules in a complex area being addressed for the first time more likely will lead to unintended applications and, therefore, an incremental approach may be appropriate.

[75] Staff, Joint Committee on Taxation, *General Explanation of Public Law 115-97*, Part I – Outbound Transactions, at 389-391 (JCS- 1-18 NO 21) (2018).

[76] This discussion below only covers multiple recipient fact patterns that occur under the hybrid transaction rule in Prop. Reg. §1.267A-2(a) due to inclusions by multiple "specified recipients." Similar concerns about multiple recipients may exist in other parts of the Proposed Regulations (e.g., anti-deferral inclusions by recipients that do not meet the definition of a specified recipient because they hold through an opaque entity) and, to the extent that final regulations change the Multiple Specified Recipients Rule, Treasury and the Service should consider implementing similar changes in these areas.

The determination as to who the "specified recipient(s)" are (and whether each of them has an Inclusion[77]) is defined by reference to the applicable foreign tax law regime (or regimes). Prop. Reg. §1.267A-5(d)(19) defines a "specified recipient" as:

> "any tax resident that derives the payment under its tax law or any taxable branch to which the payment is attributable under its tax law. The principles of Reg. §1.894-1(d)(1) apply for purposes of determining whether a tax resident derives a specified payment under its tax law, without regard to whether the tax resident is a resident of a country that has an income tax treaty with the United States. There may be more than one specified recipient with respect to a specified payment."

Under Reg. §1.894-1(d)(1), any entity "derives" an item of income if the income is paid to the entity and the entity is not fiscally transparent under the laws of the entity's jurisdiction, as defined in Reg. §1.894-1(d)(3)(ii), with respect to the item of income; and an interest holder in that entity derives that item of income if the entity is considered to be fiscally transparent under the laws of the interest holder's jurisdiction with respect to the item of income, as defined in Reg. §1.894-1(d)(3)(iii), and the interest holder is not fiscally transparent in its jurisdiction with respect to the item of income. An entity or interest holder's "jurisdiction" for this purpose is the jurisdiction where it is organized or is otherwise considered a resident under that jurisdiction's laws.[78]

Applying these rules to determine the specified recipients of a payment of interest or royalties to an entity: (i) the *entity* is a specified recipient if the entity is not fiscally transparent with respect to the income in its tax residency jurisdiction (i.e., the entity is treated under that tax law as a taxpayer) and (ii) *any interest holder* in the entity is a specified recipient if, under the interest holder's tax residency jurisdiction, the entity is fiscally transparent (and the interest holder is not). Thus, there could be multiple specified recipients of the same payment. For example, both the entity receiving the payment and one or more direct or indirect owners of interests therein can be specified recipients of the payment because they each are treated as deriving the payment under their respective tax laws.

This is significant because under the Proposed Regulations, if *any* specified recipient has a NI outcome with respect to the payment and the NI results from the payment not being treated as interest or a royalty under that specified recipient's tax law, the payment is a nondeductible hybrid transaction payment to the extent of the NI (the "**Multiple Specified Recipients Rule**").[79]

[77] As discussed above, a specified recipient generally has an Inclusion with respect to a specified payment if, in the jurisdiction in which it is taxed as a resident (and there could be more than one), it includes the payment in its tax base and is taxed at the full marginal rate applicable to ordinary income.

[78] Reg. §§1.894-1(d)(3)(ii)(B) and (iii)(B).

[79] If there is no specified recipient of a payment of interest or royalty under the Section 894 rules because the entity receiving the payment is transparent in its jurisdiction and the interest holders' jurisdictions see the entity as opaque, then the hybrid transaction payment rule is not the applicable rule; instead, the payment to a reverse hybrid rule applies.

This means that foreign tax law determines which foreign tax law and which persons are relevant, and a less than full inclusion at the highest rates applicable to ordinary income in any one relevant foreign jurisdiction causes Section 267A to apply to the specified party payor *even if* the payment is fully taxed in a different jurisdiction.

The OECD Recommendations incorporate the opposite rule, providing that the inclusion in any single jurisdiction satisfies the Inclusion requirement. The OECD Recommendations place the onus on the taxpayer to establish that there has been an inclusion by the direct recipient of the payment or, because of the transparency of the direct recipient, by the owner of that entity; and, if there are multiple possible recipients (e.g., in the case of a payment received by a Country A branch of a Country B corporation), the inclusion by any one of them will establish the required Inclusion outcome.[80]

The Preamble explains the reasoning behind the proposed Multiple Specified Recipients Rule primarily by providing an illustration of a result that the drafters viewed as inappropriate:

> The proposed regulations provide that a specified payment is a disqualified hybrid amount if a D/NI outcome occurs as a result of hybridity in any foreign jurisdiction, even if the payment is included in income in another foreign jurisdiction…. Absent such a rule, an inclusion of a specified payment in income in a jurisdiction with a (generally applicable) low rate might discharge the application of section 267A even though a D/NI outcome occurs in another jurisdiction as a result of hybridity.
>
> For example, assume FX, a tax resident of Country X, owns US1, a domestic corporation, and FZ, a tax resident of Country Z that is fiscally transparent for Country X tax purposes. Also, assume that Country Z has a single, low-tax rate applicable to all income. Further, assume that FX holds an instrument issued by US1, a $100x payment with respect to which is treated as interest for U.S. tax purposes and an excludible dividend for Country X tax purposes. In an attempt to avoid US1's deduction for the $100x payment being denied under the hybrid transaction rule, FX contributes the instrument to FZ, and, upon US1's $100x payment, US1 asserts that, although a $100x no-inclusion occurs with respect to FX as a result of the payment being made pursuant to the hybrid transaction, the payment is not a disqualified hybrid amount because FZ fully includes the payment

[80] *See* OECD Hybrid Mismatch Report, Paragraphs 89, 90, 417 and 418; and Example 1.8 ("A D/NI outcome will only arise where a payment that is deductible under the laws of one jurisdiction (the payer jurisdiction) is not included in ordinary income under the laws of any other jurisdiction where the payment is treated as being received (the payee jurisdiction).")

in income (albeit at a low-tax rate). The proposed regulations treat the payment as a disqualified hybrid amount.[81]

Prop. Reg. §1.267A-6(c) *Example 1(iii)* addresses the same FX-FZ-US1 structure, but omits the tax-avoidance-motivated transfer from FX to FZ by instead simply positing that FZ owns the instrument at the time the payment is made. The Example concludes that the payment is a disqualified hybrid amount regardless of whether Z has a high or low tax rate.

The Preamble requests comments on the Multiple Specified Recipients Rule as follows: "The Treasury Department and IRS request comments on whether an exception should apply if the specified payment is included in income in any foreign jurisdiction, taking into account accommodation transactions involving low-tax entities."[82]

The concern expressed in the Preamble is important and the rules should not be vulnerable to being avoided by the simple expedient of inserting a tax-haven-based entity that has no significance or impact apart from avoiding Section 267A. We believe, however, that the Multiple Specified Recipients Rule is not the appropriate mechanism for addressing that concern.

First, the Multiple Specified Recipients Rule does not effectively prevent that type of avoidance because it applies only if the tax-haven based entity is transparent under the laws of the investor's jurisdiction; if the tax-haven based entity is treated as a corporation under the laws of the investor's jurisdiction, then the investor is not "deriving" the income under the Section 894 Regulations (so the non-inclusion by the investor is no longer relevant) and the absence of a corporate income tax in the tax haven does not cause the Section 267A disallowance to apply (because the non-inclusion does not result from the tax-haven treating the payment as something other than interest or a royalty).[83] In this manner, the Multiple Specified Recipients Rule seems unfair and inequitable because it requires an inclusion in more than one jurisdiction in some fact patterns but not in others, and the factual differences that trigger the requirement of the additional

[81] Preamble at 67619.

[82] Preamble at 67619.

[83] The tax-haven corporation is a "tax resident" (i.e., an entity that can be a specified recipient) because the Proposed Regulations define that term as: "A body corporate or other entity or body of persons liable to tax under the tax law of a country as a resident. For this purpose, a body corporate or other entity or body of persons may be considered liable to tax under the tax law of a country as a resident even though such tax law does not impose a corporate income tax." Prop. Reg. §1.267A-5(a)(23). The tax haven corporation does not have an Inclusion because the Proposed Regulations define what it means for a tax resident to have an Inclusion as follows: "a tax resident … includes in income a specified payment to the extent that, under the tax law of the tax resident…[i]t includes … the payment in its income or tax base at the full marginal rate imposed on ordinary income". Prop. Reg. §1.267A-3(a)(1). However, that NI does not result from the different characterization of the payment. Hence the requirement for the NI to result in a hybrid transaction payment is not met.

The OECD Recommendations address payments to tax haven entities the same way, with a more extensive discussion such that the result is clearer. *See* OECD Hybrid Mismatch Report, Paragraph 89; 384, 398, 418 and 425 and Examples 1.6 and 1.8. *See also id.* Example 1.7 (the payee jurisdiction exempts all foreign source income – so there is a mismatch but it is not attributable to the instrument).

inclusion(s) do not relate to the types of hybrid mismatches that the Proposed Regulations are focused on: that is, the factual differences relate to the hybrid treatment of the recipient entity and not the hybrid treatment of the payment that is generating the US tax deduction.

Second, the reliance on the rules in Reg. §1.894-1(d) itself indicates why this approach does not "fit" in the Section 267A context. The Section 894 Regulations establish a condition that must be met in order for a non-US person to obtain a *benefit* under a tax treaty with respect to an item of US source income. That is, those rules apply when a non-US person is seeking a reduced US tax rate (or exemption from a US tax) imposed on US source income received by that person through a hybrid entity by claiming the benefits of a tax treaty. Consistent with the contracting jurisdictions' intentions and global treaty policy, the pre-condition to receiving the treaty benefits is proving that the person who is a tax resident of the treaty partner is seen by that treaty partner's law as the recipient of the US source payment. Thus, the Section 894 Regulations aim to establish that the person claiming to be the recipient is in fact the recipient in the way the treaty requires.[84] The Section 267A rules have a different focus: they are asking whether the single deduction in the US should be *disallowed* because it is not matched by an inclusion in a non-US jurisdiction. For Section 267A purposes, it does not matter where the inclusion is or what the tax rate in that jurisdiction is. Therefore, it is inconsistent with the policies of Section 267A to look beyond the direct recipient if that direct recipient has an inclusion. The OECD approach treats an inclusion at the level of the direct recipient as sufficient and if there is no inclusion at that level permits the taxpayer to establish that there was an inclusion at the investor level. This approach conforms better to the policies of Section 267A than the Multiple Specified Recipients Rule.

Third, and perhaps most important, the Multiple Specified Recipients Rule is inconsistent with the underlying rationale motivating the hybrid mismatch rules. The OECD Recommendations were the outgrowth of an international consensus that D/NI outcomes (along with double deduction outcomes) were harmful to the international economy and should be prevented through international cooperation and a coordinated consistent response. Requiring an inclusion in multiple jurisdictions is not necessary or appropriate to prevent a D/NI outcome and is at odds with what the OECD countries have recommended as the coordinated consistent response.

We recognize that the Multiple Specified Recipients Rule requires an inclusion in ordinary income at the investor level only if the investor's tax jurisdiction treats the investor as the recipient. Thus, inclusion at two levels is required under the Multiple Specified Recipients Rule only when the investor has chosen a structure where the direct recipient is treated as opaque in its jurisdiction but transparent in the investor's jurisdiction. It is arguably fair to require the investor to establish that the investor is not benefitting from the investor's jurisdiction treating the specified payment

[84] *See* T.D. 8889 (65 F.R. 40993, June 2000) (Preamble to Reg. §1.894-1(d) discussing the policy and that the rules reflect international consensus as reflected in an OECD report).

as something other than interest or a royalty and because of that difference providing a tax benefit to the investor with respect to that payment. However, on balance, we believe that the support for following the OECD approach outweighs the support for the Multiple Specified Recipients Rule. Accordingly, our recommendation is that the Multiple Specified Recipients Rule be replaced with the OECD's approach to defining what constitutes an Inclusion.

Turning back to the Preamble's example of an avoidance-motivated transfer to a hybrid tax-haven entity, discussed above, even if the Multiple Specified Recipients Rule is retained, it will not prevent an avoidance-motivated interposition of a tax haven entity that is opaque in the owner's jurisdiction. By the same token, under our approach the proposed Anti-Avoidance Rule could monitor such situations, because the Anti-Avoidance Rule applies if "a principal purpose of the plan or arrangement is to avoid the purposes of the regulations under section 267A". This approach seems preferable to the retention of the Multiple Specified Recipients Rule as a way of responding to the interposition of tax-haven entities as an avoidance mechanism.[85]

We have also considered several middle-ground approaches. Such approaches would retain the Multiple Specified Recipients Rule but would measure the existence and extent of a NI outcome by taking into account the rates of foreign tax imposed on all specified recipients of the same payment. Under such a rule, the existence of more than one recipient would trigger a further analysis of the applicable tax rates imposed on all specified recipients of the payment. One approach would be a proportionate disallowance based upon a comparison of the cumulative rate of tax imposed on the payment as compared to the tax rate of the US taxpayer claiming the deduction. A second approach would be to provide a proportionate disallowance based upon the rate of tax paid by the hybrid entity as compared to the rate imposed on ordinary income by the jurisdiction of the investor who is also a specified recipient. A third approach would be to provide that there is no disallowance as long as the cumulative effective rate of taxation of the specified payment taking into account all applicable jurisdictions is at least equal to the GILTI effective tax rate of 10.5% or the aggregate maximum US and foreign effective tax rate on GILTI of 13.125%; and where such minimum effective tax rate is not achieved, there would be full (or partial) disallowance.

Each of these approaches introduces a significant degree of complexity, but these approaches would still be preferable to the Multiple Specified Recipients Rule and the burden would be on the taxpayer to establish the necessary facts.

[85] Additional analysis of the Anti-Avoidance Rule is provided below in Part IV.A.5.a.

2. Structured Arrangements

Section 267A by its terms applies only to deductions arising from a transaction with a "related party".[86] A "related party" is one that controls or is controlled by the payor or is controlled by the same person or persons, with "control" meaning ownership of more than 50% of the voting stock of a corporation or more than 50% of the value of the interests in a partnership, trust or estate.[87] The regulatory grant in Section 267A(e) specifically authorizes extending the rules to structured arrangements not otherwise covered by the statutory definitions.[88] The Proposed Regulations' "**Structured Arrangements Rule**" applies the anti-hybrid rules[89] to transactions between unrelated parties if the specified payment is made pursuant to a "structured arrangement."[90]

Before addressing the specifics of the Structured Arrangements Rule and our related recommendations, we note that the legislative history does not provide any specific guidance regarding the manner in which the statute should apply beyond related party transactions, including whether any such application should or must match the OECD Recommendations. Consistent with this, the effective date of the Structured Arrangement Rule is tax years beginning on or after the date the Proposed Regulations are published in the Federal Register, whereas the remainder of the rules are generally applicable to tax years beginning after December 31, 2017.[91]

a. The Details of the Structured Arrangements Rule and Comparison to the OECD Recommendation

The Structured Arrangements Rule is derived from the OECD Recommendations, which use the same term, although the Proposed Regulations define (and apply) the term somewhat

[86] Section 267A(b)(1). The "specified payment" must be paid or accrued to a related party and that related party must have a non-inclusion or deduction.

[87] Section 954(d)(3); Section 267A(b)(2). Control is determining applying constructive ownership but not by way of downward attribution. *See* Prop. Reg. §1.267A-5(a)(14).

[88] Section 267A(e)(3) reads: "(e) Regulations. -- The Secretary shall issue such regulations or other guidance as may be necessary or appropriate to carry out the purposes of this section, including regulations or other guidance providing for --…(3) rules for treating certain structured transactions as subject to subsection (a)." The term used in this regulatory grant is "structured transactions", which is also the term used in the legislative history. The Proposed Regulations use two different, but similar terms, and both are used to extend the statute and there can be some confusion. The term 'structured transaction" is used in the Proposed Regulations to define the types of interest-like and royalty-like payments that will be treated as "specified payments" (even though they are not actual interest or royalties for other tax purposes), and the term "structured arrangement" is used to define the types of transactional arrangements between unrelated parties that will be subject to Section 267A(a) even though the statutory requirement that the parties are related is not met. We believe that both of these extensions are adequately supported by the broad regulatory authority grant in Section 267A(e).

[89] This extension does not apply in the case of deemed branch payments because those payments by definition always involve a home office and branch of that home office. *See* Prop. Reg. §1.267A-2(c)(2).

[90] Prop. Reg. §1.267A-2(f).

[91] Prop. Reg. §1.267A-7(a).

differently than the OECD Recommendations. (We address these differences below.) The Preamble and the Special Analyses of the Proposed Regulations provided by the Office of Management and Budget's Office of Information and Regulatory Affairs (the "**OIRA Special Analyses**")[92] (set out immediately following the Preamble) indicate that the extension beyond related-parties was considered important to prevent taxpayers from designing structures that would create the tax avoidance results that Section 267A was aimed at curtailing:

> "[T]he Treasury Department and the IRS are aware that some hybrid arrangements involving unrelated parties are designed to give rise to a D/NI outcome and therefore present the policy concerns underlying section 267A. Furthermore, it is likely that in such cases the specified party will have, or can reasonably obtain, the information necessary to comply with section 267A….
>
> The statute, as written, does not apply to certain hybrid arrangements…. The exclusion of these arrangements could have large economic and fiscal consequences due to taxpayers shifting tax planning towards these arrangements to avoid the new anti-abuse statute. The proposed regulations close off this potential avenue for additional tax avoidance by applying the rules of section 267A to … certain transactions with unrelated parties that are structured to achieve D/NI outcomes….
>
> Without accompanying rules to cover branches, structured arrangements, imported mismatches, and similar structures, the statute would be extremely easy to avoid, a pathway that is contrary to Congressional intent."[93]

These statements address the reasons for the Structured Arrangements Rule, but do not elaborate on the reasons for the rule having the terms it does or the reasons for those terms following the OECD Recommendations in part and departing from the OECD Recommendations in part. While it is clear that the Proposed Regulations' drafters started with the OECD Recommendations, it is not clear why they departed from them in the way that they did. The main difference is that the OECD Recommendations use an objective test that does not require establishing the actual motivations or intentions of any of the parties, whereas the Proposed Regulations introduce a subjective actual purpose test. Because our recommendation is to revise the Proposed Regulations to more closely match the OECD approach, we set out here a comparison of the two approaches.

The Proposed Regulations. The Proposed Regulations provide that the relatedness requirement does not apply if "a specified recipient, a tax resident or taxable branch to which a

[92] *See* 83 FR 67612-01 (Dec. 28, 2018), at 67624-67632.

[93] Preamble at 67618 and OIRA Special Analyses at 67627.

specified payment is made, an investor, or a home office... is a party to a structured arrangement… pursuant to which the specified payment is made."[94] The Proposed Regulations define a "structured arrangement" as "an arrangement" where *either* of the following is true (the "**Structured Arrangement Test**"):

(i) "[t]he hybrid mismatch is priced into the terms of the arrangement" (the "**Pricing Test**") *or*

(ii) "[b]ased on all the facts and circumstances, the hybrid mismatch is a principal purpose of the arrangement" (the "**Principal Purpose Test**").[95]

The Proposed Regulations do not provide any specific definition for the term "arrangement" or for what it means to be a "party" to a structured arrangement.

The OECD Recommendations. The OECD Recommendations also dispense with the relatedness requirement if the deductible payment is part of a structured arrangement. A structured arrangement is also defined through an alternative two-part test -- *either*:

(i) "the hybrid mismatch is priced into the terms of the arrangement" *or*

(ii) "the facts and circumstances (including the terms) of the arrangement indicate that it has been designed to produce a hybrid mismatch."[96]

In addition, the OECD Recommendations apply the rule to a taxpayer involved in a structured arrangement only if the taxpayer or a member of the same control group "could reasonably have been expected to be aware of the hybrid mismatch" or "shared in the value of the tax benefit resulting from the hybrid mismatch."[97]

The OECD Recommendations include an extended discussion of these tests which explains that the purpose of the tests is to have the rule apply only to a taxpayer that either knew about the mismatch or benefitted from it, but that the rule itself is an objective test that does not depend upon proving that the taxpayer did in fact know – rather, the test is whether a reasonable person in the

[94] Prop. Reg. §1.267A-2(f).

[95] Prop. Reg. §1.267A-5(a)(20).

[96] OECD Hybrid Mismatch Report, Recommendation 10 "Definition of structured arrangement".

[97] The OECD Recommendation may actually mean that both of these requirements must be met for a taxpayer to be subject to this rule – the text is arguably unclear. It reads as follows: "A taxpayer will not be treated as a party to a structured arrangement if neither the taxpayer nor any member of the same control group could reasonably have been expected to be aware of the hybrid mismatch and did not share in the value of the tax benefit resulting from the hybrid mismatch." *Id.*

taxpayer's position (knowing the facts and circumstances the taxpayer knew) would have known of the existence of the mismatch.

The Proposed Regulations and the OECD Recommendations have the same first test (the Pricing Test); both also have a second facts-and-circumstances test but these tests differ. The Proposed Regulations are asking whether the facts and circumstances show that "the hybrid mismatch is a principal purpose of the arrangement" – in other words, what was motivating one or more persons. By contrast, the OECD Recommendations are asking whether "the facts and circumstances would indicate to an objective observer that the arrangement has been designed to produce a mismatch in tax outcomes…that the mismatch in tax outcomes was an intended feature of the arrangement."[98] The OECD Recommendations, separately, ask whether the specific taxpayer at issue either benefitted from the mismatch or "could …reasonably have been expected to be aware of" it.[99]

Both the Proposed Regulations and the OECD Recommendations provide a list of facts and circumstances to be considered in applying their respective second "facts and circumstances" test and, as will be seen below where we compare the two lists, they are almost identical. This is potentially problematic, however, because the question that is to be answered by reference to these facts and circumstances is not the same - in fact, the two questions are quite different. Facts and circumstances that support a finding that the arrangement was designed so as to have a specific tax result will not necessarily also be probative of whether a taxpayer's principal purpose for engaging in the transaction was to obtain that tax result.

The Proposed Regulations. The Proposed Regulations provide as follows:

> "Facts and circumstances that indicate the hybrid mismatch is a principal purpose of the arrangement include —
>
> (A) Marketing the arrangement as tax-advantaged where some or all of the tax advantage derives from the hybrid mismatch;
>
> (B) Primarily marketing the arrangement to tax residents of a country the tax law of which enables the hybrid mismatch;

[98] *Id.*, Paragraph 319.

[99] *Id*., Paragraph 320. The OECD discussion emphasizes that intent is not relevant and that the facts and circumstances listed are not intended to be guides to discerning intent: "The test for whether an arrangement is structured is objective. It applies, regardless of the parties' intentions, whenever the facts and circumstances would indicate to an objective observer that the arrangement has been designed to produce a mismatch in tax outcomes. …. if a reasonable person, looking at the facts of the arrangement, would otherwise conclude that it was designed to engineer a mismatch in tax outcomes, then the arrangement should be caught by the definition regardless of the actual intention or understanding of the taxpayer when entering into an arrangement." *Id.*, Paragraphs 319 and 321.

(C) Features that alter the terms of the arrangement, including the return, in the event the hybrid mismatch is no longer available; or

(D) A below-market return absent the tax effects or benefits resulting from the hybrid mismatch."

The OECD Recommendations. The OECD Recommendations provide as follows:

"Facts and circumstances that indicate that an arrangement has been designed to produce a hybrid mismatch include any of the following:

(a) an arrangement that is designed, or is part of a plan, to create a hybrid mismatch;

(b) an arrangement that incorporates a term, step or transaction used in order to create a hybrid mismatch;

(c) an arrangement that is marketed, in whole or in part, as a tax-advantaged product where some or all of the tax advantage derives from the hybrid mismatch;

(d) an arrangement that is primarily marketed to taxpayers in a jurisdiction where the hybrid mismatch arises;[100]

(e) an arrangement that contains features that alter the terms under the arrangement, including the return, in the event that the hybrid mismatch is no longer available;[101] or

(f) an arrangement that would produce a negative return absent the hybrid mismatch."[102]

b. Discussion and Recommendations

The Pricing Test sounds like a simple test, but we are concerned that in practice it will not be. This test came straight from the OECD Recommendations but we are not aware of a test like this having been previously applied in any US tax rules. The listed facts and circumstances in the Proposed Regulations are set forth as being relevant to the application of the Principal Purpose Test, not the Pricing Test, but two of them would seem to be indicators that the mismatch was priced into the terms: (1) features that alter the terms of the arrangement, including the return, in the event the hybrid mismatch is no longer available, and (2) a below-market return absent the tax effects or benefits resulting from the hybrid mismatch. In interpreting the Pricing Test, one could

[100] The OECD Recommendations elaborate that, if the arrangement is also available to other investors who do not benefit from hybridity, the element is present, if the majority of investors do benefit. *Id.*, Paragraph 336.

[101] The OECD Recommendations elaborate that ordinary tax-risk triggers do not indicate this is present if the taxpayer can show these are normally included. *Id.*, Paragraphs 338 and 339.

[102] *Id.*, Recommendation 10 "Definition of structured arrangement".

question the import of these factors being listed as relevant to the Principal Purpose Test: is it possible that the two factors could be present without the Pricing Test being met? The addition of one or more examples would assist in clarifying the Pricing Test.

With respect to the Principal Purpose Test, our concerns and questions about clarity, administrability, and effectiveness include the following:

i. Which person's or persons' purposes are relevant?

ii. Is the question what motivated them to enter into the arrangement at all or what motivated them to enter into the arrangement on the terms and with the structure that resulted in the hybrid mismatch?

Generally, no special structure is needed to make a payment of interest or a royalty deductible for US tax purposes, which suggests that obtaining the NI outcome is what the purpose inquiry should be focused on. This would match up to the text of the Proposed Regulations, which specifies that the relatedness requirement is dispensed with when the specified recipient (or other payee or investor in the payee) is a "party" to a structured arrangement. If this is correct, then the purpose inquiry should be focused on the recipient. The disallowance that occurs when the rule applies, however, is a disallowance to the payor. If the purpose of the unrelated payee is the relevant purpose, this seems particularly unfair to the payor who is not benefitting from the mismatch and may not even know about it (i.e., if the payor is benefiting from the mismatch, then the Pricing Test would presumably be met).

If instead the relevant purpose is the one motivating the payor, then the question is how could this test be met without the Pricing Test also being met. If the payor is motivated to obtain the NI outcome, that would presumably be because the payor is obtaining a benefit and presumably that benefit would be a reduction in pricing (i.e., a lower interest or royalty rate). If the mismatch is not priced into the arrangement, then why would the payor be motivated to obtain the NI outcome? Conceivably, the payor could be obtaining some other economic benefit sufficient to bring about the required motivation.

Some examples may help illustrate how the Pricing Test and the Principal Purpose Test work and interact.

Example 2:

US Corp needs financing of $1x to fund a commitment. US Corp approaches a foreign lender and the foreign lender offers (i) a plain vanilla loan from the foreign lender's US subsidiary or (ii) a hybrid loan from the foreign lender with a lower interest rate.

Alternative facts: US Corp requests a plain vanilla loan and the foreign lender says, "We don't do that anymore; we only do hybrid loans and it needs to have these specific provisions in order to work for us."

Alternative facts: US Corp requests a plain vanilla loan and the foreign lender says, "We need to modify one term as follows".

The first case would appear to meet the Pricing Test; whether it also meets the Principal Purpose Test could be a complicated inquiry and question of proof. The second fact pattern raises the question of whose purpose matters and whether the payor should be seen as benefitting from the hybridity under these circumstances. The third fact pattern raises the question of whether the change in the one feature is sufficient structuring to establish that a principal purpose of the arrangement was the hybrid mismatch result.

By contrast, in applying the OECD's second test to the three fact patterns, it seems relatively clear that the test would be met in all three cases.

We believe that the OECD's objective approach is not only more clear and administrable, but we believe it is also more effective and more consistent with the goals for having a Structured Arrangements Rule. We believe that the content of the Structured Arrangements Rule should be driven by, and flow from, why there is a Structured Arrangements Rule at all. In other words, why is the main rule limited to related party transactions and why is it extended to unrelated parties at all? The Preamble provides some indication of what Treasury and the IRS believe and it appears to match the views of the OECD Recommendations.

First, hybrid arrangements are a concern because, according to the OIRA Special Analyses, they "take advantage of tax treatment mismatches between jurisdictions in order to achieve favorable tax outcomes at the detriment of tax revenues (see OECD/G20 Hybrid Mismatch Report, October 2015 and OECD/G20 Branch Mismatch Report, July 2017)".[103] Second, without a robust structured arrangements rule, the statute could be easily avoided. That is, if the government limits the anti-hybrid rules to transactions between related parties, then taxpayers will coordinate with

[103] OIRA Special Analyses at 67625.

unrelated parties to achieve the result targeted by the anti-hybrid rules.[104] When taxpayers coordinate with unrelated parties to achieve such result, taxpayers are likely to have the information needed to identify that there is a D/NI outcome. By contrast, where taxpayers have not "designed" the arrangement to achieve the result, taxpayers may not be aware and may not be able to obtain the information needed to apply Section 267A. Thus, the reason for the limitation to related parties and for the extension beyond related parties relates to whether the parties intended to create a D/NI outcome – that is, whether they knowingly acted so as to bring about that result.

As discussed above, the OECD Recommendations focus on knowledge rather than purpose, applying a structured arrangements rule only to persons who actually knew or should have known based upon the information available to them.[105] The reason for this approach was a concern about the burden of proof on the payor in the absence of a knowledge-based limitation when entering into a market-based transaction. For example, the OECD Recommendations provide that:

> "A taxpayer may enter into a number of on-market transactions with unrelated parties that give rise to D/NI outcomes and the payor may not have the capacity to undertake due diligence on the transaction to determine whether there is a mismatch (or the reason for it). On-market transactions between unrelated parties will not, however, generally fall within the scope of the branch payee mismatch rules as the payor would generally be expected to enter these transactions on arm's length terms and could not be expected to make enquires as to a counterparty's tax position in the context of these type of trades."[106]

Consistent with the commentary in the Preamble and in the OECD Recommendations, we believe that the focus should be on what the payor knows or reasonably should be expected to know about the transaction. Thus, the Structured Arrangements Rule should ask whether, based upon all the facts and circumstances, the payor actually knows or should have known that the

[104] The OIRA Special Analyses state that "[t]he statute, as written, does not apply to certain hybrid arrangements…. The exclusion of these arrangements could have large economic and fiscal consequences due to taxpayers shifting tax planning towards these arrangements to avoid the new anti-abuse statute." *Id.* at 67627. The OIRA Special Analyses also states that "the statute would be extremely easy to avoid, a pathway that is contrary to Congressional intent". *Id.* The Preamble states that the "Treasury Department and the IRS are aware that some hybrid arrangements involving unrelated parties are designed to give rise to a D/NI outcome and therefore present the policy concerns underlying section 267A. Furthermore, it is likely that in such cases the specified party will have, or can reasonably obtain, the information necessary to comply with section 267A." Preamble at 67618.

[105] Under the OECD approach, "[a] taxpayer will not be treated as a party to a structured arrangement … where neither the taxpayer nor any member of the same control group was aware of the mismatch in tax outcomes or obtained any benefit from the mismatch." OECD Hybrid Mismatch Report, Paragraph 342. Moreover, the OECD only includes in its definition of parties to a structured arrangement persons that have a "sufficient level of involvement . . . to understand how [the arrangement] has been structured and what its tax effects might be." *Id*.

[106] OECD Branch Mismatch Report, Paragraph 59.

arrangement results in a hybrid mismatch that produces a more than minor benefit or benefits (in the aggregate) for (i) the payor (including a benefit in the form of more favorable pricing and including a benefit that is realized by the payor or a related party through a separate transaction with one or more investors or their related parties), or (ii) one or more investors. Constructing the Structured Arrangements Test in this fashion should deter payors from infusing hybridity into the terms of the instrument or knowingly participating in a hybrid arrangement with unrelated payees to achieve cross-border tax results to the detriment of the fisc, while allowing payors to enter into transactions that appear to them to be on-market for both parties without having to prove the absence of any element of hybridity, no matter how small.[107] This construction also incorporates the Pricing Test and does so in a way that we believe addresses the uncertainties we identified above with respect to the Proposed Regulations' formulation of that test.

c. Delayed Effective Date for Structured Arrangements Rule

Under the Proposed Regulations, the Structured Arrangement Rule would have a later effective date than other rules in that it would apply only to taxable years beginning on or after December 20, 2018 (i.e., the date that the Proposed Regulations were filed with the Federal Register), as opposed to the primary effective date (provided for by the statute) of payments after December 31, 2017.[108] Given that structured arrangements are transactions between unrelated parties, they may be difficult or costly for a US taxpayer to unwind. For example, a US borrower with an outstanding loan from an international bank that extended the loan through a reverse hybrid structure may face heavy prepayment penalties and transaction costs if it terminates the borrowing early. Unwinding related party transactions are unlikely to result in these types of prepayment penalties and other costs paid to third parties. Even if the Structured Arrangement Rule is revised to more closely match the OECD Recommendations (which were finalized in October 2015), taxpayers were arguably not on notice that the US would enact and adopt such a rule until shortly before the TCJA was enacted. We recommend that consideration be given to providing transitional relief from the Structured Arrangement Rule for some or all payments made under arrangements entered into on or before December 20, 2018 (or, alternatively, before the date of enactment of the TCJA, December 22, 2017). We acknowledge that grandfathering such arrangements in their entirety may not be consistent with the cut-off approach taken by Congress generally under Section 267A (i.e., the statutory provision applies to payments after December 31, 2017 regardless of when the arrangement was entered into). Accordingly, transitional relief could be more narrowly drawn

[107] The exclusion of arrangements involving minor benefits of hybridity seems consistent with the OECD Recommendations and the legislative intent behind Section 267A. The Joint Committee on Taxation's General Explanation provides: "An example of an overly broad application of this provision may involve a debt issuance that is primarily targeted and sold to a tax-exempt domestic investor base, but a minor portion of which is acquired by unrelated persons who benefit from hybrid treatment in their countries of residence." Staff, Joint Committee on Taxation, *General Explanation of Public Law 115-97*, Part I – Outbound Transactions, at 391 (JCS- 1-18 NO 21) (2018).

[108] Prop. Reg. §1.267A-7(b).

to provide relief for grandfathered arrangements only to the extent of payments made before a specified date (e.g., December 31, 2020), thereby giving participants a reasonable amount of time to unwind them.[109]

3. Imported Mismatches

As described above, the Imported Mismatch Rule disallows deductions for non-hybrid "imported mismatch payments" to the extent a "hybrid deduction" offsets the corresponding income in another jurisdiction.[110] Generally speaking, a hybrid deduction offsets the imported mismatch payments that directly or indirectly fund the hybrid deduction. However, that general concept is complicated when the payor of a hybrid deduction has income from multiple sources. The Imported Mismatch Rule, therefore, offers a set of ordering rules for determining whether a particular hybrid deduction in one jurisdiction offsets a particular imported mismatch payment in another jurisdiction.[111]

First, hybrid deductions offset "factually related imported mismatch payments" or imported mismatch payments made under a plan or related transaction that includes the hybrid deduction.[112] Second, hybrid deductions offset imported mismatch payments directly paid to the payor of a hybrid deduction.[113] Third, hybrid deductions offset an imported mismatch payment that indirectly funds the hybrid deduction through a chain of deductible payments termed "funded taxable payments" connecting the payor of the hybrid deduction and the payor of the imported mismatch payment.[114]

Generally, the ordering rules only take into account payments from US specified parties, i.e., US persons, US taxable branches, and CFCs. However, in limited circumstances, the Proposed Regulations recognize a hybrid deduction can be funded with payments from non-US specified parties. Specifically, the Proposed Regulations provide that if another jurisdiction disallows a deduction for an amount under a rule similar to the Imported Mismatch Rule, such amount is a deemed imported mismatch payment for purposes of the ordering rules.[115]

[109] Alternatively, relief could be limited to payors who could demonstrate that they had no knowledge of any hybrid elements benefitting them or investors when they entered into the arrangement.

[110] Prop. Reg. §1.267A-4(a).

[111] Prop. Reg. §1.267A-4(c).

[112] Prop. Reg. §1.267A-4(c)(2)(i).

[113] Prop. Reg. §1.267A-4(c)(2)(ii); §1.267A-4(c)(3)(i).

[114] Prop. Reg. §1.267A-4(c)(2)(iii); §1.267A-4(c)(3)(ii-v).

[115] Prop. Reg. §1.267A-4(f). Significantly, the rule applies without regard to whether the payment otherwise would be treated as a specified payment from a specified party, which is otherwise a prerequisite to being an imported mismatch payment considered for the ordering rule.

Regulatory authority for the Imported Mismatch Rule is provided via both an explicit statutory mandate to address conduit arrangements as well as the general legislative intent for Section 267A to be consistent with the OECD Recommendations. [116] The Proposed Regulations borrow broadly from the OECD's recommended imported mismatch rules. The OECD approach also uses a similar three-tier ordering rule to track whether a hybrid deduction offsets an imported mismatch payment. However, there are material differences between the imported mismatch rules in the Proposed Regulations and those contained in the OECD Recommendations. Our main areas of concern with the current form of the Imported Mismatch Rule revolve around its interactions with (i) similar rules in other jurisdictions; and (ii) the Hybrid Payment Rule. Unaddressed, these interactions may result in double disallowances for some taxpayers and may allow other taxpayers to avoid the application of the Imported Mismatch Rule entirely. Accordingly, we make the below recommendations, mostly in line with the OECD Recommendations, where we believe Treasury and the IRS should consider amending the Proposed Regulation:

1. Deemed imported mismatch amounts due to disallowances under other jurisdictions' hybrid mismatch rules should rank first in the set-off ordering priority.

2. Payments from tax residents of any jurisdiction that has anti-hybrid rules should be considered for the ordering rules (not just payments from specified parties).

3. Payments not disallowed in jurisdictions with substantially similar, e.g., OECD based, hybrid mismatch rules should not be treated as hybrid, and potentially all payments to OECD compliant jurisdictions should be excluded from being imported mismatch payments.

4. Hybrid payments from a CFC deductible in its local jurisdiction should be hybrid deductions under the Imported Mismatch Rule to the extent, and only to the extent, the disallowance of such payments under the Hybrid Payment Rule does not cause a US shareholder to have an inclusion.

5. Prop. Reg. §1.267A-3(b)'s override for payments that create US inclusions also applies to testing the hybridity of a tentative hybrid deduction under the Imported Mismatch Rule.

6. *The indirect funding rule should require each party to a chain of funded taxable payments to be related to, or parties to a structured arrangement with, the imported mismatch payor.*

7. *Funded taxable payments should only include payments that are taxable in the recipient jurisdiction.*

[116] Section 267A(e)(1); Senate Committee on Finance, Explanation of the Bill, at 384 (November 22, 2017); OECD Hybrid Mismatch Report, Recommendation 8 "Imported Mismatch Rule".

a. Deemed imported mismatch amounts due to disallowances under other jurisdictions' hybrid mismatch rules should rank first in the set-off ordering priority.

First, we request guidance regarding the size and priority within the ordering rules for amounts disallowed in other jurisdictions that are deemed to be imported mismatch payments. Absent guidance, such amounts may result in double disallowances, e.g., when the foreign imported mismatch rule treats the amount as a factually-related payment and the US rule treats the amount as an indirect payment. At some level, this is a problem that is endemic to BEPS.[117] Implementing base erosion and profit shifting rules, and particularly implementing anti-hybrid rules, requires coordination between jurisdictions.

The Imported Mismatch Rule is modeled on the OECD approach. The OIRA Analysis explains that the United States' adoption of the OECD approach for imported mismatches has the advantage of "neutralizing the risk of double taxation." However, differences between the US and the OECD still can make calculations associated with the Imported Mismatch Rule in the US look very different from the calculations occurring in other jurisdictions. And so, even though the US has adopted a rule similar to the OECD's, the risk of double taxation via double disallowances continues to loom large.

Most notably, the OECD views all deductible payments as imported mismatch payments. The Proposed Regulations only view specified payments (interest, royalties, and structured payments) as imported mismatch payments.[118] So even if the US were to agree with an OECD country that a hybrid deduction is funded by imported mismatch on a pro-rata basis to each country's respective amounts of imported mismatch payments, in practice each country would have a different starting point as to how to apportion the hybrid deduction between the two jurisdictions. Secondly, the US's highest tier in the ordering rule is for payments that are factually related to a hybrid deduction. Factually related includes (amongst other categories of relatedness) all payments made pursuant to the same series of transactions as the hybrid deduction. The OECD's highest tier is for payments made pursuant to the same structured arrangement as the hybrid deduction. The OECD structured arrangement standard includes a smaller range of transactions than the factually related standard, e.g., situations where the hybrid mismatch is built into the terms of the imported transaction or situations where the imported mismatch payment is designed to or part of a plan to create a hybrid transaction. That standard does not include all transactions pursuant to the same series of transactions as the hybrid deduction. Lastly, differing

[117] An argument can be made in favor of aligning regulations with the OECD Recommendations that other jurisdictions will likely incorporate in order to ensure that the rule creating a deemed imported mismatch payment for amounts disallowed in the other jurisdiction yields the intended and predictable result.

[118] The Proposed Regulations do follow the OECD's broader approach for the definition of funded taxable payments, an approach which raises questions (do such payments always present the same conduit-focused risks?), particularly when paired with the narrower imported mismatch payment definition (should an indirect funding via a services payments be worse than a direct funding via a services payment?).

views on what constitutes a hybrid deduction, e.g., with respect to long-term deferral, notional interest deductions, multiple recipients, substitute payments, will make the calculation in the US look very different from the calculation in other jurisdictions. Prop. Reg. §1.267A-4(f)'s deemed imported mismatch amount rule for amounts disallowed in other jurisdictions will help in some, but not all, situations.

Accordingly, we suggest final regulations incorporate a rule that provides that deemed imported mismatch amounts rank first in ordering priority. Ranking deemed imported mismatch amounts highest in priority would effectively allow such amounts to be a credit against the disqualified imported mismatch amount in the US. We think giving such precedence to other jurisdictions is appropriate because the Imported Mismatch Rule is not primarily intended to protect the integrity of the US tax base. The integrity of the US tax base is the province of Section 163(j), Section 385, Section 59A, and similar provisions. Rather, the intent is to participate with the international community in preventing base erosion. Such participation with the international community necessarily requires a strong coordinating rule to ensure no double disallowances.

Example 3: Size of Deemed Imported Mismatch Payment

Facts: US1 pays $50 interest to FX. US2 pays $50 interest to FX. FY also pays $100 interest to FX. FX has a total of $200 of income and $100 of hybrid deductions. Country Y has hybrid mismatch rules identical to the OECD Recommendations. Under those rules, FY is disallowed $50 of interest deductions. None of the payments are factually related to FX's hybrid deduction. FY is not a CFC. All parties are related.

Analysis under Proposed Regulations: While uncertain, it appears the following result may occur under the Proposed Regulations. The $50 amount disallowed in Country Y would be deemed an imported mismatch payment. In total, there would be $150 of imported mismatch payments and $100 of hybrid deductions. Accordingly, two-thirds of the US1-FX payment and the US2-FX payment would be disallowed. This would result in a total disallowance of $116.66 resulting from FX's $100 of hybrid deductions, or a $16.66 double disallowance.

Analysis under Suggested Approach: The $50 of disallowed FY deductions would first offset the hybrid deduction, leaving $50 hybrid deduction remaining. A pro-rata amount of US1-FX $50 payment and US2-FX $50 payments, or $25 each, would offset the remainder. This creates no double disallowance.

Example 4: Priority of Deemed Imported Mismatch Payment

Facts: Same as above in Example 3, except (i) the US1 and US2 payments are factually related to FX hybrid deductions; and (ii) the US1 and US2 payments are not interest payments but are royalty payments of a type that do not provide a financing or equity return; (iii) Country Y's hybrid mismatch rule are identical to the US's but do not view such royalty payments as imported mismatch payments and Country Y therefore disallows the full $100 of the FY-FX payment.[119]

Analysis under Proposed Regulations: While uncertain, it appears the following result may occur under the Proposed Regulations. The $100 amount disallowed in FY would be deemed an imported mismatch payment. However, that deemed imported mismatch payment would rank lower than the factually related US1 and US2 payments. Accordingly, the US1 and US2 payments would be entirely disallowed. This would result in a total disallowance of $200 resulting from FX's $100 of hybrid deductions, or a $100 double disallowance.

Analysis under Suggested Approach: The $100 of disallowed FY deductions would first offset the hybrid deduction, leaving $0 hybrid deduction remaining. Thus, none of the US1-FX $50 payment or US2-FX $50 payment would be disallowed. This approach creates no double disallowance.

Example 5: Comparison of US and Foreign Imported Mismatch Rule Calculations

Facts: US1 pays $50 interest to FX. FY pays $50 interest and $50 services payments to FX. FX pays $50 to FZ pursuant to a hybrid instrument, included 25 months later. FX pays $50 to FT pursuant to a hybrid instrument, included 37 months later. Without regard to the related-party payments, FX has $10000 of net income from its own operations. There was no design or plan for the hybrid mismatch to erode FX's related party income. The hybridity occurred without an avoidance purpose but instead due to differences between jurisdictions. Notwithstanding that all parties are related, the hybrid transaction cannot be easily restructured into a non-hybrid equivalent due to financial covenants provided to 3rd party lenders. The hybrid instruments and US1 debt were implemented on the same day pursuant to a series of transactions associated with the formation of the group when the group started as a new business venture. The FY debt and services arrangements were implemented later and are not factually related to the hybrid instruments. All parties are related and are CFCs. FY has implemented rules consistent with the OECD and uses a 24 month standard for determining a reasonable time period within which income must be included.

[119] Other versions of this example can be created for a jurisdiction that does not prioritize direct over indirect funding given that taxpayers can elect whether they want to directly or indirectly fund a hybrid deduction. Similar situations can also arise if a jurisdiction excludes factually related payments from an accounting period-by-accounting period analysis to ensure that factually related payments are properly traced to the jurisdictions from where they arose. Finally, similar issues can occur if different jurisdictions have different presumptions regarding the ordering rule (see following example).

Analysis under Country Y OECD Law: Under Country Y law, there are $100 of hybrid deductions and $150 of imported mismatch payments that directly-funded the hybrid deduction. None of the imported mismatch payments were pursuant to a structured arrangement with the hybrid deduction. $100 of the $150 imported mismatch payments came from Country Y, $50 from the interest payment and $50 from the services payment. Country Y will disallow $33 of each of FY's $50 dollar interest and services payments, for a total of a $66 disallowance in Country Y.

Analysis under Proposed Regulations: Under the Proposed Regulations', there are $50 of hybrid deductions from the FX-FT instrument that is included 37 months later. Potentially offsetting such hybrid deductions, under the Proposed Regulations there are $50 of factually related imported mismatch payments from the US1-FX debt, $50 of non-factually related imported mismatch payments from the FY-FX debt (FY is a CFC and the payment was a specified payment, interest, so the entire FY-FX is included in the calculation without regard to the actual amount disallowed), and $33 dollars of non-factually related deemed imported mismatch payments from the FY-FX services payments disallowed in Country Y. The US1-FX interest payment is factually related, so it will be viewed as fully offsetting the $50 FX-FT hybrid deduction, and the US will disallow the entire $50 dollar deduction for the US1-FX payment. In total, the group has $116 disallowed in both jurisdictions, notwithstanding that the US only viewed there being $50 of hybrid deductions present and Country Y only viewed there being $100 of hybrid deductions present.

Analysis under Suggested Approach: Under our suggested approach, the $66 disallowed in Country Y ranks first in offsetting the $50 hybrid deductions and the US will not disallow any additional amounts.

b. Payments from tax residents of any jurisdiction that has anti-hybrid rules should be considered for the ordering rules (not just payments from specified parties).

Second, the Proposed Regulations differ from the OECD Recommendations in another critical manner. The ordering rule allocates a hybrid deduction between different funding sources with the intent to determine whether a particular hybrid deduction offsets a particular, potentially deductible, imported mismatch payment. To that end, it follows that the ordering rule should take into account payments from non-US jurisdictions as well as from the US. However, the ordering rules only incorporate payments from a non-specified party to the extent such payment is disallowed in another jurisdiction. [120] The OECD Recommendations, on the other hand, includes payments from all jurisdictions in the ordering rule.[121] Therefore, we recommend for purposes of the ordering rule that final regulations include payments from tax residents of any jurisdiction that

[120] Prop. Reg. §§1.267A-4(a), 1.267A-1(b), 1.267A-6(a)(17), 1.267A-4(f).

[121] *See* OECD Hybrid Mismatch Report, Paragraphs 242, 255-265.

has anti-hybrid rules. Such a rule would also have the positive effect of removing planning opportunities regarding the use of CFCs to change which payments are treated as specified payments to be considered for the ordering rules.

Example 6: Imported Mismatch Payment from non-specified parties

Facts: US1 pays $100 interest to FX, FY pays $100 interest to FX, FZ pays $100 interest to FX. FX has $100 of hybrid deductions. FY and FZ are not CFCs. All parties are related. Countries Y and Z have hybrid mismatch rules consistent with the OECD Recommendations.

Analysis under Proposed Regulations: As a starting point, FX has $100 imported mismatch payments from US1 and $100 of hybrid deductions. Absent additional information, the entire US1 $100 payment will be disallowed. Because Countries Y and Z also have hybrid mismatch rules, there is a potential for a double disallowance. The extent of such double disallowance (if any) will depend on the exact implementation of cross-border coordinating rules in each of the three relevant jurisdictions, the US, Country Y, and Country Z.

Analysis under Suggested Approach: The US would disallow a maximum of $33.33. The potential for a double disallowance remains (depending on how much is disallowed in Y and Z and the precise application of the US, Y, and Z coordinating rules). However, the US at least will only have taken at most its pro-rata share of the hybrid deduction as calculated under its own rules. A double disallowance should not result assuming the US, Y, and Z agree on what constitutes an imported mismatch payment and on the ordering rules.

Alternative Facts: Same as above, except the common parents of FY and FZ insert a US partnership as the majority owner of FY and FZ, making FY and FZ CFCs notwithstanding that all the direct and indirect taxpaying beneficial owners remain non-US.

Analysis of Alternative Facts (under both the Proposed Regulations and the Suggested Approach): This structure creates the same result under both the current Proposed Regulation and under our suggested approach. The insertion of the US partnership makes FY and FZ CFCs, which causes the payments from FY and FZ to become specified payments. The FY and FZ payments thereby also become imported mismatch payments, taken into consideration for the ordering rules. This structuring approach ensures that only $33.33 of the US1-FX payment is disallowed, without regard to whether the proposed rule changes and without regard to additional cross-border coordinating rules.

Alternative Facts 2: Same as the original facts above, except FY and FZ each also pay $100 of rent to FX. Pursuant to the OECD Recommendations, FY and FZ view the rental payments as imported mismatch payments that fund a portion of the hybrid deduction.[122]

[122] OECD Mismatch Report Recommendation 8.3 at Paragraph 242.

FY and FZ, therefore, each fund $200 of the $500 imported mismatch payments under the OECD, and consequently each disallows $40 of the $200 imported mismatch payments in its respective jurisdiction, together disallowing $80.

Analysis of Alternative Facts 2 (under both the Proposed Regulations and the Suggested Approach): This example shows the need for a strong cross-border coordinating rule, as discussed above. Taking the suggested approach to the question of whether the US takes into account other jurisdiction's payments will not entirely alleviate double disallowances. Here, the potential for a double disallowance exists even under the suggested approach, because the US and OECD disagree on what constitutes an imported mismatch payment to go into the ordering rules (in that the US would not view the rental payments as imported mismatch payments but FY and FZ do). The only solution for this type of double disallowance is a strong, credit-type, coordinating rule, as described above.

c. Payments not disallowed in jurisdictions with substantially similar, e.g., OECD based, hybrid mismatch rules should not be treated as hybrid, and potentially all payments to OECD compliant jurisdictions should be excluded from being imported mismatch payments.

Third, there is some uncertainty around whether hybrid deductions include deductions allowed in a jurisdiction if the deductions would have been disallowed were the Proposed Regulations to apply in such jurisdiction. The Proposed Regulations define a hybrid deduction as a payment that "would be disallowed if such law contained rules *substantially similar* to those under…".[123] The use of the phrase "substantially similar" gives rise to three viable interpretations. Arguably, "substantially similar" can be interpreted to imply that if a jurisdiction does have substantially similar anti-hybrid rules, and the jurisdiction still does not disallow the deduction, then the payment is not a hybrid deduction, notwithstanding the payment would be a hybrid deduction, under the US rules. Whether a jurisdiction has substantially similar rules can be tested by reference to the definition of "hybrid mismatch rules" provided in the Proposed Regulations, which includes rules based on the OECD Recommendations.[124] A second interpretation would treat a payment as a hybrid deduction only if the deduction would be disallowed under every single set of anti-hybrid rules that is treated as substantially similar to the Proposed Regulations. Finally, the provision could be interpreted to mean that the tentative rules testing hybridity are identical to the US rules, with perhaps minor coordinating adjustments to account for differences between regimes.

The first approach appears the fairest in principle. It is also more consistent with the OECD Hybrid Mismatch Report, Recommendation 8.3. OECD Hybrid Mismatch Report

[123] Prop. Reg. 1.267A-4(b). Italics added.

[124] Prop. Reg. §1.267A-5(a)(10).

Recommendation 8.3 excludes from the term "imported mismatch payments" any payments to jurisdictions that have adopted anti-hybrid rules. The first interpretation would create the same result for directly-funded hybrid deductions. Therefore, we recommend final regulations adopt the first interpretation above.

We also recommend that consideration be given to final regulations generally incorporating the OECD Recommendation 8.3 that payments to jurisdictions that have adopted anti-hybrid rules are excluded from being imported mismatch payments. Final regulations could implement this rule by reference to the definition of "hybrid mismatch rules", which includes rules based on the OECD Recommendations.[125] Any payment to a jurisdiction that has adopted OECD-based hybrid mismatch rules would, under this approach, be excluded from being an imported mismatch payment. Eliminating such payments from the Imported Mismatch Rule would decrease the number of situations that could potentially give rise to a double disallowance. Such a cooperative approach would also be supportive of the reality, as stated in the OECD report, that "the most reliable protection against imported mismatches will be for jurisdictions to introduce hybrid mismatch rules."[126]

Example 7: Payments not disallowed under substantially similar hybrid mismatch rules

Facts: US1 pays $50 interest to FX. FX pays $50 of interest to FY under a hybrid instrument. FY's parent, FZ, includes the $50 at ordinary income rates. Country X has hybrid mismatch rules identical to the OECD Recommendations. Under those rules, the hybrid deductions are not disallowed because there is an offsetting inclusion of $50 at ordinary income rates by FZ. US1 also pays $50 interest to FW. FW pays $50 interest to FY under a hybrid instrument. FZ, FY's parent, also includes this $50 at ordinary income rates. Country W does not have anti-hybrid rules. All parties are related.

Analysis under Proposed Regulations: Under the first interpretation of the Proposed Regulations, the $50 FX-FY payment is not a hybrid deduction, but the FW-FY payment is a hybrid deduction. Under the second interpretation, neither is a hybrid deduction. Under the third interpretation, both are hybrid deductions.

Analysis under Suggested Approach: We recommend the first interpretation above, so the FX-FY payment will not be viewed as hybrid and will not give rise to a disqualified imported mismatch amount but the FW-FY payment will be viewed as hybrid and will give rise to a disqualified imported mismatch amount. We also recommend consideration be given to adopting the OECD Recommendation to exclude payments to jurisdictions that have implemented OECD rules from the definition of an imported mismatch payment.

[125] Prop. Reg. §1.267A-5(a)(10).

[126] OECD Hybrid Mismatch Report, Paragraphs 240 and 268.

That rule would also ensure the US1-FX payment does not give rise to a disqualified imported mismatch amount (but the US1-FW payment would be an imported mismatch payment and therefore may give rise to a disqualified imported mismatch amount).

Example 8: Indirect payments not disallowed under substantially similar hybrid mismatch rules

Facts: Same as above, except Country X also does not have hybrid mismatch rules and US1 makes both payments to FT which pays on to FX and FW. Country T has hybrid mismatch rules identical to the OECD Recommendations.

Analysis under Proposed Regulations: Under both the first and third interpretation, both US1 payments fund hybrid deductions and will be disallowed. Under the second interpretation, neither funds a hybrid deduction.

Analysis under Suggested Approach: US1 makes both payments to a jurisdiction that has adopted anti-hybrid rules. So, under the suggested OECD approach, neither US1 payment will be an imported mismatch payment subject to disallowance. This rule decreases complexity and lowers the risk that both the direct and the indirect funder of the same hybrid deduction are subject to a double disallowance.

d. Hybrid payments from a CFC deductible in its local jurisdiction should be hybrid deductions under the Imported Mismatch Rule to the extent, and only to the extent, the disallowance of such payments under the Hybrid Payment Rule does not cause a US shareholder to have an inclusion.

Fourth, we request guidance regarding whether a CFC can pay a hybrid deduction or funded taxable payment. The definition of hybrid deduction and funded taxable payment both include the modifier: "with respect to a tax resident or taxable branch that is not a specified party."[127] The term "specified party" includes a CFC.[128] It is commendable that the Proposed Regulations recognize that subjecting CFCs to both the Imported Mismatch Rule and the Hybrid Payment Rule may result in a double disallowance. A payment from a US person to a CFC that has a hybrid deduction may result in a disallowed deduction for the CFC under the Hybrid Payment Rule and a disallowed deduction for the US person under the Imported Mismatch Rule. The Proposed Regulations seemingly coordinate between these two rules by only treating the payments of non-specified parties as hybrid deductions or funded taxable payments. However, this approach may allow taxpayers to avoid the Imported Mismatch Rule through the use of CFCs in cases that do not result in inclusions under Sections 951 or 951A. Such planning may utilize CFCs with no ultimate taxpaying US shareholders, e.g., CFCs that only have CFC status due to the treatment of

[127] Prop. Reg. §§1.267A-4(b) and 1.267A-4(c)(3)(v).

[128] Prop. Reg. §1.267A-5(a)(17).

US partnerships that are shareholders or due to constructive attribution. We recommend that final regulations provide that a CFC can pay hybrid deductions or funded taxable payments. But, final regulations should adopt an explicit coordinating rule to the effect that only the portion of a CFC's hybrid deduction or funded taxable payment that does not give rise to a US shareholder inclusion will be a hybrid deduction or funded taxable payment.

Example 9: Hybrid Deductions of a CFC

Facts: US1 pays $100 interest to FX. FX is a CFC held by USP, a US partnership. USP has one US taxpaying partner, US2 that owns 20% of USP. FX pays $100 via a hybrid instrument to FY. All parties are related.

Analysis under Proposed Regulations: Under the Hybrid Payment Rule, FX's $100 deduction is disallowed for US federal income tax purposes. This may decrease US2's gross deductions for GILTI by a maximum of $20. The FX payment appears not to be a hybrid deduction under the Imported Mismatch Rule.

Analysis under Suggested Approach: Under the suggested approach, the FX payment should be a hybrid deduction to the extent the disallowance under the Hybrid Payment Rule does not increase the US tax base. Because the $100 disallowance only increased the US tax base by $20, the remaining $80 should be subject to the Imported Mismatch Rule.

e. Prop. Reg. §1.267A-3(b)'s override for payments that create US inclusions also applies to testing the hybridity of a tentative hybrid deduction under the Imported Mismatch Rule.

Fifth, we recommend that the US Inclusion Kick-out Rule be adjusted in its application to the Imported Mismatch Rule. Prop. Reg. §1.267A-3(b) provides that amounts generally treated as creating a NI result will be treated as creating an Inclusion result if such amounts create an inclusion in the US tax base of the recipient or a partner of the recipient or a 10% shareholder of the recipient. That provision evidences a policy decision that if an amount is included in US income, then the corresponding deduction should not be disallowed under the anti-hybrid rules. Final regulations should clarify that when testing hybridity for the Imported Mismatch Rule, taxpayers can also rely on this principle both when a tentative hybrid deduction creates an inclusion in the US tax base *or* when a tentative hybrid deduction creates an inclusion in income for the payor jurisdiction's tax base.[129] Such an approach would correctly implement the US policy goal of not disallowing deductions for payments that create US inclusions while recognizing that other jurisdictions also will naturally want the rule to apply by reference to their own tax bases.

[129] It is not clear why the US Inclusion Kick-out Rule uses a unique formulation, creating the concept of a "tentative disqualified hybrid amount" and then determining situations in which the "tentative disqualified hybrid amount is reduced." A simpler formulation might have been expected. E.g., "a specified payment is included to the extent that it… [results in a US inclusion]".

Example 10: US vs. Local Inclusions under the Imported Mismatch Rule

Facts: US1 pays $100 interest to FX. FX pays $100 hybrid deductions to FY. FY has two owners, a 60% US owner and a 40% Country X owner. Under the US and Country X CFC regimes, both owners include their entire portion of the payment in income when paid. US1, FX, and FY are related.

Analysis under Proposed Regulations: The $40 included in Country X reduces the hybrid deduction in Country X as that would be the result if Country X adopted the US's hybrid mismatch rules. It is uncertain whether the $60 included in the US reduces the disqualified imported mismatch amount.

Analysis under Suggested Approach: Under the suggested approach, the $40 Country X inclusion should reduce the Country X hybrid deduction and the $60 US inclusion should decrease the tentative disqualified imported mismatch amount, with the result that the entire $100 payment by US1 is allowed.

Final regulations should also clarify the manner of operation of this rule. We believe the correct manner of operation is as follows: First, a deduction is not hybrid to the extent it creates an inclusion in the payor jurisdiction's tax base. That first step provides a kick-out if there is a local inclusion. On the basis of that first step, one can calculate the tentative disqualified imported amount. Second, the tentative disqualified imported mismatch amount is reduced to the extent that the transaction caused a US inclusion. These two steps provide a kick out if there is an inclusion either in the payor's jurisdiction or in the US. This clarification regarding the manner of operation will be especially important if final regulations change their approach to the hybrid deductions and funded taxable payments of a CFC.

Example 11: Mechanics of US Inclusion Kick-Out Rule

Facts: US1 pays $100 interest to FX. FX is a CFC but has no 10% US owners. FX pays $100 interest to FY. FY is a CFC, and $20 is included in income of a 10% US shareholder of FY. FY pays $100 hybrid deductions to FZ. FZ is not a CFC. All parties are related.

Analysis under Proposed Regulations: Under the Proposed Regulations, FX is a CFC and cannot make a hybrid deduction or funded taxable payment. However, if that rule changes, then appropriate adjustments should be made to the US Inclusion Kick-Out such that the $20 US inclusion reduces the tentative disqualified imported mismatch amount even though the US inclusion does not occur at the level of the recipient of the payment that generated the hybrid deduction (in this example, FZ) but arises from a funded taxable payment (as in this example, at the level of FY) or from an imported mismatch payment (the equivalent of FX in this example).

f. The indirect funding rule should require each party to a chain of funded taxable payments to be related to, or parties to a structured arrangement with, the imported mismatch payor.

Seventh, we recommend that each party to a chain of funded taxable payments must be related or parties to a structured arrangement. Under the Proposed Regulations, the hybrid deduction payor must be related (or a party to a structured arrangement) to the imported mismatch payor.[130] But, it is not clear that all parties in a chain of funded taxable payments must be related to one another. Furthermore, in most cases, it would be impossible to know whether a chain of funded taxable payments through unrelated parties connects the hybrid deduction payor and the imported mismatch payor. Unrelated parties necessarily conduct their activities on arms-length terms, so the chain of deductible and includable payments between unrelated parties is not indicative of profit shifting. Finally, necessitating that each member of the chain of funded taxable payments is related (or parties to a structured arrangement) would be consistent with the approach taken by the OECD. The OECD's recommended imported mismatch rule for non-structured arrangements only considers payment flows within a group.[131]

Example 12: Funded Taxable Payments between Unrelated Parties

Facts: US1 pays $100 interest to FX, US1's Country X affiliate. As part of its business, FX engages in hedging transactions with large foreign bank IB1, resulting in $100 of taxable income and $100 of deductible payments between FX and IB1. FZ, US1's Country Z affiliate, also engages in the same hedging transactions with IB1 to protect against the same business risks. These hedging transactions also result in $100 of taxable income and $100 of deductible payments between FZ and IB1. FZ has $100 of hybrid deductions paid to FT, a Country T affiliate. FZ receives no funded taxable payments or imported mismatch payments from FX and US1, respectively.

Alternative Facts: Same, except FZ uses foreign bank IB2. IB1 and IB2 are unrelated, although, consistent with being large banks, regularly act as counterparties with regards to each other's derivatives transactions, many of which for tax purposes are treated as debt transactions. As a result, IB1 and IB2 will each in a typical year have $1 million of taxable income from and $1 million deductible payments to the other.

Analysis under Proposed Regulations: While uncertain and likely unintentional, there is a risk under the Proposed Regulations that both fact patterns result in a disqualified imported mismatch amount.

[130] Prop. Reg. §1.267A-4(a).

[131] OECD Hybrid Mismatch Report, Paragraph 251. The OECD group standard is an even higher standard than the OECD's related party standard applicable to many of the other OECD anti-hybrid recommendations.

Analysis under Suggested Approach: Under the suggested approach, neither fact pattern should result in a disqualified imported mismatch amount.

g. Funded taxable payments should only include payments that are taxable in the recipient jurisdiction.

The Proposed Regulations do not explicitly state that a funded taxable payment must be taxable in the recipient jurisdiction. However, we think that result is necessary because otherwise the hybrid deduction cannot offset the income inclusion. We request guidance clarifying this point.

Example 13: Funded Taxable Payments that are not Included

Facts: US1 pays $100 interest to FX. Country X has an exemption on interest income. FX pays $100 interest pursuant to a hybrid instrument to FY. All parties are related.

Alternative Facts: US1 pays $100 interest to FX. FX pays $100 interest to FY. Country Y has an exemption on interest income. FY pays $100 interest pursuant to a hybrid instrument to FZ. All parties are related.

Analysis under Proposed Regulations: It appears clear under the Proposed Regulation that there is no disqualified imported mismatch amount under the first fact pattern as the hybrid deduction does not offset any income in Country X attributable to the US1 interest payment. While likely unintentional, the second fact pattern may have a different result. The Proposed Regulations do not clearly state that a hybrid deduction must be funded by a funded taxable payment that is taxable. However, perhaps that requirement can be inferred from the term "funded *taxable* payment."

Analysis under Suggested Approach: Under the suggested approach, neither situation should result in a disqualified imported mismatch amount.

4. Determining the Existence and Extent of D/NI outcomes

a. Definition of Interest, Royalties, Specified Payments, and Structured Payments

Unlike the approach taken by the proposed regulations under Section 163(j), the Proposed Regulations created a separate category of "structured payments" within the concept of "specified payments" in Prop. Reg. §1.267A-5(b)(5)(ii), distinct from interest otherwise subject to Section 267A. The Proposed Regulations potentially could have included structured payments under the definition of interest.

It is possible that Treasury and the Service intend for structured payments to be treated identical to interest, notwithstanding that they are in a separate category. Treasury and the Service may have categorized structured payments separately under the authority grant in Section

267A(e)(3) to address "structured transactions." One can arguably infer this rationale of Treasury and the Service from the statement in the Preamble that "in order to address certain structured transactions, the Proposed Regulations apply equally to 'structured payments.'[132] However, it is not apparent that the Code's reference to structured transactions is meant to encompass structured payments. The reference to structured transactions arguably refers to what the Proposed Regulations call "structured arrangements".[133]

Alternatively, Treasury and the Service may have created a separate category for structured payments in order to provide in certain areas a different substantive result for structured payments as compared to interest. Indeed, in numerous instances the Proposed Regulations refer to interest and royalties instead of "specified payments," the term that would encompass structured payments in addition to interest and royalties. It is not clear, however, if such provisions were intended to be limited to interest and royalties, as they do not appear to differentiate logically between including or excluding structured payments. Accordingly, to avoid unnecessary complexity and confusion, Treasury should consider including structured payments within the definition of interest or otherwise clarifying whether the relevant rules apply to all specified payments or only interest and royalties. Such approach would also be consistent with the proposed regulations under Section 163(j). Below is a more detailed review of the instances in which the Proposed Regulations refer to interest and royalties instead of specified payments.

b. Areas of the Proposed Regulations that Potentially Distinguish between Interest and Structured Payments

i. Hybrid Transaction

The Proposed Regulations provide a two-pronged definition for "hybrid transaction," which includes (i) a payment that is treated as *interest or royalties* for US tax purposes, but is not so treated for purposes of the tax law of a specified recipient; or (ii) a specified payment that is *recognized* by the specified recipient under its tax law more than 36 months after the end of the

[132] Preamble at 67620.

[133] The OECD Recommendations (e.g., Example 1.36(5)) refer to whether an instrument is "structured" or is a "structured transaction" in discussing derivative instruments and substitute payments that may be similar to the Proposed Regulation's structured payments. Nonetheless, it appears forced for Treasury to use the same two words that are used in the statute, "structured transactions," to provide the authority for both structured arrangements and structured payments, concepts that are unrelated to each other. Given that structured arrangements is a more novel concept than structured payments, it would make more sense for Treasury to use the words "structured transaction" to support the structured arrangements regulation and for Treasury to regulate structured payments under their general authority.

taxable year in which the specified party would be allowed a deduction for the payment under US tax law.[134]

A hybrid structured payment that is not treated as interest or royalties cannot be subject to the first prong because the first prong requires that the payment be treated as "interest or royalties for US tax purposes." Accordingly, hybrid structured payments will only be subject to the second prong that targets long-term deferral. But, the second prong may not be the correct tool to prevent the use of hybrid structured payments to create permanent D/NI outcomes. First, the wording of the second prong should be read to refer only to situations where the payment will eventually be recognized, i.e., long-term deferral fact patterns. Situations where the payment will never be recognized should not be within the second prong (see the discussion of this issue in Part IV.A.4.g.ii). Second, whether income is *recognized* is likely a lower standard than whether such amount is included or includible in income under Prop. Reg. §1.267A-3(a). For example, income may be recognized but still may be exempt. Such a payment would be treated as creating a No Inclusion result under the standard in Prop. Reg. §1.267A-3(a), but would not trigger hybrid transaction treatment under Prop. Reg. §1.267A-2(a)(2). It is understandable that the second prong generally uses this lower standard, given that the 36-month deferral (or non-recognition) rule of under Prop. Reg. §1.267A-2(a)(2) creates hybridity for payments that are not otherwise hybrid. It is not clear, however, why structured payments are only included in the second prong and cannot be subject to the first prong if they are hybrid and such hybridity causes a NI result. For example, if a hybrid structured payment were recognized but treated as an exempt dividend in the recipient jurisdiction, under this reading, such payment is not subject to the first prong (because it is not an interest or royalty payment as defined as defined in Prop. Reg. § 1.267A-5(a)(12) and 1.267A-5(a)(16)) nor is it subject to the second prong since it is immediately recognized in the recipient jurisdiction. It is not clear what policy basis there would be to allow in this manner the use of hybrid structured payments to create D/NI results.[135] Accordingly, we ask Treasury to confirm whether this reading is correct.

ii. Disregarded Payments

The Proposed Regulations provide a definition for "disregarded payments," the excess of which over a specified party's dual inclusion income is generally treated as a disqualified hybrid

[134] Prop. Reg. §1.267A-2(a)(2).

[135] It is possible that Treasury was conscious of the ambiguous tax character of structured payments generally (for both US and foreign purposes) and so decided simply to exclude structured payments from the hybrid transaction test (other than by reason of long-term deferral). For example, suppose a commitment fee is paid by a US entity to a foreign entity, and, due to the terms of that commitment fee, the foreign entity's jurisdiction treats the payment as interest for all purposes of its tax law whereas the US would treat such payment as a fee. Even if the foreign jurisdiction offers a beneficial rate on interest and would have taxed a fee at ordinary rates, it is questionable whether the transaction should be treated as a hybrid transaction. Arguably, the payment should not be considered a hybrid transaction, given that the commitment fee only became subject to the US rule to begin with based on its similarity to interest.

amount subject to limitation under Section 267A.[136] The definition states the following: "a payment to the extent that, under the tax law of a tax resident or taxable branch to which the payment is made, the payment is not regarded and, were the payment to be regarded (and treated as interest or a royalty, as applicable) under such tax law, then the tax resident or taxable branch would include the payment in income." The reference to interest and royalties would, on its face, provide that the counterfactual to apply to a structured payment that is disregarded is whether that payment would have been included in income were the recipient jurisdiction to (i) regard such payment and (ii) characterize such payment as an interest payment.[137] Hence, strangely, it does not matter if a structured payment would have been included had the payment been regarded and properly characterized under the recipient jurisdiction's law in a manner consistent with the recipient jurisdiction's normal treatment of such payment. It appears that a payment is covered only if it would have been included had it been regarded *and* if it had been treated as interest.[138] Here again, there does not appear to be a policy motivation for a distinction between interest and structured payments.[139]

iii. Deemed Branch Payment Inconsistency

The Proposed Regulations define "deemed branch payment" to include "any amount of interest or royalties allowable as a deduction in computing the business profits of the US permanent establishment, to the extent the amount is not regarded (or otherwise taken into account) under the

[136] Prop. Reg. §1.267A-2(b)(2).

[137] All the structured payments are similar to interest. So presumably for structured payments the correct interpretation of the words "as applicable" in the regulations is to view structured payments as interest, as opposed to royalties, in applying the words "and treated as interest or a royalty, as applicable,"

[138] For example, suppose a commitment fee were paid by a US payor to a foreign branch which disregards the payment (because it is a branch). The disregarded payment rule is aimed at testing whether the disregarded branch transaction prevents inclusion of an otherwise includable payment. So the correct counterfactual would appear to be whether the foreign jurisdiction would have included the commitment fee in income if the disregarded transaction were regarded. However, the reference to interest or royalties in the disregarded payment rule appears to apply a different counterfactual. The disregarded payments rule tests a disregarded structured payment by reference to whether a regarded conventional interest payment would have been included in the recipient jurisdiction. If the foreign jurisdiction would have excluded interest, the disregarded payment rule seemingly would not apply. The reverse scenario is also not intuitive. If a structured payment, had it been regarded, would not have been included in the foreign jurisdiction, the disregarded payment rule should not be implicated even if the payment would have been included had it been conventional interest.

[139] This provision's intent regarding structured payments is uncertain. It is possible that the parenthetical intends to tell the reader to assume for purposes of the test that the income is treated as interest in the foreign jurisdiction, and thereby the payment only fails the test if the jurisdiction does not have an exemption for interest. Alternatively, it is possible that the primary intent of the parenthetical was to cover transactions that are both disregarded transactions *and* hybrid transactions. For such transactions, even after you test what would have occurred had the transaction been regarded, you still would get a No Inclusion result due to the hybrid transaction. For such transactions, but not regular disregarded transactions, one needs to assume that the jurisdiction treats the payment as interest or royalties in order for the test to give the proper result. Regardless, the language used changes the result for structured payments because the counterfactual for structured payments appears to operate by reference to the recipient jurisdiction's treatment of interest and not its treatment of the relevant structured payment.

home office's tax law (or the other branch's tax law)."[140] This definition by its terms only applies to interest and royalties, not structured payments. Similarly, the definition of "US taxable branch payments" refers only to interest and royalties. Here too, the policy motivation for omitting a reference to "structured payments" is not apparent. We ask Treasury to confirm whether the distinction is intentional.

iv. De Minimis rule

The de minimis rule in Prop. Reg. §1.267A-1(c) excludes certain taxpayers from the rules of Section 267A refers to "interest and royalties," but seemingly not to structured payments. The effect of this rule is that if a taxpayer has few interest and royalty deductions, but a large number of structured payments, it would qualify for the *de minimis* exception. One policy justification for this may be that the *de minimis* rule is designed to alleviate the compliance burden for smaller taxpayers. The Proposed Regulations may have presumed that ascertaining the existence of deductions for structured payments may in and of itself lead to unwarranted compliance burdens. This reasoning does not appear to be compelling, because taxpayers who incur structured payments would generally be in a position to easily identify them.[141] At the same time, taxpayers who structure their deductions as structured payments, while keeping their conventional interest and royalties nominal, could avoid the application of Section 267A altogether. In any event, this narrow context itself does not seem to warrant the creation of structured payments as a category distinct from interest.

c. Types of Structured Payments

i. Substitute Payments

"Substitute interest payments," which refer to interest payments described in Reg. §1.861-2(a)(7), are included in the definition of structured payments. Thus, substitute payments characterized as interest for the purpose of the US tax source rules, but treated differently for non-US tax purposes, are considered specified payments, and thereby subject to the disallowance rules of the Proposed Regulations. This provision generally appears to be reasonable and is consistent with the OECD Hybrid Mismatch Report (as described below). The concept parallels the term "substitute payment" under the OECD Hybrid Mismatch Report.

It is not entirely clear, however, how the Proposed Regulations treat substitute interest payments and other structured payments not generally characterized as interest for purposes of the hybrid transaction test in Prop. Reg. §1.267A-2(a)(2). For example, if a substitute interest payment is not considered interest for general US tax purposes, it is not apparent what treatment in the

[140] Prop. Reg. §1.267A-2(c)(2).

[141] Amounts predominantly associated with the time value of money arise in complex transactions likely only utilized by sophisticated taxpayers who can track such transactions. Conversely, bond issuance costs and commitment fees are simple expenses that likely are easily tracked by any taxpayer.

recipient jurisdiction gives rise to a hybrid transaction under Prop. Reg. §1.267A-2(a)(2).[142] If the payment is treated as actual interest in the recipient jurisdiction, but entitled to a beneficial rate, or if the payment is treated exactly the same as in the US, but not as interest, it is not clear if those scenarios give rise to a hybrid transaction.[143]

In addition, the concept of substitute payments under the OECD Recommendations encompasses more than substitute interest under the Proposed Regulations. Under the OECD, substitute payments include any payments in a transfer of a financial instrument that creates a better tax result than would have occurred for an associated item of income assuming the financial instrument was not transferred. The OECD uses two alternative frameworks to determine whether there is a hybrid mismatch in the case of repos and securities lending. The first evaluates the existence of a "hybrid transfer," while the second evaluates the existence of a "substitute payment."[144] A "hybrid transfer" is defined in the OECD Hybrid Mismatch report as "any arrangement to transfer a financial instrument entered into by a taxpayer with another person where: (i) the taxpayer is the owner of the transferred asset and the rights of the counterparty in respect of that asset are treated as obligations of the taxpayer; and (ii) under the laws of the counterparty jurisdiction, the counterparty is the owner of the transferred asset and the rights of the taxpayer in respect of that asset are treated as obligations of the counterparty." The report defines "substitute payment" as "any payment, made under an arrangement to transfer a financial instrument, to the extent it includes, or is payment of an amount representing, a financing or equity return on the underlying financial instrument where the payment or return would (i) not have been included in ordinary income of the payer; (ii) have been included in ordinary income of the payee; or (iii) have given rise to hybrid mismatch; if it had been made directly under the financial instrument." For example, the OECD Recommendations would view bond premium paid in acquiring an instrument with accrued but unrecognized interest as a substitute payment that potentially triggers an adjustment, e.g., if the bond premium is exempt capital gain for the recipient and if the sale is pursuant to a structured arrangement.[145] The Proposed Regulations do not directly cover these types of fact patterns, however, as the Proposed Regulations do not provide a special framework to hybrid transfers and substitute payments. We are not at this time recommending that Treasury change its current approach. It is possible that many of the arbitrages that would be included under the OECD's special framework would not succeed, in any event, under domestic US tax law. So, even if Treasury were to adopt the OECD approach, doing so may only have significant effect, if any, in the context of the Imported Mismatch Rule. Changing the result in the imported mismatch context may be insufficient justification for introducing a separate

[142] Here we refer to the rule in the first sentence of Prop. Reg. 1.267A-2(a)(2). The 36-month deferral rule in the third sentence of Prop. Reg. 1.267A-2(a)(2) can be applied to structured payments without issue.

[143] See also above footnotes 134, 137, 138 and accompanying text regarding the interaction between these structured payments and the hybrid transaction and disregarded payment rules.

[144] Recommendation 1.2(b) and 1.2(e), respectively.

[145] OECD Hybrid Mismatch Report at Example 1.36.

framework for hybrid transfers and substitute payments. Additionally, it is possible that the types of hybrid transfers and substitute interest payments that are not specifically covered under the Proposed Regulations and are specifically covered by the OECD Recommendations may be outside of the scope of what the Section 267A statute intended to address.

ii. Other Structured Payments/Capitalized Payments

The Proposed Regulations provide that debt issuance costs and commitment fees are structured payments.[146] The deductions associated with such payments are thereby potentially subject to disallowance under the Proposed Regulations.[147] Debt issuance costs generally are transaction costs incurred by an issuer of debt and are generally capitalized.[148] The costs are then amortized using the same constant yield method applicable to the accrual of interest expense.[149]

Commitment fees generally refer to fees paid to preserve the availability of funds to borrow from a lender. If such amounts create a capital asset, they are generally capitalized and amortized ratably over the life of the loan.[150] Ratable amortization is generally more favorable than the constant yield method applicable to interest. If such fees do not create a capital asset (e.g., ongoing quarterly fees on a revolver), then they are generally currently deductible as business expenses.[151] If such fees create a capital asset, but no loan is ever drawn, the amount can generally be taken as a loss when the option to draw the loan expires.[152]

Amounts predominantly associated with the time value of money are also treated as a structured payment.[153] Such amounts include expenses and losses incurred in a transaction securing the use of funds if the expense or loss is predominately for the time-value of money.[154] The Preamble cross-references to Reg. §§1.861-9T and 1.954-2, where the same language is used.[155] The examples in that regulation would include a scenario where a party sells borrowed fungible property, thereby securing for a period of time the use of the funds, while hedging through e.g., a forward contract, an option, or another derivative on similar fungible property, the risk

[146] Prop. Reg. §1.267A-5(b)(5)(ii)(A)(2)(i) and (3).

[147] Prop. Reg. §§1.267A-5(b)(5)(i) and 1.267A-1(b).

[148] Reg. §1.446-5(a).

[149] Reg. §1.446-5(b)(1). Treasury may consider clarifying guidance confirming our understanding that the relevant specified recipient of the debt issuance costs is the party that receives the payments associated with such costs (e.g., the law firm or financial advisor) and is not necessarily the party providing the financing.

[150] *See* Rev. Rul. 81-161, 1980-1 C.B. 21; *see also* Rev. Rul. 81-160, 1980-1 C.B. 230.

[151] FAA 20182502F.

[152] *See* Rev. Rul. 81-160 *supra*. Commitment fees are only treated as structured payments if a loan is drawn. Prop. Reg. §1.267A-5(b)(5)(ii)(A)(3).

[153] Prop. Reg. §1.267A-5(b)(5)(ii)(B).

[154] *Id.*

[155] Preamble at 67620.

associated with repayment to a cost equivalent to the time value of money.[156] The associated loss or expense from engaging in such a transaction is treated as a structured payment.

The inclusion of the above costs as structured payments raises a broader question of whether Section 267A could disallow amortization or depreciation deductions other than those associated with capitalized costs in respect of structured payments. Section 267A disallows amounts "paid or accrued."[157] The potential disallowance of the aforementioned payments presupposes that at least some amortized capitalized costs can be viewed as "paid or accrued" for the purposes of the Proposed Regulations. It is not clear whether the disallowed amortization is limited to circumstances in which the Proposed Regulations explicitly refer to payments that are always capitalized (or at least ordinarily capitalized) or could also apply to capitalized interest or royalties. We believe that the disallowance of deductions relating to capitalized costs should be limited to structured payments.

The aforementioned structured payments are not naturally interest for general tax purposes. They are recast to be similar to interest for purposes of the Proposed Regulations. Consistent with such recast, it is understandable to view their associated payments as deductible, even though for general tax purposes the payments are not deductible, but are capitalized, and the corresponding asset is amortized. Final regulations may consider clarifying this point.

d. US Inclusion Kick-out Rule application to GILTI and PFICs

Section 267A(b)(1) provides that, to the extent interest and royalties paid to a CFC are included in gross income of a US shareholder under Section 951(a) (as subpart F income), such amounts are not subject to disallowance under Section 267A. By contrast, Section 267A does not provide an exception for a payment made to a CFC that is taken into account under Section 951A as GILTI by such CFC's US shareholders. However, Section 267A(e) includes a specific grant of regulatory authority including a reference to exceptions in "cases which the Secretary determines do not present a risk of eroding the Federal tax base."[158]

The Proposed Regulations provide rules that reduce disqualified hybrid amounts to the extent that the amounts are included or includible in the income of a US tax resident or US taxable branch (i.e., the US Inclusion Kick-out Rule).[159] The Proposed Regulations also provide that a specified payment is not a disqualified hybrid amount to the extent that the specified payment (i) is received by a CFC and includible under Section 951(a)(1) (determined without regard to allocable deductions or qualified deficits) in the gross income of a US shareholder of the CFC or (ii) under Section 951A, increases a US shareholder's pro rata share of tested income of a CFC,

[156] Reg. § 1.861-9T(b)(1)(ii)

[157] Prop. Reg. §1.267A-1(b).

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

[159] Prop. Reg. §1.267A-3(b)(1)-(2).

reduces the shareholder's pro rata share of tested loss of a CFC, or both.[160] The Preamble explains that the Proposed Regulations ensure that a specified payment is not a disqualified hybrid amount to the extent included in the income of a US tax resident or US taxable branch, or taken into account by a US shareholder under the subpart F or GILTI rules.[161]

Thus, the Proposed Regulations provide that if a specified payment is taken into account for US tax purposes, deductions for interest and royalties are not subject to disallowance under Section 267A.[162] Significantly, according to the OIRA Special Analyses, "[p]ayments that are included directly in the US tax base or that are included in GILTI do not give rise to a D/NI outcome and, therefore, it is consistent with the policy of section 267A and the grant of authority in section 267A(e) to exempt them from disallowance under section 267A."[163]

Section 250 allows US corporations to deduct a portion of their GILTI, effectively reducing the rate on GILTI to 10.5% to 12.5%. Further, the US Inclusion Kick-Out Rule applies even if the specified payment is merely included in tested income for GILTI and is offset by a tested loss of another CFC or is offset by the allowed return on qualified business asset investment ("**QBAI**"). Incorporating Section 951A in the US Inclusion Kick-out Rule thus would potentially allow taxpayers to achieve a lower tax rate in the US through the use of a hybrid instrument. But, it may be unlikely that the related party payments that are the main focus of the anti-hybrid rules would generate GILTI, as opposed to subpart F income. For example, active royalties or interest would generate GILTI, but related party payments often would not be treated as active royalties or interest. Nonetheless, for situations where this arbitrage is available, it is uncertain whether this result is reasonable from a policy perspective.

The US Inclusion Kick-out Rule is intuitive from a policy perspective. The deduction for what would otherwise be a disqualified hybrid amount should not be disallowed where the payment has not left the US tax net and has resulted in an inclusion within the US tax system. Consistent with that logic, we recommend that Treasury and the Service consider expanding the US Inclusion Kick-out Rule to scenarios in which the corresponding income is included in the US as a result of an election to be treated as a qualified electing fund with respect to a passive foreign investment company under Section 1295 of the Code.[164] This would create the same result for a qualified electing fund as for a partnership, which makes sense as both entities pass through all income to their beneficial owners for US tax purposes.

[160] Prop. Reg. §1.267A-3(b)(3)-(4).

[161] Preamble at 67619.

[162] The statute provides that to the extent payments are included in the income of a US shareholder under Section 951(a), such payment is not a disqualified related party amount. Section 267A(b)(1).

[163] OIRA Special Analyses at 67628.

[164] An expansion of the kick-out to include qualified electing funds may require that the payor substantiate that the income was included by the electing shareholders.

e. Treatment of US and foreign withholding taxes

The US imposes withholding tax on a gross-basis under Sections 871 or 881 with respect to outbound payments of certain US source income, including interest and royalties, and the tax is deducted and withheld under Sections 1441 or 1442. For example, if US source interest is paid to a foreign person, and there is no reduction in the tax rate by an applicable income tax treaty, such interest is subject to a flat rate of 30% withholding tax in the US. Notwithstanding that a foreign person may be subject to withholding tax in the US, the Preamble states that source-based withholding taxes imposed by the US (or any other country) on disqualified hybrid amounts do not neutralize the D/NI outcome.[165] Thus, if tax is imposed and withheld on US source payments, such gross-basis withholding does not reduce or otherwise affect disqualified hybrid amounts. However, in our view, by imposing a withholding tax, the specified recipient has been subject to tax in the US, and we believe that Section 267A should be consistent in its treatment of specified recipients that have been subject to tax and exclude such specified payment from being a disqualified hybrid amount to the extent the US imposes a withholding tax on the specified payment.

The Proposed Regulations provide exceptions to Section 267A disallowance for amounts included in income as GILTI or subpart F or included in the income of a US taxable branch. According to the OIRA Special Analyses, although Treasury and IRS considered providing no exceptions for payments included in the US tax base, this approach was rejected in the Proposed Regulations because it would result in double taxation by the US. Without an exception, in the case of a payment to a US taxpayer the result would be both the denial of a deduction for the payment as well as the inclusion of such payment in income for US tax purposes. The OIRA Special Analyses acknowledge a similar outcome in the case of hybrid payments made by one CFC to another CFC with the same US shareholders, noting that

> [A] payment would be included in tested income of the recipient CFC and therefore taken into account under GILTI. If Section 267A were to apply to also disallow the deduction by the payor CFC, this could also lead to the same amount being subject to Section 951A twice because the payor CFC's tested income would increase as a result of the denial of deduction, and the payee would have additional tested income for the same payment.[166]

Although the Proposed Regulations provide these exceptions, no such exception applies in the case of gross-basis withholding. According to the Preamble, withholding tax policies are unrelated to the policies underlying hybrid arrangements, and as a result, withholding taxes are not

[165] Preamble at 67619. This approach is consistent with the BEPS Action 2 Report (paragraph 407).

[166] OIRA Special Analyses at 67628.

a substitute for a specified payment being included in the income by a tax resident or a taxable branch.[167]

We recommend that Treasury provide that a specified payment is not a disqualified hybrid amount to the extent that the US imposes a withholding tax on the specified payment. To the extent that an income tax treaty reduces the amount of withholding imposed on a specified payment, such amount should be treated as a disqualified hybrid amount to the extent of the reduction in withholding under rules similar to those in Section 163(j)(5)(B) as in effect before the TJCA. Form 1042 and the accompanying information returns could be used to report the specified payment and eliminate any subsequent claims for refund when a deduction for the interest or royalty has been taken into account by the related party payor.[168]

By reason of the US imposing a withholding tax, the specified recipient has been subject to tax in the US. Moreover, if a deduction is denied in the US and the US also imposes a withholding tax, the payment is effectively taxed twice by the US. Adopting such an approach would be inconsistent with the policy behind providing exceptions with respect to payments included in the US tax base (either directly or under subpart F or GILTI).[169]

The Preamble acknowledges that other jurisdictions applying the defensive or secondary rule to a payment (which generally requires the payee to include the payment in income if the payor is not denied a deduction for the payment under the primary rule) may not treat withholding taxes as satisfying the primary rule and may therefore require the payee to include the payment in income if a deduction for the payment is not disallowed (regardless of whether withholding tax has been imposed). This issue would need to be addressed, in particular because it is possible that a withholding tax as high as 30% on a gross basis may apply in the US. However, it seems questionable to impose disallowance on amounts subject to US withholding tax due to a concern that the payee jurisdiction would force an inclusion. Further work should be undertaken on a multilateral level to ensure that hybrid mismatch rules are coordinated among jurisdictions to ensure economic double taxation does not occur in these instances.

[167] *Id.*

[168] For example, in general, a withholding agent must make an information return on Form 1042-S to report the amounts subject to withholding. Treas. Reg. 1.1461-1(c)(1). Moreover, a copy of the Form 1042-S must be attached to the claim for refund. Treas. Reg. 301.6402-3(e).

[169] It is possible that a foreign tax credit for the withholding tax paid in the US could be claimed in the foreign jurisdiction. However, this would also be true with respect to the exceptions to Section 267A disallowance currently provided by Treasury (e.g., with respect to amounts included in income as GILTI or subpart F) – i.e., these exceptions are available regardless of the treatment of the payment under foreign tax law. Furthermore, in many cases, in order to claim a foreign tax credit in the foreign jurisdiction, there would have to have been an inclusion, in which case, it would not result in a D/NI outcome.

f. Treatment of specified payments to reverse hybrids

The Proposed Regulations provide that when a specified payment is made to a reverse hybrid, it generally is a disqualified hybrid amount to the extent that an investor does not include the payment in income ("**Reverse Hybrid Rule**").[170] According to the Proposed Regulations, a reverse hybrid is an entity (domestic or foreign) that is fiscally transparent under the tax law of its country of organization or establishment but not fiscally transparent under the tax law of an investor of the entity.[171] Due to this rule, a specified payment made to a reverse hybrid is generally treated as a disqualified hybrid amount under the Reverse Hybrid Rule even if the reverse hybrid, while fiscally transparent in the jurisdiction where it is organized or established, is resident for tax purposes under the tax laws of another jurisdiction, and the specified payment is subject to tax in that jurisdiction. We recommend that Treasury modify the Reverse Hybrid Rule to provide that a specified payment will not constitute a disqualified hybrid amount to the extent that the specified payment is taken into account in the jurisdiction in which the reverse hybrid is resident for tax purposes.

Example 14: Inclusion in jurisdiction of tax residence of reverse hybrid

> Entity A is established in Country A, and is treated as a tax resident in Country B (e.g., Entity A is managed and controlled in Country B). Entity A is treated as fiscally transparent under the tax law of Country A, but is not treated as fiscally transparent under the tax law of its investor. A specified payment is made to Entity A in Year 1. The specified payment is not subject to tax in Country A, but is taken into account for tax purposes in Country B. For purposes of Section 267A, a D/NI outcome should not result, and the specified payment should not constitute a disqualified hybrid amount.

g. Timing mismatches

i. The 36-month rule

Prop. Reg. §1.267A-3(a)(1)(i) provides that a specified recipient has an Inclusion if the specified recipient includes the income in its tax base at ordinary rates during a taxable year that ends no more than 36 months after the end of the specified party's taxable year. In addition to the 36-month rule in Prop. Reg. §1.267A-3(a)(1)(i), which governs when long-term deferral is treated as a NI result occurs, there also is a 36-month rule in Prop. Reg. §1.267A-2, which governs when long-term deferral is viewed as a hybrid transaction. Prop. Reg. §1.267A-2(a)(2) treats as a hybrid transaction any transaction that has a payment that is not recognized in a taxable year that ends within 36 months after the end of the taxable year in which the deduction for such payment was

[170] In order for the specified payment to be a disqualified hybrid amount, the investor's no-inclusion must also be a result of the payment being made to the reverse hybrid. Prop. Reg. §1.267A-2(d)(1).

[171] Prop. Reg. §1.267A-2(d)(2).

taken (Prop. Reg. §1.267A-3(a)(1)(i) and Prop. Reg. §1.267A-2(a)(2), separately and together, as appropriate, the "**36-month rule**") .

A. Whether timing mismatches should be treated as creating NI and hybridity.

While the 36-month rule recognizes that long-term deferral can provide significant tax benefits tantamount to non-inclusion, timing differences between jurisdictions are widespread and, in some cases, unavoidable. Viewing deferral (long-term or otherwise) as creating NI and hybridity potentially expands the scope of the anti-hybrid rules substantially and may sweep into their net transactions that are not structured to exploit differences in tax systems. Having said that, timing differences are addressed in the OECD Recommendations, which provide that a timing mismatch will be treated as creating a NI result if the payment under the instrument is not expected to be included in income "within a reasonable period of time."[172] The 36-month rule is consistent with the OECD Recommendations and provides more certainty as to what constitutes a reasonable period of time for the inclusion to occur. Accordingly, on balance, we support the 36-month rule.

As with any bright line test, a downside of the 36-month rule is that it creates a cliff effect– that is, it would deny any deduction where the inclusion occurs beyond 36 months. We recommend balancing the competing policy concerns at play by providing, similar to Section 267(a)(3), that in the event of deferral for longer than 36 months, the deduction would be deferred until the payment is included in the specified recipient's income under the relevant foreign tax law.

B. Additional recommended adjustments to the 36-month rule

We further recommend tweaking the 36-month rule to clarify that the rule takes into account inclusions occurring in a period prior to the period of the specified payment.

> **Example 15.** FP owns all of USP. FP makes a 1000x USD loan to USP. FP, under its local tax law, includes 10x USD of interest income in year 1 with respect to the instrument on an accrual basis, even though no payments have been made on the instrument. For US purposes, Section 267(a)(3) applies to this related party payment. Because the interest has not yet been paid, under Section 267(a)(3), USP does not deduct the 10x USD of interest. In year 2, USP pays the 10x USD of interest and tentatively deducts such amount in such year.

Though FP includes the 10x USD in income in year 1, the payment in year 2 appears to be a D/NI outcome because FP does not include the payment in income in year 2, or within the 36-month period beginning after year 2. Such result is not consistent with the purposes of Section 267A, which is to disallow deductions for payments that are not included in the recipient's income.

[172] OECD Hybrid Mismatch Report, Paragraph 55.

We therefore recommend that Prop. Reg. §1.267A-3(a)(1)(i) be amended as follows: "For purposes of Section 267A, a tax resident or taxable branch includes in income a specified payment to the extent that, under the tax law of the tax resident or taxable branch, it includes, <u>*has included*</u> or will include during a taxable year that ends no more than 36 months after the end of the specified party's taxable year the payment in its income or tax base at the full marginal rate imposed on ordinary income."[173]

ii. Application of 36-month rule in Prop. Reg. §1.267A-2(a)(2) to payments to zero-tax jurisdictions

Under Prop. Reg. §1.267A-2(a)(2), "a specified payment is deemed to be made pursuant to a hybrid transaction if the taxable year in which a specified recipient recognizes the payment under its tax law ends more than 36 months after the end of the taxable year in which the specified party would be allowed a deduction for the payment under US tax law." We understand this 36-month rule to apply only in situations where recognition will in fact eventually occur at some point in time, but after the 36-month period. We believe that this 36-month rule does not apply when recognition will never occur. Accordingly, we do not view payments to zero-tax jurisdictions as automatically being hybrid, notwithstanding that such payments are not included within 36 months. Any other reading would appear to override the causality requirement and the counterfactual test. We urge Treasury and the Service to make this point clearer in final regulations.

h. Base differences (principal v interest) and measurement differences (e.g., valuation)

i. Testing Inclusions on an aggregate vs. payment by payment basis

Under Prop. Reg. §1.267A-2(a)(1), a payment made pursuant to a hybrid transaction is a disqualified hybrid amount to the extent that (1) the payment is not included in income of the specified recipient, and (2) the specified recipient's non-inclusion is the result of the payment being made pursuant to a hybrid transaction. Under Prop. Reg. §1.267A-2(a)(2), a hybrid transaction includes an instrument the payment with respect to which is treated as interest for US tax purposes but treated as a return of principal under the tax law of the specified recipient.

Example 16. *Principal v. Interest.* FP, a Country X corporation, makes a $100x loan with a three-year term to USP. USP makes payments as follows:

[173] While there may be a reasonable position to achieve this result on the language of the Proposed Regulations, given the importance of this issue we request guidance confirming this result.

Year	Total Payment	US Treatment	Country X Treatment
1	$10x	$10x interest	$10x principal
2	$10x	$10x interest	$10x principal
3	$110x	$10x interest; $100x principal	$80x principal; $30x interest

For US tax purposes, USP's payments are treated first as payments of interest to the extent of accrued and unpaid interest as of the date the payment becomes due.[174] For Country X tax purposes, the payments are first treated as payments of principal.

Analysis. The loan is a hybrid transaction because one or more payments (i.e., the payments in years 1 and 2) are treated as interest for US tax purposes but are treated as a return of principal for Country X tax purposes. Each payment in years 1 and 2 is not included in the income of FP. Instead, $30x of the year 3 payment will be included in FP's income. Although the $30x included in year 3 occurs within the 36-month time frame testing long-term deferral in the Proposed Regulations, that $30x inclusion (arguably) relates to a portion of the year 3 payment rather than the year 1 and 2 payments. So a NI result may be present. In addition, the NI is caused by the transaction being a hybrid transaction because if the payments in years 1 and 2 were interest for Country X tax purposes then they would be included in the FP's income in years 1 and 2. Thus, the $10x of interest that is paid in each of years 1 and 2 is not deductible under Section 267A.

Recommendation

In the example above, the entire $30 that would otherwise be deductible by USP is included in the income of FP within the time frame allotted by the 36-month rule.[175] The example thus illustrates the pitfall of applying Section 267A on a payment-by-payment basis. Accordingly, we recommend final regulations clarify that Inclusions generally are tested on an aggregate basis taking into account all related payments within a transaction.[176] Under this approach, for example, specified payments would not be included in the disqualified hybrid amount to the extent that there is an offsetting income inclusion by the specified recipient from a related payment. The offsetting

[174] *See* Reg. §1.446-2(e)(1).

[175] As mentioned in Part IV.A.4.g.i, the 36-month rule in Prop. Reg. §1.267A-3(a)(1)(i) provides that a specified recipient includes a payment in income if the specified recipient includes (or will include during a taxable year that ends no more than 36 months after the end of the specified party's taxable year) the payment in its income or tax base at the full marginal rate imposed on ordinary income.

[176] While there may be a reasonable position to achieve this result on the language of the Proposed Regulations, we request explicit guidance given the importance of this issue.

income inclusion would have to occur within the 36-month rule's time frame. In the example above, our recommended approach would not treat the year 1 and 2 payments as disqualified hybrid amounts because these amounts are included in FP's income in year 3. One issue to consider is that, when combined with the 36-month rule, a payor would need to know *ex ante* whether there would be a corresponding income inclusion within the 36-month period mandated by Prop. Reg. §1.267A-3(a)(1)(i). To solve for this, the Proposed Regulations could allow the payor to rely on the terms of the instrument or foreign law: If the terms of the instrument or foreign law require an income inclusion within the 36-month period, the payment is not included in the hybrid deduction amount. [177]

ii. Proper treatment of marginal forms of hybridity

Treasury should also consider further whether the conversion of interest to principal on an instrument that both jurisdictions respect as debt is hybrid enough to be treated as a hybrid transaction, as is currently provided in Prop. Reg. 1.267A-2(a)(2) (second sentence). The OECD Recommendations intentionally do not specify what types of differences make something "hybrid," with the articulated intent that the term be broadly construed.[178] However, marginal forms of hybridity often merely amount to deferral, where a Deduction / No Inclusion result will be offset by additional tax on a later payment or on a different transaction, e.g., through increased capital gains tax on the sale of the associated instrument. The OECD Recommendations do not view long-term deferral as creating a mismatch when the elements driving long-term deferral are reasonable in light of the commercial objectives and the terms that would be agreed to by unrelated parties.[179] Treasury may want to consider following a similar logic and limit the application of Prop. Reg. §1.267A-2(a)(2) (first sentence) to marginal forms of hybridity solely if the hybridity stems from terms that are not reasonable in light of the intended transaction and the reason for such transaction. This limitation particularly makes sense for types of hybridity such as interest-to-principal, interest-to-return of capital, royalty-to-disposition proceeds, royalty-to-return of basis, etc., as these types of hybridity may be too common and unavoidable to warrant hybrid

[177] Regulations could allow borrowers to rely on a representation from the lender that the income will be included within 36 months under the terms of the instrument and applicable foreign law.

The shortcoming with taking an aggregate approach and relying on the terms of the instrument or foreign law, however, is that the specified recipient may nonetheless avoid including the payment in income. In the example above, if Country X law excludes capital gains from income, FP may be able to avoid the $30 of interest income with respect to the year 3 payment by disposing of the instrument prior to such payment being made. To mitigate this problem, an alternative rule would require the payor to certify that the specified recipient will include an amount equal to the specified payment in income within the 36-month period. Alternatively, another approach would simply adopt a rule similar to Section 267(a)(3), which would defer any deduction until the corresponding Inclusion by the related party recipient under foreign law.

[178] See OECD Hybrid Mismatch Report, Paragraph 20.

[179] See *id*. at paragraph 58-60, Example 1.22 (15-year deferral is reasonable where intended commercial transaction is a contingent interest payment to a related, but not identically owned, party with potentially divergent interests.)

transaction treatment unless there is some indication that the hybridity is unreasonable in light of the intended commercial terms and the reasons for such terms.

i. Treatment of foreign currency gain or loss

Prop. Reg. §1.267A-5(b)(2) provides that foreign currency gain or loss with respect to a specified payment is only taken into account under Section 267A to the extent that the specified payment is disallowed. If a specified payment is disallowed under Section 267A, a proportionate amount of any Section 988 loss with respect to the specified amount is also disallowed, and a proportionate amount of the foreign currency gain with respect to the specified payment reduces the amount of the disallowance.[180] The Proposed Regulations explain that "the proportionate amount is the amount of foreign currency gain or loss with respect to the specified payment multiplied by the amount of the specified payment for which a deduction is disallowed under section 267A." Treasury has requested comments on the foreign currency rule, including any rules regarding the translation of amounts between currencies.

We agree with the Proposed Regulations' treatment of foreign currency gain or loss. We do note that there appears to be a drafting error in the definition of proportionate amount. We believe that definition should be amended as follows: "the proportionate amount is the amount of foreign currency gain or loss under section 988 with respect to the specified payment multiplied by a fraction, the numerator of which is the amount of the specified payment for which a deduction is disallowed under section 267A and the denominator of which is the total amount of the specified payment."

j. Impact of exemption regimes on the calculation of dual inclusion income

We request clarification regarding how dual inclusion income is calculated when a recipient jurisdiction has other special exemption regimes, e.g., a participation exemption or patent box regime. Prop. Reg. §1.267A-3(a) and Prop. Reg. §1.267A-2(b)(3), taken together, may be read to mean that a participation regime would reduce dual inclusion income. Prop. Reg. §1.267A-2(b)(3) tests the extent to which the underlying income of the payor of a disregarded payment is included in the income of the recipient of the disregarded payment. Prop. Reg. §1.267A-2(b)(3)(i) incorporates by reference the rules of Prop. Reg. §1.267A-3(a). Prop. Reg. §1.267A-3(a)(1)(ii) says that a payment does not create a full Inclusion result to the extent that the tax on such payment is reduced by relief particular to such payment. But it is not clear if it is the correct policy result for relief particular to underlying gross income of a payor of a disregarded payment to reduce dual inclusion income.

[180] The proportionate amount is the amount of foreign currency gain or loss with respect to the specified payment multiplied by the amount of the specified payment for which a deduction is disallowed under Section 267A.

Example 17: US1 pays a $1000 dividend to its shareholders. US2, which owns 10% of US1's stock, thereby receives a $100 dividend. US2 also earns services income of $20. US2 pays its parent, FX, interest of $120. The US2 interest would be deductible under the various provisions of the Code, including Section 163(j). Country X views US2 as a disregarded entity and a branch. US2 is treated as a corporation for US tax purposes. Hence, Country X disregards the US2-FX interest payment. Country X generally taxes all the income of the US2 branch. Country X does, however, provide a participation exemption for 10% owned subsidiaries. Accordingly, Country X only subjects FX to tax on US2's $20 services income.

In this case, if the participation regime does not reduce dual inclusion income, the $100 dividend is subject to zero layers of additional tax. However, that NI result is consistent with the policy decisions of Country X, as that would be the same result that would occur if FX held the US1 stock on a direct basis and the US2 disregarded payment never occurred. So, allowing the US2-FX interest to be deductible leads to the same result that would have occurred had the hybrid element (US2, viewed as a branch by Country X and as a corporation by the United States) not been present. Accordingly, there is an argument that the participation regime should not reduce dual inclusion income.

The Preamble in several locations indicates that the main concern relating to a disregarded payment offsetting non-dual inclusion income relates to the use of the US consolidation regime, an element not present in the above example.[181]

The above example differs in an important way from the facts of Prop. Reg. §1.267A-6(c)(3)(iii)(B), in which a participation exemption is treated as reducing dual inclusion income. In the example in the Proposed Regulations, the equivalent of the US1-US2 payment is deductible as interest in the US but treated as an excludible dividend in Country X. Hence, had FX held such instrument on a fully transparent basis, the hybrid transaction rule would have disallowed the

[181] *See* Preamble at 67617 (discussing disregarded payments): "In general, a disregarded payment is a disqualified hybrid amount only to the extent it exceeds dual inclusion income. For example, if a domestic corporation that for foreign tax purposes is a disregarded entity of its foreign owner makes a disregarded payment to its foreign owner, the payment is a disqualified hybrid amount only to the extent it exceeds the net of the items of gross income and deductible expense taken into account in determining the domestic corporation's income for U.S. tax purposes and the foreign owner's income for foreign tax purposes. *This prevents the excess of the disregarded payment over dual inclusion income from offsetting non-dual inclusion income. Such an offset could otherwise occur, for example, through the U.S. consolidation regime, or a sale, merger, or similar transaction*." Italics added. *See also* Preamble at 67617 (differentiating deemed branch payments that are disallowed only when paid to a territorial regime, a more taxpayer-friendly standard than the dual inclusion income standard operative for disregarded payments): "When a specified payment is a deemed branch payment, it is a disqualified hybrid amount if the home office's tax law provides an exclusion or exemption for income attributable to the branch. *In these cases, a deduction for the deemed branch payment would offset non-dual inclusion income and therefore give rise to a D/NI outcome. If the home office's tax law does not have an exclusion or exemption for income attributable to the branch, then, because U.S. permanent establishments cannot consolidate or otherwise share losses with U.S. taxpayers, there would generally not be an opportunity for a deduction for the deemed branch payment to offset non-dual inclusion income*." Italics added.

interest deduction on what would have been the US1-FX payment. In our example, where there is no benefit from the use of the hybrid disregarded entity and disregarded transaction as compared with holding on a fully transparent basis, there is an argument that dual inclusion income should not be decreased relative to holding on a fully transparent basis. Accordingly, we request the final regulations give additional guidance on this matter.

l. Deemed Branch Payments

i. Deemed branch payments generally

Deemed branch payments under Prop. Reg. §1.267A-2(c)(2) exist only where a non-U.S. corporation has a US branch that qualifies as a "permanent establishment" ("**PE**") under a tax treaty between that corporation's country of residence and the U.S., the non-U.S. corporation uses that treaty's rules for computing the taxable profits of that PE in lieu of using the U.S. rules standing-alone, that treaty's rules for determining the business profits of the PE create a deemed deductible payment of interest or royalties from the PE to the home office, and notwithstanding the treaty's provisions the treaty party's tax law does not require a corresponding Inclusion in taxable income to the home office. This mismatch is to be distinguished from situations where the home office's tax law and the branch's tax law have a mismatch with respect to the allocation between the home office and the branch of actual payments made to or received from third parties. Instead, deemed branch payments are fictional payments that are deemed to exist only for purposes of computing the branch's net income subject to US tax under a treaty. They are deemed to exist only because the United States entered into a tax treaty with the other jurisdiction and provided for the branch to compute its taxable business profit *as if* the branch and the home office were separate entities.[182] They can exist only if the foreign owner of the branch claims the benefits of the treaty with respect to the computation of the branch's taxable business profits (as distinguished from following the results provided for by the Code without the overlay of the treaty).

At this time we have no specific recommendation with regards to deemed branch payments, but we believe that this category raises issues that should be carefully considered.

As noted above, these deemed payments are a product of bilateral tax treaties that the US has entered into with other countries. Under each such treaty, the US and the applicable counterparty have agreed on a method for computing the taxable business profits of PEs operating in their jurisdiction and agreed that they will impose tax on only that amount of business profits. That method includes allowing the PE a deduction for interest or royalties deemed to be paid to the home office, without regard to whether the home office is required to pay tax on that deemed

[182] Interestingly, the rule appears to apply without regard to how the home office's tax law would treat an actual payment of interest or royalties, and in this respect is distinct from most of the other Section 267A categories.

income in the counterparty jurisdiction. Now, the US would be creating a new condition on the allowance of the deduction based upon an intervening change in US law.

We are not addressing whether the US has the legal authority to do this – there is ample commentary on the later-in-time rule in the context of changes in U.S. law that impact existing tax treaties (so-called "treaty overrides"), including by us in prior Tax Section reports.[183] One factor that is discussed in the commentary is whether Congress expressed an intention to override treaties. Here, the authority for the deemed branch payments would be the regulatory grant in Section 267A(e)(2).[184] The discussion in the Joint Committee's Technical Explanation with respect to extending the rules to branches consists of a lengthy footnote that addresses specified payments made by a U.S. corporation to a U.S. branch of a related foreign corporation. In the first example, the U.S. branch is not taxable in the U.S. and in the second example, the U.S. sees the payment as income of the home office. There is no discussion in the legislative history of deemed payments from a branch pursuant to a treaty.

Other considerations relevant specifically to treaty overrides through Treasury Regulations are discussed extensively in *National Westminster Bank, PLC* v. *U.S.*[185]

While the legislative history does not explicitly refer to deemed branch payments, it does, as discussed above, refer to the OECD hybrid reports and expresses an intention to be following the recommendations in those reports to some extent. The OECD Recommendations are also significant here in evaluating the possibility of a treaty override by regulation.

The OECD's Branch Mismatch Report includes, as Recommendation 3, the application of hybrid disallowance rules to deemed payments by a branch to its home office where the home office's tax rules do not include the deemed payment in taxable income (because the payment is not regarded or is otherwise exempt). It is not clear, however, if the recommendation in the report is limited to deemed payments created unilaterally under the law of the jurisdiction where the branch is operating and is not intended to be applied where the deemed payment is the result of a consensus reached between the two applicable countries as to the appropriate profits to be taxed by the jurisdiction where the branch is operating. There are numerous places in the OECD Branch Mismatch Report that indicate that Recommendation 3 is not intended to apply where the two

[183] NYSBA Tax Section, Report No. 1398 on Sections 864(c)(8) and 1446(f) (Aug. 2018); NYSBA Tax Section, Report No. 1364 on Proposed Section 2801 Regulations (Jan 2017); Avi-Yonah and Wells, "The BEAT and Treaty Overrides: A Brief Response to Rosenbloom and Shaheen", Tax Analysts' Worldwide Tax Daily (Nov. 7, 2018).

[184] "(e) Regulations. -- The Secretary shall issue such regulations or other guidance as may be necessary or appropriate to carry out the purposes of this section, including regulations or other guidance providing for --(2) rules for the application of this section to branches or domestic entities".

[185] 512 F.3d 1347 (Fed. Cir. 2008); *see also* Reinhold and Harrington, *What NatWest Tells US About Tax Treaty Interpretation*, Tax Analysts Doc 2008-5866 (2008).

countries have reached an agreement regarding the treatment of the branch.[186] Accordingly, whether the OECD Branch Mismatch Report is support for Congress intending a treaty override and whether it is support for the existence of an international consensus is questionable. The OECD Branch Mismatch Report cites to the anti-hybrid rules adopted by the U.K. in 2017 and those adopted by the E.U. in 2017 as indicators of the international consensus regarding the anti-hybrid rules that should apply to branches and both of those rules are, like Recommendation 3, arguably unclear as to whether they apply only where there is no governing treaty provision, but a fair reading of both of them is that they are so limited.

The treaty provision that provides for this type of a deemed payment is based upon the OECD's approach to determining the business profits of PEs (the "**Authorized OECD Approach**" or "**AOA**") and applies transfer pricing principles as if the branch and the home office were separate (but related) legal entities. The AOA has been embraced by the international community, including the US, and is reflected in the US Model Convention. The specific provision in the US Model Treaty reads as follows:

> For the purposes of this Article, the profits that are attributable in each Contracting State to the permanent establishment referred to in paragraph 1 of this Article are the profits it might be expected to make, in particular in its dealings with other parts of the enterprise, if it were a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions, taking into account the functions performed, assets used and risks assumed by the enterprise through the permanent establishment and through the other parts of the enterprise.

The deemed branch payment rule is an additional rule that would apply *after* the application of the treaty provision. While this may be viewed as supporting a position that the deemed branch payment rule is contrary to the international consensus, there is an alternative perspective to be considered.

[186] In addition, the Report refers throughout to the intent to preserving a country's obligations under existing tax treaties. See OECD Branch Mismatch Report at paragraphs 28 ("Any adjustments under the recommendations set out in this report should not affect the allocation of taxing rights under a tax treaty."); 35 ("provided any adjustment is consistent with a jurisdiction's tax treaty obligations, and tax policy settings in that jurisdiction."); 26 ("The recommendations in Chapter 1 should not, however, be interpreted as requiring countries to make any change to deliberate policy decisions they have made, including in respect of the territorial scope of their tax regime, and do not purport to affect a country's obligations under a tax treaty."); 40 ("should also be noted that the residence jurisdiction may be prevented from restricting the scope of the branch exemption in those cases where the tax treaty in effect between the residence and branch jurisdiction contains a provision equivalent to…."); and 57 ("In these cases the residence jurisdiction may be prevented from restricting the scope of the branch exemption under Recommendation 1 owing to the overriding effect of the tax treaty.").

The Preamble indicates that the drafters see the deemed branch payment rule as a corollary to the rules that apply to specified payments by entities.[187] This approach makes sense in that the deemed payment exists only because the AOA treats the branch as a separate entity. If that fiction were true, then the hybrid transaction rule likely would have applied. So there is a need to back up the hybrid transaction rule with a deemed branch payment rule in order to ensure that branches (and the AOA) are not used to avoid the application of the basic hybrid transaction rule. Expressed in this way, the rule seems entirely necessary and appropriate. There are also portions of the OECD Branch Mismatch Report that could be understood to establish that Recommendation 3 is based upon this perspective and is intended to have this effect.

In light of the above considerations, including prior case law, and possible uncertainty about the status of the rule, we recommend that, if the rule is retained in final regulations, that there be a discussion of these considerations and the support for the rule.[188]

ii. Application of deemed branch payments in the imported mismatch context

Deemed branch payments are similar to disregarded payments.[189] Deemed branch payments are disallowed if they are paid to a jurisdiction with a territorial regime. Disregarded payments, on the other hand, are disallowed if paid to an entity for which the disregarded deduction exceeds dual inclusion income. The deemed branch payment rule is more taxpayer-friendly in this regard. This is also a deviation from the OECD Recommendations.[190] The OECD Recommendations apply the dual-inclusion income standard to both disregarded payments and the OECD's equivalent of deemed branch payments. The territorial regime standard is more taxpayer-friendly because deemed branch payments to a home office with a territorial regime will always exceed the home office's dual inclusion income. The home office's territorial regime excluding branch income will ensure that dual inclusion income with respect to the branch is always zero. In contrast, there can be many situations where disregarded deductions exceed dual inclusion income even though the payment is made to a jurisdiction that does not have a territorial regime.

The Preamble explains the reason for the lower standard with respect to deemed branch payments as follows: "because U.S. permanent establishments cannot consolidate or otherwise

[187] OIRA Analysis at 67628.

[188] In the event that Final Regulations remove the deemed branch payment rule, we recommend they retain the clarification that deemed branch payments are not disregarded payments subject to Prop. Reg. 1.267A-2(b).

[189] Prop. Reg. 1.267A-2(b) excludes deemed branch payments from being treated as disregarded payments. This indicates that at least in some cases deemed branch payments would otherwise have been treated as a disregarded payment, if not for the exclusion. While it is unclear if deemed branch payments of interest and royalties are pulled into the definitions of interest and royalties in the Proposed Regulations, a deemed branch payment of interest may potentially be treated as a structured payment under Prop. Reg. 1.267A-5(b)(5)(ii)(B) as an amount predominantly associated with the time value of money.

[190] OECD Branch Mismatch Report at paragraph 81.

share losses with U.S. taxpayers, there would generally not be an opportunity for a deduction for the deemed branch payment to offset non-dual inclusion income."[191] The logic behind this statement can be explained as follows: Assume a home office taxes all the income of a branch. Assume the branch erodes all its US income with disregarded payments. At face value, that should be acceptable, because the disregarded deductions do not exceed dual inclusion income. Assume then the branch also pays additional disregarded deductions. At face value, there can be no benefit to those deductions and no reason to disallow those deductions. Those deductions may turn into net operating losses, but those net operating losses will still only be used to offset dual inclusion income in later years. However, if under the United States consolidation regime those deductions can be used to offset the US income of other home office US subsidiaries, subsidiaries with respect to which the home office does not derive dual inclusion income, then those disregarded payments in excess of the branch's gross income start to generate meaningful D/NI results. So this (apparently) was one of Treasury's and the Service's main concerns regarding the potential use of disregarded payments in excess of dual inclusion income. For US permanent establishments, this concern is not applicable because US permanent establishments cannot consolidate with other US entities. On that basis, Treasury and the Service appear to have adopted for deemed branch payments a simpler rule that only disallows the deduction if paid to a home office with a territorial regime.

As a gating matter, it is unclear why Treasury and the Service view the aforementioned use of the US consolidation regime as the main route that a taxpayer might use to take advantage of deductions from disregarded payments in excess of dual inclusion income. Prop. Reg. §1.267A-6(c)(3)(iii)(B) provides an example of using disregarded payments in excess of dual inclusion in a manner that does not employ the US consolidation regime (discussed above). We also have no knowledge whether or not Treasury's and the Service's assumptions regarding the ability to use a consolidation regime are reasonable in the context of the Imported Mismatch Rule. It is possible that other jurisdictions allow permanent establishments to consolidate with other entities.

That said, we do think the territorial regime standard for deemed branch payments will be far easier to administer than a dual inclusion income standard.

5. The Section 267A Anti-Avoidance Rule

Under the Anti-Avoidance Rule, a specified payment need not be one of the five types of "disqualified hybrid amounts" or an imported mismatch amount. Instead, a deduction for a specified payment can be disallowed even if there is no hybridity if the following two requirements are met:

[191] Preamble at 67617

i. a non-inclusion outcome, determined without regard to the rule that treats a 90% inclusion as a full inclusion[192]

ii. a principal purpose of the plan or arrangement to avoid the purposes of the regulations under section 267A.[193]

We do not object to a general purpose-based Anti-Avoidance Rule. Many regulations have a general purpose-based Anti-Avoidance Rule. The prevalence of these purpose-based Anti-Avoidance Rules reflects, among other things, that it is (i) often not possible for the regulation drafters to identify all potential transactional permutations which may be contrary to the policies underlying a regulation, and (ii) not desirable for the drafters to attempt to do so because adding rules particular to each avoidance strategy will substantially increase the complexity of the regulation.

A broad open-ended purpose-based Anti-Avoidance Rule in the context of these regulations may, however, not be appropriate because of unique aspects of the anti-hybrid rules. The anti-hybrid rules are, in their entirety, Anti-Avoidance Rules, and the Proposed Regulations have defined specifically what is prohibited utilizing complex and detailed (yet broad) rules. They have already done (in large measure) what general anti-avoidance rules are meant to make unnecessary and intended to replace.

We do recognize, on the other hand, that even these very detailed and broad rules could likely still be avoided by clever planning. We question though whether the proposed general Anti-Avoidance Rule, in the context of the targeted rules defining the abuse that is being targeted, disrupts the appropriate balance of objectives of fairness (by putting taxpayers on notice of what the law is), administrability, and achieving the statutory goals. One particular concern with a broad purpose-based anti-avoidance rule is whether the taxpayer making the specified payment will have fair notice of all the facts and the avoidance purpose in the context of transactions between unrelated parties. Taking all these considerations into account, an argument can be made that the Anti-Avoidance Rule should not be used to supplant the careful balance struck by the other avoidance-focused provisions, such as the Structured Arrangements Rule, the Imported Mismatch Rule, and the Multiple Specified Recipients Rule. On the other hand, an argument can be made

[192] Accordingly, a 10% (or less) non-inclusion could be subject to this Anti-Avoidance Rule.

[193] Prop Reg § 1.267A-5(b)(6), quoted in full below:

(6) Anti-avoidance rule. A specified party's deduction for a specified payment is disallowed to the extent that both of the following requirements are satisfied:

(i) The payment (or income attributable to the payment) is not included in the income of a tax resident or taxable branch, as determined under §1.267A-3(a) (but without regard to the de minimis and full inclusion rules in §1.267A-3(a)(3)).

(ii) A principal purpose of the plan or arrangement is to avoid the purposes of the regulations under section 267A.

that a broad purpose-based rule remains appropriate, even when layered on top of targeted anti-avoidance rules. Final regulations may wish to give additional attention to this issue.

Assuming that a form of anti-avoidance rule will be included in the regulations, we believe it is helpful to consider the proper role and terms of such rule together with the proper role and terms of the Structured Arrangements Rule. Above we recommended that the Structured Arrangements Rule be modified to focus only on objective factors, eliminating a subjective, purpose-based component. If that recommendation is not adopted, it will be necessary to provide a clearer distinction between the subjective component of the Structured Arrangements Rule and the Anti-Avoidance Rule.

Both the Anti-Avoidance Rule and the Structured Arrangements Rule apply to situations where the general rules do not apply because one or more of their requirements is not met. In the Structured Arrangements Rule, the requirement that the parties be related is eliminated and replaced with the requirement that the hybrid mismatch result was a goal of the arrangement or that the resulting tax savings was shared between the unrelated parties. In the Anti-Avoidance Rule, the requirement that there is hybridity or that hybridity is the cause of the NI outcome is eliminated and replaced with the requirement that there was a goal of simultaneously achieving the D/NI outcome while not triggering the application of the regulations.

This suggests that the formulation of the Anti-Avoidance Rule should focus on the utilization of a specific structure or terms in order to accomplish the D/NI result without otherwise triggering the application of the regulations. In other words, the Anti-Avoidance Rule should apply if steps were taken to create a transaction or structure that does *not* meet the requirements of the regulations.

Thus, we recommend that the Anti-Avoidance Rule be revised so that it applies when "a principal purpose of the terms or structure of the arrangement (including the form and tax residence of the parties to the arrangement) is to avoid the application of Section 267A in a manner that is contrary to the purposes of Section 267A or the regulations under Section 267A".

Example 18: Application of the Anti-Avoidance Rule

Situation 1. US1 pays $100 interest to its parent FX. Under Country X principles, the interest income is exempt. FX typically funds US1 with debt to take advantage of the D/NI resulting from the exemption for interest, notwithstanding that both jurisdictions have the same 21% tax rate and Country X would provide a full participation exemption for US1 dividends. The exemption applies to all interest income under Country X law and is intended to incentivize saving and lending in Country X. All parties are related.

Situation 2.[194] FP owns FX and US1. US1 pays $100 interest to its sister entity FX. The income is fully taxed in Country X at ordinary rates. FX pays no funded taxable payments to FP. US1 and FX only pay dividends to FP. FP has $50 of services operating income. FP make a $50 payment to its owners pursuant to a hybrid transaction and pays $100 as a dividend. The absence of funded taxable payments between FP and US1 and FX is due to the natural business practices applicable to the FP group and is not intended to avoid Section 267A. FP utilizes the hybrid transaction to make the $50 payment to its owners in order to obtain a D/NI result in Country P and in the jurisdictions of the FP owners.

Situation 3.[195] In Year 1, US1 pays $100 interest to its sister entity FX. $50 of income is fully taxed at ordinary income rates in Country Y in the hands of FY, FX's 50% owner, under an anti-deferral regime. $50 of income is fully taxed at ordinary income rates in Country Z in the hands of FZ, FX's other 50% owner, as Country Z views FZ as deriving the payment. US1's $100 interest deduction is disallowed under Section 267A. After consulting with its tax advisors' FX transfers the US1 note to FY and FZ, respectively. In Year 2, US1 pays the $100 interest directly to FY and FZ (skipping FX). The restructuring was intended to avoid the application of Section 267A.

Situation 4. US1 pays $100 interest to its parent FX. Under Country X law, US1 is disregarded and the interest payment is disregarded. The disregarded interest payment does not exceed dual inclusion income. FX chooses to utilize an entity for US1 that is disregarded for Country X purposes because Country X provides a more favorable tax rate for companies with large gross receipts, and structuring US1 as a disregarded entity for Country X purposes allows FX to taken into consideration all of US1's gross receipts (as opposed to only taking into consideration the net dividend from US1). The gross receipts rate is not particular to any type of income. All parties are related.

Analysis under the Proposed Regulation. We believe there is a compelling case that none of the above transactions violate the Anti-Avoidance Rule as drafted. But, there will always be some residual uncertainty under the language of the Proposed Regulations. In each of the above situations, the taxpayer has a tax-planning motive that may avoid at least some of the purposes of the Proposed Regulations under Section 267A. This is because the Proposed Regulation has broad purposes: preventing base erosion, increasing fairness, increasing worldwide tax revenues, reducing tax-advantages that cross-border capital may have over domestic capital, efficiency, etc. However, some of these purposes are curtailed

[194] The Anti-Avoidance Rule in the Proposed Regulations can be read to not apply to this example and other imported mismatch fact patterns because the specified party's specified payments are considered to be included under Prop. Reg. § 1.267A-3(a), notwithstanding that payments considered to be included under Prop. Reg. §1.267A-3(a) can still potentially be subject to disallowance under the Imported Mismatch Rule.

[195] The Anti-Avoidance Rule's requirement that the payment "is not included in the income of a tax resident or taxable branch" may be able to be read to say that the Anti-Avoidance Rule does not apply to multiple recipient fact patterns if one recipient has an inclusion.

within the regulation with more precise rules. Those more precise rules are motivated by contravening policy purposes, e.g., administrability. We believe those more precise rules reflect policy decisions that support each of the above situations as being outside of Section 267A. The anti-avoidance rule should not overtake the precise and thoughtful policy decisions made by the drafters of the Proposed Regulations in crafting the general rules of the Proposed Regulations.

Analysis under the Suggested Approach. Under our suggested language, none of the above transactions should be subject to the anti-avoidance rule. In Situations 1 and 2, no steps were taken to avoid Section 267A. In Situations 3 and 4, the steps that were taken do not appear contrary to the purposes of the Proposed Regulations.

6. Other Rules

a. De Minimis Exception

Treasury considered setting the *de minimis* threshold strictly based on the deductions of a taxpayer that involve hybrid arrangements[196] but ultimately adopted an approach that allows small taxpayers to determine eligibility for the *de minimis* exception by simply adding up any and all of their interest and royalty deductions. That approach allows qualification for the *de minimis* exception to be determined without delving into the Section 267A rules. While the Section 267A rules generally target the types of hybridity that typically would be created by sophisticated large taxpayers, Treasury recognized that "in limited cases, small taxpayers could be subject to these rules, for example, as a result of timing differences or a lack of familiarity with foreign law."[197]

The application of the threshold amount to all interest and royalty deductions regardless of whether they arose from hybrid arrangements, however, may unnecessarily produce inequitable results among similarly situated taxpayers. For example, two taxpayers, each (i) making $30,000 in interest payments pursuant to a hybrid instrument, and (ii) making $30,000 in payments to a third party, would be treated differently merely because one payment to the respective third party is a royalty (whether or not arising from a hybrid arrangement), and the other payment is compensation for services. The taxpayer making royalty payments is obligated to determine whether Section 267A limits the deductibility of its hybrid interest payment.

A more appropriate rule may be to apply a *de minimis* threshold to interest and royalty deductions arising from hybrid arrangements, as Treasury originally considered, rather than to all interest and royalty deductions. This will better serve the policy goals of these rules without unnecessarily distinguishing between taxpayers of a similar profile. We do not believe that using a *de minimis* threshold that applies only to deductions associated with hybrid arrangements will

[196] OIRA Analysis at 67628.

[197] OIRA Analysis at 67627.

increase taxpayer burden, because, as with the rule in the Proposed Regulations, taxpayers could easily ascertain that they are exempt from Section 267A by simply adding up their interest and royalty deductions (regardless of hybridity). Only after engaging in this simple calculation would a taxpayer need to determine which of the taxpayer's interest and royalty deductions relate to hybrid arrangements and then only if the taxpayer failed to qualify for the de minimis standard taking into account all interest and royalty deductions. Thus, a *de minimis* rule focused solely on hybrid deductions, rather than all interest and royalty payments, will create a more equitable result without significantly increasing taxpayer burden.

b. Effect of Disallowance on Earnings and Profits

The Proposed Regulations sensibly provide that the Section 267A deduction disallowance rule will not affect earnings and profits ("**E&P**) of a corporation.[198] This is consistent with the approach generally taken in respect of other deduction and loss disallowance rules, namely, Section 267(a)(1), Section 1211, and Section 163(j).[199] This approach is clearly appropriate for disallowed specified payments of a US corporation or a foreign corporation with a US branch. However, it is less clear whether this approach is appropriate for disallowed specified payments of a CFC.

Under the Proposed Regulations, a specified party includes a CFC.[200] That is presumably designed to ensure a CFC does not enter into an improper hybrid arrangement to reduce US taxes imposed on 10% US shareholders. 10% US shareholders are subject to tax on a CFC's subpart F income or GILTI.[201] Extending Section 267A to CFCs seems fair given the fact that Section 267A is by its terms not limited to US taxpayers. It also makes sense for CFCs to be subject to Section 267A given the general purpose of eliminating D/NI results arising from hybrid arrangements that impact the calculation of US tax.

However, reducing E&P of a CFC for disallowed specified payments may allow 10% US shareholders of the CFC to reduce subpart F inclusions, because the CFC's E&P cap the potential amount of any subpart F inclusion by a 10% US shareholder.[202]

Accordingly, Treasury and the Service may wish to consider adding a provision in the Proposed Regulations applicable to disallowed specified payments of a CFC analogous to Reg. §1.267(a)(3)-3(b)(3). Reg. §1.267(a)(3)-3(b)(3) effectively provides that E&P will not be reduced

[198] Prop. Reg. 1.267A-5(b)(4).

[199] Reg. 1.312-7(b)(1); Prop. Regs. 1.163(j)-4(c)(1).

[200] Prop. Reg. 1.267A-5(a)(17).

[201] Section 951(a); Section 951A(a).

[202] Section 952(c)(1). There is a recapture rule if sufficient earnings & profits arises in later years. Section 952(c)(2).

by deductions deferred pursuant to Section 267(a)(3) (providing for matching of a deduction and payee income item in the case of expenses and interest paid to a foreign related party).

Alternatively, Treasury and the Service may wish to consider a rule that adds back the amount of the deduction solely for the purposes of calculating the E&P profits cap to subpart F income under Section 952(c)(1). This approach would potentially ensure the 10% US shareholder incurs subpart F income while not causing non-10% US shareholders to recognize a dividend in respect of a distribution. A third alternative, which may be the most appropriate for this type of issue, is for Treasury and the Service to implement a Section 952(c)(1) adjustment via an anti-avoidance rule which will only operate to prevent this type of planning.

The Preamble notes that the approach of the Proposed Regulations to decouple the deduction disallowance and the determination of for both foreign E&P and domestic corporations is consistent with the treatment of corporate E&P in connection with other disallowance rules, including the loss disallowance rules of Section 267(a) and Section 1211.[203] It is also consistent with the approach adopted in the Proposed Regulations recently promulgated under Section 163(j).[204] Moreover, this approach to the measurement of E&P is entirely consistent with its intended purpose: to provide an economically accurate measure of a corporation's dividend-paying capacity. Providing a special exception for specified forms of economic outlays would distort the measurement of dividend-paying capacity and potentially open the door to using adjustments to E&P to achieve other, unrelated policy goals.

Notwithstanding, it can be argued that Section 267A is unique with respect to the issue of coordinating the deduction disallowance with a CFC's E&P. Section 267A has a broad anti-avoidance rationale to eliminate D/NI in the context of hybrid arrangements and, where it applies, Section 267A triggers a full disallowance and not deferral. Further, as stated in the Preamble, a goal of Section 267A is to eliminate the indirect reduction of US tax from hybrid arrangements of CFCs with respect to 10% US shareholders.[205]

Failure to coordinate Section 267A disallowance for a CFC and the E&P calculation for a CFC could fail that policy goal, leaving an avenue for 10% US shareholders of CFCs to obtain the D/NI benefit of hybrid arrangements that reduce E&P. For example, if a CFC is owned by a US corporate owner which in turn is owned by a foreign owner, and the CFC makes a hybrid specified payment to the indirect foreign owner (skipping the US corporate owner), that payment could potentially reduce the subpart F inclusion of the US corporate owner if the payment reduces E&P

[203] Preamble at 67622.

[204] Prop. Reg. §1.163(j)-4(c)(1). *See also* Rev. Rul. 77-442, 1977-2 C.B. 264 (providing that E&P is reduced by certain payments that are illegal bribes or kickbacks, a result that no longer applies for subpart F purposes for payments made after November 3, 1976 by reason of an amendment to Section 964(a) made by the Tax Reform Act of 1976); Rev. Rul. 2009-25, 2009-2 C.B. 365 (citing Rev. Rul. 77-442 and ruling that E&P is reduced for disallowed interest under Section 264(a)(4)).

[205] Preamble at 67615.

below the amount of the subpart F inclusion. Therefore, we recommend Treasury and the Service add an anti-avoidance rule clarifying that a disallowance by Section 267A of a deduction by the CFC does not reduce its current E&P if there is an intent to avoid subpart F income through the use of a hybrid payment.

Example 19: Use of Hybrid Payments to Avoid Subpart F

Facts: FT owns FX who owns US1 who owns FY. FY receives $100 of Supart F income. For US tax purposes, FY pays $100 interest to FX. FX is a reverse hybrid, and the payment is not included in Country X or T. All parties are related.

Analysis under the Proposed Regulation: Notwithstanding that FY's deduction is disallowed for US tax purposes, the payment still reduces FY's earnings and profits. The reverse hybrid payment may therefore result in US1 not having a subpart F inclusion.

Analysis under Suggested Approach: Under the suggested approach's anti-avoidance rule, for purposes of Section 952(c)(1), FY's disallowed deduction does not lower the earnings and profits cap on US1's subpart F inclusion. US1 will have a $100 subpart F inclusion.

c. ***Coordination with Section 163(j)***

As currently drafted, there is a potential inconsistency between the coordination rules in the proposed Section 163(j) regulations and the coordination rules in the Proposed Regulations under Section 267A. The former essentially provide that Section 163(j) applies after all other provisions that disallow or defer interest deductions.[206] In contrast, the latter provide that, except as otherwise provided in the Code or Regulations, Section 267A applies last.[207] Final regulations should clarify that Section 267A applies prior to the application of Section 163(j).[208]

7. Areas We Recommend that Final Regulations Reserve To Address at a Later Time.

In several areas, we believe regulations would be worthwhile, but that Treasury should gather more information before acting.

a. Notional and Deemed Interest Deductions

The Proposed Regulations view notional interest deductions (deductions allowed in respect of equity) as hybrid, both for the Imported Mismatch Rule of Section 267A and for Section

[206] Prop. Reg. § 1.163(j)-7(b).

[207] Prop. Reg. §1.267A-5(b)(1).

[208] This issue will be particularly important in applying the 36-month timing rules of Prop. Reg. §1.267A-2(a)(2) and §1.267-3(a)(1)(i).

245A(e).[209] This is new ground in the international context. The OECD Recommendations do not view notional interest deductions as presenting problematic hybrid payments. At a theoretical level, do notional interest deductions on instruments viewed as equity in all jurisdictions present the type of hybridity that Congress was focused on? Both in theory and in practice, are notional interest deductions being used by jurisdictions as an effective tax rate reduction (like Section 199A), as a form of stimulus for capital investment (like accelerated depreciation), or to enable tax-haven focused planning? And, most importantly, because the OECD Recommendations do not address notional interest deductions, will the unilateral extension of US anti-hybrid rules to them by Regulation put businesses with US operations at a competitive disadvantage, and will this affect the willingness of companies to set up branches and subsidiaries in the US? As a result, we believe that Treasury and the Service should reserve on of this aspect of the Proposed Regulations in order to determine whether an acceptable solution can be achieved on a multilateral basis.

In addition, deemed interest deductions on instruments viewed as debt by both the issuer and holder jurisdictions were similarly viewed under the OECD Recommendations as not within the purview of the hybrid payment provisions.[210] In particular, in one example involving an interest-free loan from a shareholder to its subsidiary, the OECD Hybrid Mismatch Report made clear that a deemed interest deduction on the interest-free loan was considered not within the scope of the OECD Recommendations because there was no payment under the debt instrument giving rise to a deduction for the issuer.[211] In contrast, under the Proposed Regulations, that example would give rise to a deemed interest payment under Section 7872 and could potentially be treated as a disregarded transaction giving rise to a D/NI result.[212] Deemed interest deductions, which often result from unilateral transfer pricing adjustments, raise a number of important considerations and, as with notional interest deductions, these considerations may be best addressed through multilateral means.

b. Disregard of Distributions from a Reverse Hybrid

A business may choose to operate in another jurisdiction via a branch or partnership, instead of through a corporation formed in the local jurisdiction, for many non-abusive, tax or non-tax, reasons. And, in many fact patterns, a non-tax commercial purpose may lead to the use of an entity such as a limited partnership which the investor's jurisdiction may view as non-transparent. In certain civil law jurisdictions, very few types of entities other than general partnerships are

[209] Prop. Reg. §1.267A-4(b) and Prop. Reg. §1.245A(e)-1(d)(2)(i)(B).

[210] By this term, we refer only to deemed payments that do not actually exist and are disregarded in the other jurisdiction (e.g., section 7872 and section 482 adjustments), to be distinguished from base and character differences on payments which are actually made over time, but which are characterized differently in the jurisdictions involved -- e.g., treated as principal, rather than as interest. Such base and character differences are discussed earlier at Part IV.A.4.h. *Cf*. OECD Hybrid Mismatch Report at Example 1.13; OECD Hybrid Mismatch Report at Example 1.13.

[211] *See* OECD Hybrid Mismatch Report at Example 1.14.

[212] Prop. Reg § 1.267A-5(a)(12)(i)(G) and Prop. Reg § 1.267A-2(b)

viewed as transparent. For example, a limited partnership may be used to ring-fence liabilities or to avoid having to consolidate balance sheets for financial accounting purposes. Alternatively, the choice of entity may be driven by the needs of a counter-party in a joint-venture. In these situations, assuming the reverse hybrid distributes all its income on a current basis and the parent is subject to tax on that income, the US will be applying a harsh disallowance even though no NI result occurs. To add to the confusion, although the US does take into account anti-deferral regime inclusions, in some jurisdictions an anti-deferral inclusion is reduced to the extent of a distribution, creating a perverse incentive to avoid current distributions in order to be outside of Section 267A.[213] Accordingly, we recommend that Treasury, for now, treat current year distributions as reducing the NI result if the investor is subject to tax on those distributions. Treasury should also reserve on whether a stricter approach is appropriate, and take more time to consider the extent to which reverse hybrid entities may be inadvertently used and the fairest way to track when a taxable distribution to an investor reduces the NI result. [214]

B. Section 245A(e)

1. The Scope of the Hybrid Deduction Account Rule

As noted above in Part III.B. above, a hybrid dividend is an amount received by a US shareholder from a CFC for which the US shareholder would otherwise be allowed a participation exemption, but only to the extent of the sum of the US shareholder's hybrid deduction accounts with respect to the CFC.[215] A hybrid deduction account reflects the amount of hybrid deductions of the CFC that are allocated to the shares of such CFC held, directly or indirectly, by a US shareholder.[216] Importantly, a hybrid deduction account will cause *any* dividend paid on *any* class of CFC stock outstanding to constitute a hybrid dividend, even if the dividend is not paid on a hybrid instrument itself. Said differently, a dividend paid by a CFC to a shareholder that has a hybrid deduction account with respect to the CFC is generally treated as a hybrid dividend to the extent of the shareholder's balance in *all* of its hybrid deduction accounts with respect to the CFC, even if the dividend is paid on a share that has not had any hybrid deductions allocated to it. As discussed below, although we believe that employing the hybrid deduction account mechanism appropriately safeguards against abuse where a hybrid deduction is accrued for foreign tax purposes far in advance of the related hybrid payment for US tax purposes, we recommend that this mechanism not apply, and instead recommend that a direct tracing regime apply, where there

[213] Prop. Reg. §1.267A-6(c)(5)(iii)

[214] The issue of how to track when a taxable distribution to an investor reduces the NI result is referenced in the Preamble. Preamble at 67618. One approach would be to view all current year net income as funding the distribution, and to reduce the NI result on specified payments by a pro-rata amount of total current year net income as compared with current year specified payments.

[215] Prop. Reg. §1.245A(e)-1(b)(2).

[216] Prop. Reg. §1.245A(e)-1(d)(1). *See* Part IV.A.7.a above regarding whether notional interest deductions with respect to equity ought to be within the purview of Section 267A or Section 245A(e).

is a legal obligation to make the hybrid payment within a reasonable timeframe (e.g., within 36 months of the accrual).

The hybrid deduction account, as currently envisioned in the Proposed Regulations, appears to go beyond the scope of the statutory language. By its terms, Section 245A(e) requires a causal relationship between the dividend received for US tax purposes and the deduction for foreign tax purposes. Section 245A(e)(4) defines a hybrid dividend as an amount received from a CFC (i) *for which a deduction would be allowed* under Section 245A(a) but for Section 245A(e), and (ii) *for which the CFC received a deduction* (or other tax benefit) under foreign tax law. The statutory language indicates that there must be a nexus between the CFC's deduction under foreign tax law and the US shareholder's participation exemption—that is, a hybrid dividend relates to a specific distribution for which the CFC obtains a local country deduction and for which the US shareholder obtains a participation exemption.

In contrast, the Proposed Regulations provide that a dividend will be a hybrid dividend to the extent of the "sum of the United States shareholder's hybrid deduction accounts with respect to each share of stock of the CFC."[217] In effect, a hybrid deduction account can "taint" *any* dividend distribution, even dividend distributions on non-hybrid instruments or gain on the disposition of non-hybrid instruments recharacterized as a dividend under Sections 1248 or 964(e), that otherwise would not have been within the scope of Section 245A(e).

The Preamble explains that absent the inclusion of a hybrid deduction account mechanism, "the purposes of section 245A(e) might be avoided by, for example, structuring dividend payments such that they are generally made on shares of stock to which a hybrid deduction has not been allocated (rather than on shares of stock to which a hybrid deduction has been allocated, such as a share that is a hybrid instrument)."[218] The following example illustrates how a taxpayer could sidestep the application of Section 245A(e) absent a rule like the hybrid deduction account mechanism provided in the Proposed Regulations.

Example 20: Distributions on non-hybrid stock

P, a domestic corporation, owns 100% of the outstanding common stock of CFC1. In year 0, CFC1 issued a hybrid instrument to P, which is treated as debt for CFC1's local country purposes and is treated as equity for US federal income tax purposes. The terms of the hybrid instrument provide that while CFC1 accrues interest annually, CFC1 will make a one-time payment of interest in 30 years from the date of issuance. Accordingly, in year 1, CFC1 accrues an interest deduction of $100x with respect to the hybrid instrument, but

[217] Prop. Reg. §1.245A(e)-1(b)(2).

[218] *See* Preamble at 67614.

> does not make a cash payment on the hybrid instrument to P. In year 2, CFC1 distributes $100x to P as a dividend with respect to CFC1's common stock.

Absent the Proposed Regulations, CFC1 can effectively re-route the $100x payment, which is intended to be an interest payment on the hybrid instrument, but which would have been subject to Section 245A(e), and instead pay a dividend on CFC1's common stock for which P could otherwise obtain a participation exemption. Accordingly, CFC1 would effectively be able to defer the effect of Section 245A(e) for 30 years until the one-time interest payment was made by CFC1 to P. Said differently, requiring a direct causal link between the hybrid deduction and the non-inclusion for US purposes (i.e., requiring that the hybrid deduction and the non-inclusion occur with respect to the same distribution) would allow taxpayers to sidestep the application of Section 245A(e) almost entirely, limited by the extent to which foreign tax law allows current deductions notwithstanding the lengthy deferral of payment.

While we agree with Treasury and the Service that, if a narrow view of the scope of Section 245A(e) is adopted, taxpayers could mitigate the impact of Section 245A(e) by making distributions solely with respect to non-hybrid instruments, an overly expansive view of the scope of Section 245A(e) may be equally inappropriate in certain cases, as illustrated by the following example.

> **Example 21**: Application of Section 245A(e) to a sale of CFC stock
>
> P, a domestic corporation, owns 100% of the outstanding common stock of CFC1 and a hybrid instrument issued by CFC1 treated as debt for local country purposes and equity for US tax purposes. P has a hybrid deduction account balance of $100x with respect to CFC1's hybrid instrument, resulting from the accrual by CFC1 of a deduction for a payment to be made within 24 months thereafter. P's basis in the common stock of CFC1 is $400x. CFC1 has $500 of earnings and profits, $400 of which is allocable to the CFC1 common stock for Section 1248 purposes. In year 1, P sells the common stock of CFC1 to an unrelated third party in exchange for cash of $850x. P recognizes gain of $450x on the sale of CFC1 common stock, $400x of which is subject to recharacterization as a dividend under Section 1248 for which P could obtain a participation exemption absent the application of the Proposed Regulations.

Under the Proposed Regulations, because (i) P could, absent the Proposed Regulations, obtain a participation exemption for the $400x of gain recharacterized as a dividend under Section 1248 with respect to CFC1's common stock, and (ii) CFC1 has a hybrid deduction account balance of $100x, $100x of P's $400x Section 1248 dividend is treated as a hybrid dividend to which Section 245A(e) applies, and the remaining $300x is eligible for the participation exemption under Section 245A. Accordingly, P recognizes $100x of dividend income under Section 245A(e), irrespective of the fact that the hybrid deduction account balance of CFC1 was solely attributable to the hybrid instrument retained by P.

Similar results would follow if the hybrid deduction account related to a lower-tier CFC. Assume the same facts as Example 21, but P owns only common stock of CFC1, which has no E&P, and CFC1 owns common stock and a hybrid instrument (with a hybrid deduction account) of CFC2, which does have E&P. If P sells the stock of CFC1 and recognizes gain, P's gain on the CFC1 stock would be recharacterized as a dividend to the extent of CFC2's E&P, under Section 1248(c)(2). The Proposed Regulations provide that CFC1's hybrid deduction account with respect to CFC2 is attributed to P, and P is treated as receiving a hybrid dividend directly from CFC2 to the extent of such account.[219] Thus, P would include subpart F income without being able to take a Section 245A deduction. P's economic gain with respect to CFC1 stock would be the same regardless of whether CFC2 makes a payment to CFC1 on the hybrid instrument (i.e., the value of CFC1 would reflect additional cash with an offsetting reduction in the value of the CFC2 hybrid instrument). Thus, this again illustrates that the lack of a causal connection between P's receipt of a dividend and a CFC's hybrid deduction does not prevent Section 245A(e) from denying a Section 245A deduction.

We believe Treasury and the Service should consider a middle ground. For example, consistent with the approach taken in the Proposed Regulations with respect to Section 267A, we recommend that Treasury consider providing a 36-month rule with respect to hybrid deduction accounts. Specifically, to the extent that a taxpayer can demonstrate that there is a legal obligation to make the payment giving rise to a hybrid deduction within 36 months of the accrual of the deduction under foreign tax law and the parties expect the payment to be timely made, such deduction would not increase the CFC's hybrid deduction account. Instead, Section 245A(e) would apply to the hybrid payment when actually made.

The following example illustrates the proposed recommendation.

Example 22: 36-month rule for hybrid deduction accounts

The facts are the same as Example 21, except that CFC1 is required to make an interest payment to P with respect to the hybrid instrument within 24 months of the issuance of the hybrid instrument. Beginning in year 1, CFC1's hybrid deduction account balance is zero. In years 1 and 2, CFC1 accrues an interest deduction of $100x per year. In year 1, CFC1 declares and pays a $100 dividend distribution to P with respect to CFC1's common stock. At the end of year 2, CFC1 makes an interest payment of $200x to P with respect to its hybrid instrument.

Under the recommended 36-month rule, because CFC1 can show that it is legally obligated to, and is expected to, make a cash payment of interest on the hybrid instrument within 36-months of the accrual of the hybrid deduction, CFC1's accrued interest deductions of $200x do not increase its hybrid deduction account balance with respect to the hybrid instrument. Accordingly, no portion

[219] Prop. Reg. §1.245A(e)-1(b)(3).

of the dividend paid to P with respect to the CFC1 common stock would be subject to Section 245A(e), but the entirety of the $200x payment on the hybrid instrument would be subject to Section 245A(e).

We believe this recommendation achieves the correct economic result, because CFC1 can no longer re-route earnings that it would otherwise be using to make payments on its hybrid instrument to which Section 245A(e) would apply, to make dividend distributions on CFC1 common stock for which P could obtain a participation exemption. While it is certainly possible for hybrid instruments to have terms beyond 36-months (e.g., CFC1 is required to make an interest payment within 48 months of issuance), a 36-month rule would be more consistent with the guidance that Treasury and the IRS have proposed under Section 267A.

2. Effective Date of the Hybrid Deduction Account Rule

As noted, the Proposed Regulations apply to distributions after December 31, 2017.[220] A deduction or other tax benefit allowed to a CFC (or a person related to the CFC) under a relevant foreign tax law is taken into account as a hybrid deduction only if it was allowed with respect to a taxable year under the relevant foreign tax law beginning after December 31, 2017.[221] However, the Proposed Regulations, issued in December 2018, introduced the requirement that taxpayers maintain the hybrid deduction account for the first time. Prior to the filing of the Proposed Regulations in the Federal Register on December 20, 2018, taxpayers were unaware that Treasury and the Service would introduce the concept of hybrid deduction accounts, because the statutory language of Section 245A does not make any mention of an "account" concept. Because the hybrid deduction accounts likely could not have been anticipated by either taxpayers or tax advisors based on the statutory language of Section 245A, taxpayers who made distributions in the 2018 tax year on non-hybrid instruments may be adversely affected by the retroactive application of the hybrid deduction account without sufficient notice. Given that the hybrid deduction account likely was an unexpected addition to the Proposed Regulations, we recommend that Treasury and the Service consider changing the effective date of this aspect of the Proposed Regulations to distributions occurring after December 31, 2018 in order to give taxpayers sufficient notice for compliance with the rules. A tracing regime could apply for hybrid distributions made during 2018 under which Section 245A(e) applies to actual hybrid distributions on a hybrid instrument. If a hybrid deduction was accrued in 2018 but no hybrid distribution on the hybrid instrument was made during that year, the hybrid deduction would increase the opening balance of the hybrid deductions account as of the beginning of 2019.

[220] Prop. Reg. §1.245A(e)-1(h).

[221] Prop. Reg. §1.245A(e)-1(d)(2)(ii).

3. Consideration of Tiered Hybrid Dividends under Relevant Foreign Tax Law

As noted, if a CFC receives a tiered hybrid dividend and a domestic corporation is a US shareholder of both CFCs, then (i) the gross amount of the tiered hybrid dividend is treated as subpart F income of the receiving CFC (notwithstanding any other provision, such as Section 954(c)(6)), (ii) the US shareholder must include in gross income its pro rata share of that subpart F income, and (iii) no credit or deduction is allowed for any foreign taxes paid or accrued with respect to the tiered hybrid dividend.[222] A tiered hybrid dividend means an amount received by a receiving CFC from another CFC to the extent that the amount would be a hybrid dividend described in the Proposed Regulations if the receiving CFC were a domestic corporation.[223] Importantly, the Proposed Regulations disregard the character and treatment of the receipt of tiered hybrid dividends for relevant foreign tax law purposes, and only take into account the recipient CFC's treatment under US federal income tax principles. As illustrated in the following example, this asymmetrical approach can lead to results that do not reflect the aggregate foreign tax treatment of the arrangement.

Example 23: Tiered Hybrid Dividends

P, a domestic corporation, owns 100% of the outstanding stock of CFC1, and CFC1, in turn, owns 100% of the outstanding stock of CFC2. CFC2 has issued a hybrid instrument to CFC1. CFC2 distributes $100x of cash to CFC1 with respect to its hybrid instrument. Upon a distribution by CFC2 to CFC1 of $100x with respect to its hybrid instrument, CFC2 is entitled to an interest deduction under its relevant foreign tax law, and CFC1 recognizes interest income under its relevant foreign tax law. If CFC1 were a domestic corporation, CFC1's receipt of the distribution from CFC2 would have been eligible for the participation exemption (absent the application of Section 245A(e)).

Applying the Proposed Regulations, CFC2 has a hybrid deduction for which an addition to CFC1's hybrid deduction account would be required. Further, the distribution would be considered a tiered hybrid dividend — that is, the distribution by CFC2 to CFC1 would be characterized as a hybrid dividend, because if CFC1 were a domestic corporation it would have been eligible for the participation exemption (absent the application of Section 245A(e)) and CFC2 was entitled to a deduction for the distribution under its relevant foreign tax law. Accordingly, under the Proposed Regulations, the hybrid dividend is subpart F income of CFC1 that is includible in P's income under Section 951.

The above characterization, however, ignores the fact that CFC1 recognized interest income under its relevant foreign tax law. In this regard, if CFC1's recognition of interest income

[222] Prop. Reg. §1.245A(e)-1(c)(1).

[223] Prop. Reg. §1.245A(e)-1(c)(2).

for foreign tax law purposes is accounted for, CFC2's interest deduction and CFC1's interest income net to zero, leaving no net hybrid deduction and no overall D/NI result. By not accounting for the relevant foreign tax law's impact of the transaction at both tiers, the Proposed Regulations create a situation in which an item deductible in one jurisdiction creates inclusions in two jurisdictions.

We believe that Treasury and the Service should consider a rule that takes into account the aggregate impact of a hybrid deductible payment under the relevant foreign tax laws in applying the tiered hybrid dividend rule. The following example illustrates this proposal.

Example 24: Proportional income inclusion for tiered hybrid dividends

P, a domestic corporation, owns 100% of the outstanding stock of CFC1, and CFC1, in turn, owns 100% of the common stock and a hybrid instrument of CFC2. CFC2 makes a $200x payment on the hybrid instrument which is deductible by CFC2 against its marginal rate of 30% and exempt to CFC1 under a participation exemption. However, CFC2 is required to withhold 15% of the payment under applicable law (or alternatively, CFC1 is subject to income tax on its receipt of the payment at the rate of 15%).

P would recognize subpart F income of $200x under Prop. Reg. §1.245A(e)-1(c)(1). However, this approach does not take into account the fact that CFC2 was subject to foreign withholding tax of 15% on the hybrid payment to CFC1. To maintain parity between the deemed inclusion by reason of Prop. Reg. §1.245A(e)-1(c)(1) by P and the non-inclusion/deduction amount of CFC1, P ought to only recognize $100x of subpart F income ($200x * 15%/30%) – that is, CFC1's withholding tax obligation ought to be taken into account in determining the amount of P's subpart F inclusion. While CFC2 obtained a benefit of a deduction at a 30% rate, CFC1 suffered an inclusion at a 15% rate. Thus, the subpart F inclusion should arguably be with respect to half the income, or $100. In the alternative where CFC1 is subject to a 15% income tax on the receipt of the payment (as opposed to a 15% withholding tax), the same issue is presented. While there may be more complexity in determining whether, and how, CFC1's jurisdiction taxes its receipt of the payment, as compared to the imposition of a withholding tax by CFC2's jurisdiction, the imposition of a foreign income tax on CFC1 would mean that there is not (or there is proportionately less of) a D/NI result.

As illustrated above, we believe the approach taken in the Proposed Regulations has the potential to give rise to results that are unduly harsh. We recommend that Treasury and the Service consider revising the tiered hybrid deduction rules to take into account the relevant foreign tax law's treatment of the receipt of the distribution by the intermediary CFC (including applicable withholding taxes).

4. Maintenance of Hybrid Deduction Accounts

As noted, a hybrid deduction account is required to be maintained with respect to each share of outstanding stock of a CFC.[224] The Proposed Regulations provide certain rules related to the maintenance of such hybrid deduction accounts.[225] Specifically, the Proposed Regulations provide adjustments to, and rules for the carryover of, hybrid deduction accounts. With respect to adjustments to the hybrid deduction accounts, the Proposed Regulations provide that: (i) first, the hybrid deduction account is increased by the amount of hybrid deductions of the CFC allocable to the share for the taxable year, and (ii) second, the account is decreased by the amount of hybrid deductions in the account that gave rise to a hybrid dividend or tiered hybrid dividend during the taxable year.[226] Treasury and the Service have requested comments on whether additional specified adjustments should be made to the hybrid deduction accounts for certain items. Each of these items is discussed in more detail below.

a. Certain Adjustments to the Hybrid Deduction Account

Treasury and the Service have requested comments on (i) whether hybrid deductions attributable to amounts included in income under Section 951(a) or Section 951A—so-called subpart F income and GILTI — should not increase the hybrid deduction account, or, alternatively, whether the hybrid deduction account should be reduced by PTI distributions, and (ii) whether the effect of any deemed paid foreign tax credits associated with such inclusions or distributions should be considered.

It is not clear whether and in what circumstances hybrid deductions should be treated as attributable to subpart F income or GILTI. Under one construct, these items may be viewed as entirely separate from each other. That is to say, it can be argued that subpart F income and GILTI are separate regimes that should not interact with Section 245A(e). In effect, separate rules govern the treatment of the accrual, recognition, and distribution of subpart F income and GILTI, which are not eligible for a dividends received deduction under Section 245A when earned or distributed and thus should not be attributed to hybrid deductions subject to Section 245A(e). Under this analysis, subpart F and GILTI inclusions do not impact the hybrid deductions accounts when earned or distributed.

Nevertheless, hybrid deductions potentially are attributable to subpart F income or GILTI to the extent a hybrid dividend, in actuality, is funded by post-2017 subpart F income or GILTI. In such case, the denial of the Section 245A deduction for other dividends paid on account of the

[224] Prop. Reg. §1.245A(e)-1(d) and (f).

[225] *See generally* Prop. Reg. §1.245A(e)-1(d)(4).

[226] Prop. Reg. §1.245A(e)-1(d)(4)(i). If a specified owner has more than one hybrid deduction account with respect to its stock of the CFC, then a pro-rata amount in each hybrid deduction account is considered to have given rise to the hybrid dividend or tiered hybrid dividend, based on the amounts in the accounts before applying Prop. Reg. §1.245A(e)-1(d)(4)(i).

positive register in the hybrid dividend account created by the hybrid payment effectively may result in two US inclusions associated with such payment (once under subpart F or GILTI and once because of the denial of the Section 245A deduction for other dividends). The following example illustrates the interaction of the hybrid deduction account rules where the hybrid dividend is funded by post-2017 subpart F income or GILTI.

Example 25: Hybrid dividends funded by post-2017 subpart F income or GILTI

P, a domestic corporation, owns 100% of the outstanding stock of CFC, a country X corporation. CFC has a hybrid instrument outstanding to P. In year 1, CFC earns two items of income: (i) $150x of subpart F income, and (ii) $50x of "tested income"[227] for purposes of determining the CFC's GILTI. Also assume that CFC's net deemed tangible income return, within the meaning of Section 951A(b)(1)(B) [228], equals or exceeds $50x, such that P's GILTI inclusion is zero. Also in year 1, CFC accrues a $150x deduction under country X law for interest accrued and paid with respect to the hybrid instrument (i.e., a hybrid deduction). Further assume that CFC pays no tax in year 1 in country X (because it has certain attributes to offset its net $50 of country X taxable income). In year 2, CFC earns no subpart F income and $50x of tested income (with at least $50x of net tangible income return) and no country X deductions are accrued on the hybrid instrument. CFC distributes $100x to P as a dividend on CFC's common stock. No deduction or other tax benefit is permitted to CFC under country X law for the distribution.

In year 1, for US tax purposes, P recognizes income of $150x under Section 951 with respect to the $150x of subpart F income earned by CFC. The $150x payment on the hybrid instrument is treated as PTI. In year 2, for US tax purposes, the $100x distribution is a dividend.

The relevant issue is to what extent the distribution of $100x on the common stock of CFC should be treated as a hybrid dividend for purposes of Section 245A(e). As noted above, this depends on the balance of P's hybrid deduction account with respect to its interests in CFC, which, in turn, depends on whether reductions to P's hybrid deduction account with respect to its CFC stock are made for subpart F inclusions (or PTI distributions), and, if so reduced, the magnitude of such reductions. If P's hybrid deduction account is not reduced at all for its recognition of subpart F income, then the balance of its hybrid deduction account would be $150x at the end of year 1, and

[227] "Tested income" of a CFC for a taxable year is the excess (if any) of the CFC's gross income, with certain specified exceptions, over the deductions (including tax) properly allocable to such gross income under rules similar to the rules of Section 954(b)(5) (or to which such deductions would be allocable if there were such gross income). *See* Section 951A(c)(2)(A).

[228] Net deemed tangible income return generally is 10 percent of "qualified business asset investment", which is the aggregate adjusted tax basis of a CFC's "specified tangible property" that is used in a trade or business and subject to an allowance for depreciation. *See* Section 951A(d)(1). "Specified tangible property" is a CFC's tangible property used in the production of tested income. *See* Section 951A(d)(2).

the entirety of the year 2 $100x dividend would be treated as a hybrid dividend to P. Accordingly, the entirety of the $100x distribution on the common stock would be treated as dividend income to P without any participation exemption under Section 245A, such that there is $250x of income recognized in the US ($150x of subpart F income in year 1 and $100x of hybrid dividend income in year 2).

This result seems questionable as it disregards the fact that CFC's $150x hybrid payment in year 1 has been funded, at least in part, by the subpart F income. CFC only earned $50x of non-subpart F income in year 1, which could not have funded the entirety of the $150x hybrid dividend.[229] The balance in the hybrid deductions account at the end of Year 1 should be no greater than $50x and perhaps lower than that. Failure to reduce the hybrid deductions account in this instance appears to result in duplication; the subpart F income is included in income by P and the hybrid deduction that it funds results in the common dividend also being fully taxable to P.

An appropriate remedy for this potential duplication is not clear. In these cases, the hybrid deductions account could be fully reduced by the CFC's subpart F income or GILTI included in income by the US shareholder or on account of the distribution of PTI attributable to the subpart F income or GILTI (i.e., which PTI funds the hybrid payment). A full reduction rule seems too generous, however.

First, it does not seem appropriate to assume that subpart F income or GILTI always funds hybrid dividends before other earnings. Moreover, we believe a tracing approach to sourcing hybrid deductions to the categories of earnings (subpart F income, GILTI, or Section 959(c)(3) earnings) would be too difficult to administer.

Second, subpart F income and GILTI may not be fully taxed in the US, either because of deemed paid foreign tax credits or because of Section 250 deductions. Arguably any deemed paid foreign tax credits or Section 250 deductions associated with such income could be denied under Section 245A(d) (or the equivalent thereof by Regulation for Section 250 deductions). In effect, such a rule would put such subpart F income and GILTI on par with other income that funds hybrid deductions and is actually distributed to a US shareholder (i.e., full inclusion in income of the US shareholder without deemed paid credits). But, a mandatory rule requiring a denial of deemed paid credits and Section 250 deductions appears to be inconsistent with the foreign tax credit rules for subpart F income or GILTI and Section 250 itself, creating results that are unduly harsh. Another possibility is to permit a taxpayer to elect to treat subpart F income or GILTI as funding hybrid dividends, so that their inclusion by a US shareholder reduces the hybrid deductions account. Under such an election, the taxpayer would have to forego associated foreign tax credits pursuant to Section 245A(d). An elective approach appears to be unduly adverse to the government's

[229] In addition, the subpart F income inclusion would have been reduced if the hybrid instrument were treated as giving rise to interest income under US tax principles. Hybridity actually increases subpart F income.

interests, however, resulting in taxpayers making the election only when it is to the government's detriment.

Although more complicated to implement, we favor the following approach. We recommend that Treasury and the Service consider and adopt (unless determined to be too difficult to administer) an arithmetic convention to identify if and to what extent subpart F income or GILTI earned in a taxable year funds a hybrid deduction in the same year. One example of such a convention would be to treat a hybrid dividend for a taxable year as sourced on a pro rata basis out of the CFC's current subpart F income, GILTI, and Section 959(c)(3) earnings. Second, once it is determined whether and the extent to which subpart F income or GILTI funded a hybrid deduction in the same year, hybrid deduction accounts could be adjusted in respect of distributions of subpart F income or GILTI, but reducing the adjustment to reflect deemed paid foreign tax credits or Section 250 benefits obtained in that year.

b. Carryover of Hybrid Deduction Account in Certain Nonrecognition Transactions

As noted above, a hybrid deduction account is required to be maintained with respect to each share of outstanding stock of a CFC.[230] As hybrid deduction accounts are maintained on a share-by-share basis with respect to each CFC, the Proposed Regulations, similar to the "successor" rules under Section 959, address scenarios where the shareholder that receives the dividend is not the same shareholder that held the stock when the hybrid deduction was incurred. However, these rules only apply when the stock is transferred among persons who are required to maintain hybrid deduction accounts (i.e., US corporations and CFCs); thus, if a CFC is transferred to a person who is not required to maintain a hybrid deduction account (e.g., a foreign corporation that is not a CFC), the account terminates, subject to the anti-avoidance rule provided in the Proposed Regulations.[231] The Proposed Regulations also take into account certain non-recognition exchanges of the stock, such as exchanges in connection with asset reorganizations, recapitalizations, and liquidations, as well as transfers that occur mid-way through the CFC's taxable year.[232]

[230] Prop. Reg. §1.245A(e)-1(d) and (f).

[231] Prop. Reg. §1.245A(e)-1(d)(4)(ii)(A) and (e). Specifically, under the anti-avoidance rule in Prop. Reg. §1.245A(e)-1(e), if a specified owner of a share of CFC stock transfers the share to another person, and the principal purpose of the transfer is to shift the hybrid deduction account with respect to the share to the other person or to cause the hybrid deduction account to be eliminated, then for purposes of Section 245A(e) the shifting or elimination of the hybrid deduction account is disregarded as to the transferor. As well, the anti-avoidance rule can apply if the Section 246 holding period requirement is purposefully not met in the case of a distribution by a lower-tier CFC (presumably, the upper-tier CFC would apply Section 954(c)(6) to exclude the dividend from its subpart F income and thus not need the participation exemption). Treasury should consider providing that merely selling the lower-tier CFC stock to an unrelated party prior to satisfying the Section 246 holding period requirements with respect to a distribution is not a case of abuse subject to the anti-avoidance rule, even if the timing of the sale was driven by tax considerations.

[232] Prop. Reg. §1.245A(e)-1(d)(4)(ii)(B).

With respect to certain non-recognition transactions, the Proposed Regulations provide that when a shareholder of a CFC (exchanging shareholder) exchanges stock of the CFC (target CFC) for stock of another CFC (acquiring CFC) pursuant to an asset reorganization described in Section 381(a)(2) in which the target CFC is the transferor corporation, then in the case of an exchanging shareholder that is a "specified owner" of the acquiring CFC immediately after the exchange, the exchanging shareholder's hybrid deduction accounts with respect to the shares of stock of the target CFC are attributed to the stock of the acquiring CFC received in exchange therefore.[233] In the case of an exchanging shareholder that is not a specified owner of one or more shares of stock of the acquiring CFC immediately after the exchange, the exchanging shareholder's hybrid deduction accounts with respect to its shares of stock of the target CFC are eliminated.[234] The Proposed Regulations also provide for specific rules related to Section 332 liquidations and recapitalizations to which Section 368(a)(1)(E) applies.[235] For example, when a second tier CFC with a hybrid deduction account liquidates into a first tier CFC under Section 332, the US shareholder adds the hybrid deduction account with respect to the second tier CFC to the hybrid deduction account for the first tier CFC.[236]

In general, these rules for tacking hybrid deduction accounts onto successor interests are sensible. We have two basic comments.

First, there could be instances where the hybrid deduction accounts of a lower-tier CFC are replicated in the hybrid deduction accounts of an upper-tier CFC. For example, assume that P owns CFC1, which in turn owns CFC2. Each of CFC1 and CFC2 has issued a "mirror" hybrid instrument and have accrued but not paid a hybrid payment resulting in a single net deduction for foreign tax purposes (i.e., because CFC1 is taxable upon the accrual with respect to CFC2's instrument). If CFC2 liquidates into CFC1 in a Section 332 transaction, then Prop. Reg. §1.245A(e)-1(d)(4)(ii)(B)(2) provides that the hybrid deduction account of the lower-tier CFC (CFC2) is effectively added to the hybrid deduction account of the upper-tier CFC (CFC1). But, CFC1's hybrid deduction account already includes CFC2's hybrid deduction account, because of the back-to-back nature of the hybrid instruments – that is, for each hybrid deduction that CFC2 accrues, CFC1 accrues a hybrid deduction in an equal amount. Thus, this approach leads to the

[233] Prop. Reg. §1.245A(e)-1(d)(4)(ii)(B)(1). A "specified owner" means, with respect to a share of stock of a CFC, a domestic corporation that is a US shareholder of the CFC, or an upper-tier CFC that would be a US shareholder of the CFC were the upper-tier CFC a domestic corporation. For example, if a domestic corporation directly owns all the shares of stock of an upper-tier CFC and the upper-tier CFC directly owns all of the shares of stock of another CFC, the domestic corporation is the specified owner of the upper-tier CFC and the upper-tier CFC is the specified owner of the lower-tier CFC. *See* Prop. Reg. §1.245A(e)-1(f)(5).

[234] Prop. Reg. §1.245A(e)-1(d)(4)(ii)(B)(1)(ii).

[235] Prop. Reg. §1.245A(e)-1(d)(4)(ii)(B)(2) and (3).

[236] Prop. Reg. §1.245A(e)-1(d)(4)(ii)(B)(2).

inappropriate duplication of the hybrid deduction account balance. We recommend that Treasury and the Service consider adopting anti-duplication rules to preclude such a result.[237]

Second, absent from the rules relating to acquisitions of hybrid deduction accounts are rules dealing with the treatment of such accounts in the case of distributions and exchanges to which Section 355 applies (a "**spin-off**"). Importantly, spin-offs are not described in Section 381(a)(2),[238] and therefore, would not be covered by the rules related to asset reorganizations in the Proposed Regulations. As a general matter, it seems appropriate to divide hybrid deduction accounts related to the distributing corporation's stock using the methodologies described in Section 358(b)(2) and Reg. §1.358-2(a)(2)(iv) with respect to the allocation of stock basis in a spin-off. Where the controlled corporation is a pre-existing CFC and the distributing corporation had one or more hybrid deduction accounts with respect to the controlled corporation's stock, consistent with the rules for Section 332 liquidations, it would seem that the distributing corporation's shareholder also should succeed to such accounts and they should attach to the stock of the controlled corporation held by the shareholder after the spin-off. Accordingly, the shareholder's hybrid dividend account for the controlled corporation following the spin-off should equal the sum of (i) the allocable share of its hybrid dividend account for the distributing corporation's stock prior to the spin-off and (ii) the distributing corporation's hybrid dividend account of the controlled corporation to which the shareholder succeeds, subject to the anti-duplication rule described above.[239]

C. Section 1503(d)

1. Domestic Reverse Hybrids

As discussed above, a DCL is a net operating loss of a dual resident corporation or a net loss attributable to a separate unit. A domestic reverse hybrid ("**DRH**") is a domestic business entity that elects under Reg. §301.7701-3(c) to be treated as a corporation for US federal income tax purposes but is treated as a fiscally transparent entity for foreign purposes (e.g., a Delaware partnership that elects to be classified as a corporation). A DRH is not subject to the current DCL

[237] As an example of other anti-duplication rules in the Code and Regulations, *see* Reg. §1.1502-33(a)(2) for the anti-duplication rules related to earnings and profits in consolidated groups.

[238] Section 381(a)(2) applies to the acquisition of assets of a corporation by another corporation in a transfer to which Section 361 applies, but only if the transfer is in connection with a reorganization described in Section 368(a)(1)(A), (C), (D), (F), or (G).

[239] We note that this approach could lead to results that may seem peculiar in certain cases. For example, assume that the distributing and controlled CFCs are of equal size and each has a hybrid deduction account of $100. Under the proposed methodology, the controlled CFC would end up with a $150 account and the distributing CFC would end up with a $50 account. However, this result seems to follow from the fact that the two accounts are separate. Moreover, an alternative approach that first combines the two accounts and allocates the two accounts ratably has its own administrative difficulties and may not reach appropriate results (e.g., because it does not take into account hybrid dividend accounts in other subsidiaries of the two corporations).

rules because it is neither a dual resident corporation (it is only subject to worldwide tax in the US) nor a separate unit of a domestic corporation (i.e., a foreign branch or a foreign hybrid entity).

However, allowing a loss generated by a DRH to escape the DCL rules appears to be inconsistent with the policy underlying Section 1503(d). The following example demonstrates a potential double-deduction outcome through the use of a DRH:

Example 26:

Foreign corporations FC1 and FC2 each own 50% of DRH, a domestic partnership treated as a partnership for foreign tax law purposes but treated as a corporation for US federal income tax purposes. DRH is the parent of a US consolidated group, owning the stock of USS. During the taxable year, DRH generates ($100) of loss, each of FC1 and FC2 earns $50 of foreign income, and USS earns $100 of income.

In this example, the $100 of loss generated by DRH offsets two economic streams of income. The $100 of loss generated by DRH reduces the taxable income of the US consolidated group by offsetting the $100 of income attributable to USS. In addition, the $100 of loss generated by DRH is allocated to FC1 and FC2 pursuant to the partnership rules of foreign tax law, to offset the partners' foreign income. This is the type of "double-dip" typically prevented by the DCL rules, but the statute does not include losses of a DRH when it defines a DCL, and accordingly the 2007 DCL Regulations do not address this situation.

In addition to allowing the double-deduction result described above, excluding a DRH from the DCL rules also may put US acquiring companies at a disadvantage when compared to foreign acquiring companies. If a US acquirer purchases a DRH, then the double-deduction benefit is unavailable because the US acquirer would treat the DRH as a corporation for US federal income tax purposes and there is no hybridity in the system. However, if a foreign acquirer purchases a DRH, then there is hybridity in the system because the foreign acquirer treats the DRH as a fiscally transparent entity under foreign tax law.

a. 2007 DCL Regulations

The 2007 DCL Regulations did not treat losses of a DRH as DCLs, notwithstanding comments suggesting that treating them as such is the correct policy.[240] We understand that this may have been, in part, because of a concern about a lack of statutory authority under Section 1503(d). The preamble to the 2007 DCL Regulations notes that a DRH is neither a dual resident corporation nor a separate unit and therefore is not subject to Section 1503(d), but that Treasury

[240] *See* the Proposed DCL Regulations Report Part IV.B.2.f. (recommending that Treasury extend the DCL limitation to DRHs owned by foreign corporations, and generally finding sufficient authority for such a change from the statute, but suggesting a legislative change if Treasury did not think it had sufficient authority).

would continue to study these and similar structures. The scope of statutory authority to treat a DRH as a dual resident corporation is beyond the scope of this Report.

b. Proposed Regulations

The Proposed Regulations subject a DRH to the DCL rules, and thus treat a loss of a DRH as a DCL, by requiring taxpayers to consent to treat a DRH as a dual resident corporation as a condition of making a check-the-box ("**CTB**") election to classify a domestic eligible entity as a corporation under Reg. §301.7701-3(c) (i.e., to elect to be a DRH). Further, even if a domestic entity previously filed a CTB election to be classified as a corporation, the Proposed Regulations provide that the domestic entity is deemed to consent to be treated as a dual resident corporation as of its first taxable year beginning on or after the end of a 12-month transition period.

While we agree, as noted above, with the underlying policy rationale for treating DRHs as subject to the DCL rules (because losses of a DRH present opportunities for "double-dip" loss utilization), we do have some concerns about using the CTB regime as the means of implementation (as opposed to promulgating a Regulation directly imposing the DCL rules on DRHs). We are not commenting herein on whether there is, or is not, statutory authority for such treatment under Sections 1503(d), 1502, 267A, 7805, or any combination thereof; rather, we think that the apparent method chosen by the Proposed Regulations to implement the policy choice (i.e., conditioning a CTB election on consent to the proposed treatment) deserves scrutiny.[241]

We urge caution with respect to the approach of conditioning a CTB election on consent to status as a dual resident corporation (i.e., the approach adopted in the Proposed Regulations). The CTB regime is so far-reaching now that Treasury and the Service (in theory) could condition a CTB election on consenting to any rule (including, potentially, rules they may not have authority to issue as a standalone proposition). However, we do not believe this would be sound tax policy, and we do not believe a broad precedent should be set. It can be debated whether a particular policy is so closely tied to the CTB regime that advancing the policy via the CTB regime in the absence of explicit statutory authority is merited. The anti-hybrid rules such as the DCL regulations are, in fact, closely tied to the CTB regime (contrast, for example, conditioning a CTB election on consent to treat a partnership as an aggregate for purposes of Section 163(j)). However, we caution against setting such a precedent, particularly if it is determined that a direct route is available.

For the reasons described above, we recommend that losses of a DRH should be treated as DCLs, provided that, if Treasury and the Service do not believe they have authority to issue Regulations directly subjecting losses of a DRH to the DCL rules (without using the CTB regime),

[241] While we acknowledge that the Proposed DCL Regulations Report Part IV.B.2.f. gave an example of one possible rule in which a CTB election was treated as consent, we do not think this example was a focus of the report, and with the passage of time and further consideration, we believe that other pathways should be explored before adopting the CTB election route.

we recommend that Treasury and the Service seek a legislative amendment to provide for such authority, instead of conditioning a CTB election on such treatment.

2. Disregarded Items

The DCL rules do not take into account items that are disregarded for US federal income tax purposes in calculating the DCL (or positive cumulative SRLY register) of a separate unit.[242] Instead, only the items of the domestic owner are taken into account.[243] The scope of statutory authority to take disregarded items into account is beyond the scope of this Report.

The Preamble notes that this may lead to certain scenarios where there is a D/NI result similar to the D/NI outcomes addressed by Sections 245A(e) and 267A and requests comments.[244] However, there may also be certain scenarios where not reflecting disregarded items results in deductions being improperly subject to limitation.

Example 27:

> USP, a domestic corporation, owns FDRE, a foreign entity disregarded as an entity separate from USP for US federal income tax purposes. FDRE owns, and is consolidated under foreign tax law with, CFC, a foreign corporation. FDRE makes a payment to USP that is disregarded for US federal income tax purposes, but the payment is deductible for foreign tax purposes and can be used to offset income of CFC.

This results in a D/NI outcome, because there is a deduction under foreign law but the transaction is disregarded for US federal income tax purposes and thus is not taken into account in calculating the DCL even though it is reflected on the books and records of FDRE.[245] In the context of the participation exemption under Section 245A (i.e., if FDRE were a foreign corporation and it were paying a hybrid dividend to USP that was deductible for foreign tax purposes but not, initially, included for US tax purposes), such a D/NI outcome would generally prohibit USP from taking the DRD, under Section 245A(e). However, in this context, the payment

[242] Reg. §1.1503(d)-5(c)(1)(ii).

[243] *Id.*

[244] Preamble at 67624. Similar issues arise in the context of determining the income attributable to a foreign tax credit basket. *See*, *e.g.*, New York State Bar Association Tax Section Report No. 1408, Report on the Proposed Foreign Tax Credit Regulations (February 5, 2019) ("Notwithstanding the complexities associated with taking into account disregarded transactions when calculating foreign branch income, we believe that significant planning opportunities may exist if disregarded transactions are not taken into account…We believe that the Proposed Regulations correctly acknowledge that for purposes of both Section 904 and the FDII deduction under Section 250, disregarded transactions must be taken into account to provide an accurate measure of foreign branch income." However, such Report did not endorse taking into account disregarded transactions between two foreign branches.

[245] In the Final DCL Regulations Report, Part II.E., we recommended that the methodology for the attribution of items to separate units be made consistent as to both foreign branches and hybrid units (disregarded entities) and that the appropriate methodology is to attribute items in accordance with local books and records, as adjusted for US tax principles. These issues are beyond the scope of this Report, as we will focus on disregarded entities.

from FDRE to USP is disregarded for US tax purposes and thus cannot give rise to income in USP, absent somehow disaggregating the disregarded item into a notionally regarded deduction and inclusion. As described below, subjecting a disregarded item to the DCL rules requires disaggregating the item, because to prevent the D/NI outcome there would need to be a current fictional income inclusion at USP and a deduction at FDRE that is subject to the SRLY limitation.

A more appealing way to resolve the D/NI problem in this case would be for the foreign jurisdiction of FDRE to deny the deduction for foreign tax purposes pursuant to anti-hybrid rules similar to those of Section 267A. In fact, it might be more appropriate for the DCL rules not to apply to this transaction, out of complexity and administrability concerns described below, and instead leave foreign tax law to deny the foreign tax deduction. However, in the absence of such a foreign tax rule, the D/NI result remains, and raises the question as to whether the DCL rules should apply to prevent a D/NI result.

Next, consider the following example where FDRE earns the income instead of the deduction. Note that this may be a common fact pattern in connection with Act-related inbound transactions where USP chooses to bring a CFC into the US tax net because of, for example, Sections 163(j) and 59A, as well as the lower corporate tax rate.

Example 28:

USP, a domestic corporation, owns FDRE, a foreign entity disregarded as an entity separate from USP for US federal income tax purposes. FDRE owns, and is consolidated under foreign tax law with, CFC, a foreign corporation. USP makes a payment of $100 to FDRE that is disregarded for US federal income tax purposes but is included in income of FDRE for foreign tax purposes. FDRE makes a payment of $100 to an unrelated service provider.

The DCL rules do not take into account FDRE's income of $100 from USP in determining its DCL for the year (or its cumulative SRLY register), even though it is reflected on the books and records of FDRE. However, the equal and offsetting deduction of FDRE arising from the payment of $100 to an unrelated service provider is regarded for US federal tax purposes and results in a $100 DCL subject to the SRLY limitation. Economically, this appears to be the incorrect result, as FDRE does not generate a loss for foreign tax purposes, and thus there is no opportunity to use the loss to offset two separate economic streams of income (i.e., there is no "double dip" because FDRE does not generate a loss for foreign tax purposes).

Arriving at the "correct" economic answer of preventing D/NI results but still allowing deductions that do not achieve D/NI results seems to require, to some extent, taking into account all relevant items on the books and records of the separate unit in calculating the DCL, rather than disregarding items that are generally disregarded for US federal income tax purposes. This appears to prevent the D/NI result in Example 27 where FDRE makes a payment to USP, and would prevent the inappropriate SRLY result in Example 28 where USP makes a payment to FDRE.

However, we acknowledge the complexities that arise if disregarded items are taken into account for purposes of the DCL rules, and we are aware that prior to the 2005 Proposed Regulations answering this question, there was significant debate as to whether disregarded items should be taken into account in calculating the DCL or positive register. For example, in Example 27 where FDRE makes a payment to USP, assuming that the only item on FDRE's books and records is the deductible payment to USP, how would a loss be created that would be subject to the DCL SRLY limitation? One approach is to disaggregate the disregarded payment into a regarded deduction of FDRE and a regarded inclusion of USP, with USP's inclusion required to be included in income currently and FDRE's deduction subject to the DCL SRLY rules. But this approach appears to require tracking all transactions between a corporate owner and its foreign branch or foreign disregarded entity. Perhaps the trend in the law is towards such tracking (e.g., the foreign branch foreign tax credit basket under Section 904(d)(1)(B), and the disregarded payment rules under Section 267A discussed above), but nonetheless this approach increases complexity and administrative burdens.

Also, this approach of taking into account disregarded items would require "making up" items of income that do not generally exist for US tax purposes (e.g., USP's fictional item of income from FDRE's disregarded payment would be included currently and FDRE's fictional item of deduction would be subject to the SRLY limitation). Further, the timing, character, and attributes of all such disregarded items, now regarded, would need to be determined. For example, USP's current income inclusion from its payment from FDRE would need to be, e.g., ordinary or capital, US source or foreign source, business interest income under Section 163(j) or not business interest income), and similar determinations would need to be made for FDRE's SRLY-limited deduction. Making these determinations for disregarded items adds significant complexity.

Another approach that could mitigate the D/NI results while not creating fictional tax items of income, is to track disregarded items, but only to offset actual regarded items, and not to "create" regarded items. In other words, in Example 27 above, if FDRE's items included not only a disregarded payment of $100 to USP, but also $120 of income received from an unrelated party, this approach would cause FDRE's positive SRLY register to be $20, instead of $120, by giving effect to the disregarded payment to USP, and allowing it to offset $100 of income from an unrelated party. Similarly, if in addition to FDRE's $100 disregarded payment to USP, FDRE also generated $100 of income and $100 of expense from regarded transactions, the $100 disregarded payment to USP could offset the $100 of income from unrelated parties, resulting in a $100 DCL attributable to the regarded deductions. This approach, while still requiring tracking transactions between USP and FDRE, at least does not involve creating tax items that do not generally exist and determining their character.

However, if FDRE's only item was the disregarded payment of $100 to USP, then this approach would not be able to match such disregarded item to a regarded item of income of FDRE. Perhaps that result would simply escape these rules (i.e., similar to current law, the $100 disregarded item would not be taken into account in calculating the DCL or the cumulative register), or alternatively, Treasury could consider creating a $100 account at FDRE that could match a regarded item of FDRE in a different year. We acknowledge the complexity in creating such an account and urge caution in increasing complexity in such a way.

The following example further illustrates the approach described above:

Example 29:

USP, a domestic corporation, owns FDRE, a foreign entity disregarded as an entity separate from USP for US federal income tax purposes. FDRE owns, and is consolidated under foreign tax law with, CFC, a foreign corporation. FDRE's books and records reflect the following:

(1) $100 gross income from operations (regarded for US tax purposes);

(2) $100 deductible expenses to third parties (regarded for US tax purposes); and

(3) $100 deductible payment to USP (disregarded for US tax purposes).

FDRE's books and records reflect a loss of $100. However, the current DCL rules ignore the disregarded $100 deductible payment by FDRE to USP and view FDRE as breaking even, with $100 gross income from operations and $100 deductible expenses to third parties. Under the approach described above, the $100 deductible payment to USP offsets the $100 of regarded FDRE income leaving only the $100 deductible expenses to third parties. This results in a $100 DCL. Because the DCL is attributable to regarded items of third party expense, there is no need to create fictional tax items and apply the DCL rules to such fictional tax items. USP would include the $100 gross income from FDRE's operations currently, and FDRE's $100 of regarded deductible expenses would be subject to the SRLY exception (unless an exception applies, such as a domestic use election).

Conversely, if FDRE's books and records reflected $100 of income from a disregarded payment by USP and $100 of regarded expense from a payment to a third party, then the $100 disregarded income item would offset the $100 deductible expense to a third party, resulting in no DCL for the year. This appears to be the correct economic result, but it does require tracking transactions that are otherwise disregarded for US federal income tax purposes. If there are no regarded items of deduction to offset in the current year, then either the benefit of the $100 disregarded payment from USP would effectively be lost (similar to current law), or to achieve greater fairness but at the cost of significant further complexity, there could be an account that carries forward to offset regarded deductions in the following year.

As described above, there are competing considerations when determining how to treat disregarded transactions for purposes of the DCL calculation, namely weighing the ability to more closely track FDRE's books and records, and thus more appropriately combat D/NI results, against the increased complexity of reflecting items that are generally disregarded for US federal income tax purposes. We recommend that Treasury consider redefining the net loss attributable to a separate unit by taking into account disregarded items to the extent they can offset regarded items of the separate unit, but we caution against affirmatively creating notional items by disaggregating items that are generally disregarded into a regarded deduction and a regarded item of income. Further, given the additional complexity involved in tracking items that are generally disregarded, if Treasury chooses to require such tracking, we recommend that Treasury should consider simplifying assumptions or mechanics (e.g., under Section 482), and perhaps a *de minimis* safe harbor for aggregate disregarded transactions less than a certain threshold amount, that are sufficient to protect against material D/NI outcomes but somewhat ease the administrative burden of tracking disregarded items.

3. Intercompany Transactions

A related area involves the treatment of regarded payments between a foreign DRE and a member of the consolidated group other than the corporate owner of the foreign DRE. Such regarded transactions are subject to the intercompany transaction regulations in Reg. §1.1502-13, which generally regard transactions between members of a consolidated group. The rules generally treat the selling member (S) and the buying member (B) in an intercompany transaction as divisions of a single entity for purposes of determining the attributes of S's and B's items,[246] but do not go so far as to actually disregard intercompany transactions for US federal income tax purposes (e.g., amount and location of items is determined on a separate member basis). In addition, in certain cases involving a member with a special status, attributes are determined on a separate company, rather than a single entity, basis.[247]

Unlike the transactions between USP and FDRE described above, which are disregarded, an intercompany transaction gives rise to regarded items that can be analyzed under the DCL rules without the need to disaggregate a disregarded transaction into two notionally regarded items. As a general matter, regarding intercompany transactions leads to more accurate DCL calculations. Furthermore, consolidated group members are already required to reflect transactions between FDRE and the group member pursuant to the intercompany transaction Regulations. Thus, the incremental administrative burden of tracking intercompany transactions is less than that of tracking disregarded items, and taking into account such transactions in calculating a DCL would not require creating fictional tax items.

If disregarded transactions are taken into account to some extent (as recommended above), then also taking into account intercompany transactions would further the policy of creating parity between the treatment of a separate entity with the treatment of a consolidated group. On the other

[246] Reg. §1.1502-13(a)(2).

[247] Reg. §1.1502-13(c)(5).

hand, if disregarded transactions remain ignored for purposes of the DCL calculation (notwithstanding our recommendation above), then allowing intercompany transactions to affect the DCL calculation while precluding disregarded transactions from doing so results in a consolidated group being able to achieve a tax result that a single entity could not achieve and is arguably inconsistent with determining attributes from intercompany transactions using single entity principles.

Example 30:

USP, a domestic corporation, owns USS, a domestic corporation. USP and USS are members of a consolidated group. USS owns FDRE, a foreign entity disregarded as an entity separate from USS for US federal income tax purposes. FDRE owns, and is consolidated under foreign tax law with, CFC, a foreign corporation. FDRE makes a $100 deductible payment to USP (as opposed to USS). In addition, FDRE earns $100 of gross income and incurs $100 of expense, each from transactions with third parties.

In this example, without taking into account the intercompany transaction, FDRE breaks even. Taking into account the intercompany transaction, FDRE has a $100 DCL, presumably $50 of which is attributable to the intercompany transaction and the other $50 of which is attributable to the third party deduction. The deductible payment by FDRE to USP is a regarded item to which the DCL rules could apply without creating fictional tax items (as opposed to taking into account disregarded items, which, as described above, would require creating fictional tax items in certain cases). In other words, in this example, it is possible, without disaggregating a disregarded transaction into component parts of income and expense, to cause USP to include $100 income and USS, through FDRE, to deduct the $100 payment, with the $50 DCL attributable to the intercompany transaction subject to the domestic use limitation ($50 of USP's income would likely not be taken into account until USS's deduction was allowed, under the matching rules of Reg. §1.1502-13(c)). The $50 portion of the DCL attributable to FDRE's third party deduction would also be subject to the domestic use limitation.

Analogous results should follow if USP instead pays FDRE, in that if intercompany transactions can be taken into account in order to more precisely combat D/NI results, then FDRE's cumulative SRLY register would increase by reason of USP's payment. Similar to the intercompany transaction resulting in a deduction for FDRE, it is possible to increase FDRE's cumulative register by reason of an intercompany transaction without creating fictional tax items. However, if disregarded items remain disregarded (i.e., if our recommendation above is not adopted), then the concern remains regarding inconsistency with single entity principles. This could lead to a group structuring its affairs to take advantage of this inconsistency to the disadvantage of the fisc. For example, a group could structure its internal transactions such that payments or accruals by FDRE are to the greatest extent possible made in disregarded transactions, whereas income or receipts of FDRE are to the greatest extent possible received in intercompany transactions.

We recommend that Treasury and the Service permit intercompany transactions to be taken into account for purposes of determining the DCL, as this promotes fulfillment of the policies underlying the DCL rules. Furthermore, we generally support consistency between the treatment of disregarded transactions and intercompany transactions, acknowledging that the former raise additional administrative burdens not associated with the latter. If disregarded transactions continue to be ignored in calculating the DCL or positive register as a general matter, then we believe consideration should be given to requiring a consolidated group to take a consistent approach to the treatment of the intercompany transactions and disregarded payments, at least where disregarded payments are substantial, to prevent a consolidated group from structuring certain transactions as disregarded payments and others as regarded intercompany payments.

4. All-or-Nothing Rule

As discussed above, the All-or-Nothing Rule generally provides that foreign utilization of "any portion" of the DCL gives rise to a "foreign use" of the entire DCL. Thus, the use of any portion of a DCL to offset foreign income of an entity other than the dual resident corporation or the separate unit (as applicable) results in the inability to make a domestic use election (i.e., the entire DCL is subject to the domestic use limitation and thus the SRLY limitation) or results in the recapture of a previously deducted loss. As described below, in the current environment, we believe the All-or-Nothing Rule is unduly harsh, and the justifications for it no longer are sufficient.

The primary justification for the All-or-Nothing Rule is that Treasury does not want to force the Service to analyze the details of foreign tax law in order to determine how much of a DCL is used to reduce foreign tax. Instead, pursuant to the All-or-Nothing Rule, the Service could simply determine whether *any* of the DCL was so used. In the preamble to the 2007 DCL Regulations, Treasury analyzed several comments received regarding the All-or-Nothing Rule and administrable alternatives that would not involve substantial analysis of foreign law. However, Treasury declined to adopt any of the recommendations, stating that departure from the All-or-Nothing Rule would lead to substantial administrative complexity, such as complex analysis of foreign law or complicated ordering, stacking, or tracing rules.

We acknowledge the administrative complexity of analyzing the details of foreign tax law to determine the portion of the DCL that is used to offset foreign income. However, we note that in the current environment, there is significantly more willingness to analyze foreign tax law, particularly evidenced by the OECD Recommendations and by the Proposed Regulations (e.g., the creation of hybrid deduction accounts and the tracking of imported mismatch accounts), and the enactment of Sections 245A(e) and 267A in the Act. It stands to reason that if foreign law is required to be analyzed, *item by item*, for purposes of these anti-hybrid rules (e.g., whether a particular payment of interest is included by the foreign recipient under foreign tax as taxable interest within three taxable years of the payment), then an *entity-level* determination of loss utilization is similarly not too administratively complex, particularly where the cost of the All-or-Nothing Rule can be immense.

Accordingly, we believe that Treasury and the Service should remove the All-or-Nothing Rule, and instead allow taxpayers to demonstrate that not all of the DCL was utilized to offset income under foreign tax law. In the Proposed DCL Regulations Report, we recommended "that domestic use election loss recapture be limited to that portion of the loss which the taxpayer can demonstrate to the satisfaction of the Commissioner has in fact been used under foreign tax law. And as a corollary, we recommend that a domestic use election be available even if a triggering event occurs in the year in which the loss is incurred to the extent the taxpayer can demonstrate that the loss has not been used under foreign law."[248] In the Final DCL Regulations Report, we recommended that Treasury and the Service should consider "adopting an additional recapture rebuttal procedure permitting the taxpayer to demonstrate, to the satisfaction of the Commissioner, that only a portion of the DCL was used for foreign tax purposes."[249]

Given the recent willingness to examine foreign tax more closely, we recommend that Treasury and the Service redefine foreign use such that a partial use of a DCL results in only a partial foreign use, provided that appropriate evidentiary standards are met. One way to achieve this would be to allow a rebuttal procedure where the taxpayer can demonstrate the portion of the DCL that was used for foreign tax purposes. Thus, the remaining portion of the DCL would remain eligible for the domestic use election (and not subject to the SRLY limitation) and would not be subject to recapture.

[248] *See* Proposed DCL Regulations Report, Part IV.B.4.b.ii.

[249] *See* Final DCL Regulations Report, Part II.A.

NEW YORK STATE TAXATION OF GILTI

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NEW YORK STATE BAR ASSOCIATION
Tax Section Summer Meeting
(May 31 – June 2, 2019)

<u>New York State Taxation of GILTI</u>

I. BACKGROUND

- The Tax Cuts and Jobs Act transitioned the U.S. federal corporate income taxation regime from one of deferral by taxing foreign earnings when repatriated, to one of a territorial type with current taxation. One provision enacted to accomplish this transition is Global Intangible Low Taxed Income ("GILTI") under the IRC §§ 951A and 250.

II. GILTI

- GILTI is the excess of net tested controlled foreign corporation ("CFC") income over the net deemed tangible income return ("NDTIR") for that year. NDTIR is essentially a 10% average rate of return on a CFC's average basis of qualified tangible property, which is called Qualified Business Asset Investment ("QBAI").
    - A U.S. shareholder is a U.S. person that owns at least 10% of the stock of the foreign corporation by vote or by value.
    - A CFC is a foreign corporation over 50% owned, by vote or by value, by U.S. shareholders.
- For U.S. corporate income tax purposes, and subject to significant limitations, 80% of foreign tax credits are allowed to offset GILTI. IRC §§ 901 and 904.
- Most state corporate income tax regimes begin with federal taxable income or specifically adopt the Internal Revenue Code. These states are likely to conform to IRC § 951A unless they have legislatively decoupled.
- States may not conform to the GILTI deduction under IRC § 250. IRC § 250(a)(1)(b) provides a deduction for 50% of GILTI (plus amounts under IRC § 78) for U.S. shareholders that are corporations. This may increase the difference between the federal and state GILTI amounts.
- For New York State corporate income tax purposes, GILTI is included in the tax base and is apportioned to New York by including the GILTI inclusion (net of the Section 250 deduction) in the denominator of the apportionment fraction. Unlike GILTI, Subpart F income is removed from the tax base when calculating New York taxable income.

III. CONSTITUTIONAL CONSIDERATIONS

- Article I, Section 8, Clause 3 of the United States Constitution provides that "Congress shall have the Power to Regulate Commerce with foreign Nations, and among the several States, and with the Indian tribes." (Emphasis added.)
- Under the Supreme Court's "Dormant Commerce Clause" jurisprudence, state authority over interstate and foreign commerce is restricted even in the absence of an express, conflicting federal

statute.[1] A state law violates the Dormant Commerce Clause when it treats in-state and out-of-state economic interests differently to the benefit of in-state activity.

- State taxes may apply to interstate commerce, but they may not discriminate against interstate commerce in favor of intrastate commerce. Under *Complete Auto Transit v. Brady,*[2] in order to withstand scrutiny under the Commerce Clause, the tax must: (i) be applied to activity which has substantial nexus to the state; (ii) be fairly apportioned among the states where the activity occurs; (iii) ***not discriminate against interstate commerce;*** and (iv) be fairly related to the services provided by the state.

- In *Japan Lines, Ltd. v. County of Los Angeles*,[3] the Court extended the *Complete Auto* test to foreign commerce and added two additional tests: (i) the tax cannot create a substantial risk of international multiple taxation; and (ii) the tax must not prevent the federal government from speaking with one voice when regulating commercial relations with foreign governments.

- In *Kraft General Foods v. Iowa Department of Revenue*,[4] the taxpayer operated a unitary business throughout the U.S. and in several foreign countries. Kraft deducted dividends it received from six subsidiaries, each of which was incorporated and conducted business in a foreign country. The Iowa Department of Revenue disallowed the dividend received deduction ("DRD") claimed by Kraft for its foreign dividends because Iowa's tax statutes permitted taxpayers to claim a DRD only for dividends from domestic subsidiaries.

    - The Supreme Court struck down the Iowa tax as being facially discriminatory against foreign commerce. The Court held that: (1) the statute impacted foreign commerce;[5] (2) the statute favored domestic interests over foreign interests; and (3) the statute did not advance a legitimate local purpose that could not be adequately served by reasonable nondiscriminatory alternatives.

    - The Court held that administrative convenience (i.e., conforming to the federal tax code with respect to DRDs) did not justify Iowa's unlawful discrimination.

- Does state taxation of GILTI violate *Kraft* by favoring domestic corporations over foreign corporations?

    - Separate company states v. unitary filing states
    - Is factor representation required in combined reporting states?

[1] *Comptroller of the Treasury v. Wynne*, 135 S.Ct 1787 (2015).
[2] 430 U.S. 274.
[3] 441 U.S. 434 (1981).
[4] 505 U.S. 71, 72 (U.S. 1992).
[5] *Id.* at 76. Both parties stipulated that the dividends constituted foreign commerce.

March 4, 2019

The Honorable Andrew M. Cuomo
Governor of New York State
NYS State Capitol Building
Albany, NY 12224

Re: Report No. 1413 – Comments on 2019-2020 New York State Executive Budget

Dear Governor Cuomo:

I am submitting herewith for your consideration materials developed by the New York State Bar Association's Tax Section, relating to the above-referenced issue.

Thank you for your attention to this matter.

Sincerely,

Ronald F. Kennedy

cc:

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Report No. 1413
March 4, 2019

Ronald F. Kennedy
Director of Governmental Relations
New York State Bar Association
One Elk Street
Albany, NY 12207

Re: *Report No. 1413 – Comments on 2019-2020 New York State Executive Budget*

Dear Mr. Kennedy:

I am pleased to submit this Report of the Tax Section of the New York State Bar Association commenting on the 2019-2020 New York State Executive Budget.

The Report focuses on certain technical, administrative and conceptual issues raised by selected provisions of the Budget Bill with reference to the New York Tax Law and the New York City Administrative Code and identifies aspects we think should be clarified or reconsidered prior to adoption by the Legislature.

We appreciate consideration of our Report. If there are any questions or comments, we will be glad to discuss and assist in any way.

Respectfully submitted,

Deborah L. Paul
Chair

Enclosure

New York State Bar Association
Tax Section
Comments on 2019-2020 New York State Executive Budget[1]

Introduction

This report on selected tax provisions of the 2019-2020 New York State Executive Budget (the "Budget Bill") was prepared by the Tax Section of the New York State Bar Association. It focuses on certain technical, administrative and conceptual issues raised by selected provisions of the Budget Bill with reference to the New York Tax Law (the "Tax Law") and the New York City Administrative Code (the "Code") and identifies aspects we think should be clarified or reconsidered prior to adoption by the Legislature.

This report offers comments and recommendations on the following parts of the Budget Bill:

Part C: Provide a Sourcing Rule for Global Intangible Low-Taxed Income ("GILTI") Apportionment

Part D: Decouple from Internal Revenue Code ("IRC") Federal Basis for NYS Manufacturing Test

Part F: Extend the Three-Year Gift Addback Rule

Part G: Eliminate Internet Tax Advantage

[1] The principal drafters of this report were: Jack Trachtenberg, Jennifer S. White, Megan L. Brackney, Paul R. Comeau, Maria Eberle, Joshua E. Gewolb, Jeremy P. Gove, Elizabeth Kessenides, Lindsay M. LaCava, Dennis Rimkunas, Irwin M. Slomka. Helpful comments were received from Kim Blanchard, Austin Bramwell, Robert Cassanos, Jeremy P. Gove, Alan S. Halperin, Stephen B. Land, Deborah L. Paul, Arthur R. Rosen, Michael Schler, and Gordon E. Warnke. This report reflects solely the views of the Tax Section and not those of its individual members, the NYSBA Executive Committee or House of Delegates, or any other party.

Part O:	Permanently Extend the Tax Shelter Provisions and Update Tax Preparer Penalties
Part X:	Exclude from Entire Net Income Certain Contributions to the Capital of a Corporation
Part Y:	Close the Carried Interest Loophole
Part Z:	Make Technical Corrections to Various Provisions of the Tax Law and the Code
Part VV:	Enact the Cannabis Regulation and Taxation Act

Discussion

I. Part C: Provide a Sourcing Rule for GILTI Apportionment

A. Current Law

Under Article 9-A of the Tax Law, a corporation's business income is defined as its entire net income minus investment income and "other exempt income."[2] For a corporation other than a foreign corporation, the computation of entire net income starts with federal taxable income, with certain adjustments not relevant to this discussion.[3]

A corporation apportions its business income to New York State using a single apportionment factor that is composed of prescribed receipts, net income, net gains, and other items of income or gain included in business income, with the portion attributable to New York

[2] Tax Law § 208.8.

[3] *Id.* at § 208.9.

based generally on customer-based sourcing.[4] Similar rules apply under the New York City business corporation tax.[5]

B. Proposed Changes

Part C, Section 1 of the Budget Bill would add a new category of receipts for inclusion in the apportionment factor, denominated "net global intangible low-taxed income" ("net GILTI"). Net GILTI is defined as global intangible low-taxed income included in federal gross income pursuant to IRC § 951A ("GILTI"), less the allowable IRC § 250(a)(1)(B)(i) deduction. The proposal would include net GILTI in the apportionment factor by including this net amount in the denominator of the fraction but no portion of GILTI in the numerator. The proposal is predicated on the assumption that the stock of the controlled foreign corporation ("CFC") that generates GILTI is business capital, and thus the amount of a corporation's net GILTI from that CFC is includable in the corporation's business income. It would apply to taxable years beginning on or after January 1, 2018.[6]

C. Comments

We begin by noting that New York has multiple options for addressing GILTI under Article 9-A, including, but not limited to: (i) decoupling from the IRC, and therefore excluding net GILTI from the taxable income base; (ii) including net GILTI in the taxable income base, but not in the apportionment factor; (iii) including net GILTI in the taxable income base and the apportionment factor, as the Budget Bill proposes, by including net GILTI in the denominator, but not the numerator of the apportionment factor; or (iv) including net GILTI (or some other amount) in the

[4] Tax Law § 210-A.

[5] New York City Admin. Code, Subch. 3-A.

[6] Part C, Section 2 of the Budget Bill would also apply to the New York City business corporation tax. Our comments apply equally to that section.

taxable income base, and including the gross receipts of the CFC that generated the net GILTI (or other amount) in the apportionment factor as if the CFC generating the GILTI were a domestic affiliate.[7] At this time, we take no position as to New York coupling or decoupling from the IRC in respect of GILTI but rather assume, for purposes of this Report, that New York does not decouple.[8] As well, on the assumption that New York does not decouple, at this time, we neither

[7] Presumably, if gross receipts are used in the apportionment factor, only those gross receipts relating to the income included in the taxable income base should be so included. For example, in Case1(C) discussed in the text below, all gross receipts giving rise to GILTI are included in the apportionment factor because gross (rather than net) GILTI is included in the taxable income base. Even in Case 1(C), however, if there were net deemed tangible income return under IRC § 951A((b)(2) ("NDTIR") that reduced the gross GILTI inclusion, arguably the portion of the gross receipts attributable to that NDTIR should be excluded from the apportionment factor or NDTIR should be added back to the taxable income base,

[8] In April 2018 the Legislature passed legislation to address some provisions of the Tax Cuts and Jobs Act of 2017 (the "TCJA"). The legislation did not address GILTI. As a result, because the computation of entire net income under Article 9-A starts with federal taxable income, both GILTI and the 50% GILTI deduction are includable in the computation of a corporation's entire net income. Such income is presumably business income under Article 9-A if the stock of the CFC that generates GILTI constitutes business capital. In June 2018, legislation to decouple from the federal treatment of GILTI was introduced and passed in the New York State Senate. The legislation, however, did not pass in the New York State Assembly. As such, GILTI remains includable in the computation of a corporation's entire net income. We note that a few states (e.g., Georgia and South Carolina) have enacted legislation to decouple from GILTI altogether. Other states (e.g., Connecticut, Illinois, Kentucky, Michigan, North Dakota, and Oklahoma) have administratively determined that they will treat GILTI in the same manner that they treat Subpart F income and, therefore, in those states, it is treated as dividend income eligible for full or partial state dividend received deductions. New Jersey, on the other hand, has issued administrative guidance under which GILTI will not be treated as a foreign dividend or deemed dividend income, and instead provides for a direct allocation of GILTI based generally on the state's share of GDP over GDP in all states with which the taxpayer has economic nexus. We note that under New York's pre-2015 corporate tax regime, the New York State Department of Taxation and Finance took the position that Subpart F income qualified as dividends, thus qualifying under Article 9-A for either full exclusion from the tax base as a dividend from subsidiary capital or a partial exclusion pursuant to the 50% deduction allowed for dividends received from entities owned 50% or less by the shareholder. *See, e.g.*, Advisory Opinion, *American International Group, Inc.*, TSB-A-87(23.1)C, TSB-A-88(7.1)C (N.Y.S. Dep't of Taxation & Fin., Nov. 2, 1992).

object to, nor endorse, the Budget Bill's approach, but rather seek to highlight issues that we believe may merit continued study. Further, we take no position on any constitutional issues that may be raised in connection with New York's approach to GILTI. We would be open to providing a report on the above issues.

The initial key question then is, on what basis should New York, which employs customer-based apportionment under Article 9-A, include GILTI in the computation of the apportionment factor, which is used to apportion all of a corporation's business income? We agree with the underlying principle in the Budget Bill that if GILTI is to be includable in a corporation's business income under Article 9-A, it should be reflected in the corporation's apportionment factor in some manner in order to properly reflect the corporation's business income and capital. The Budget Bill proposes to include 100% of GILTI (net of the IRC § 250 deduction) in the denominator of the apportionment fraction, but zero in the numerator of the fraction. This appears to be based on the view that GILTI constitutes foreign source income, and therefore no portion of it should be included in the numerator of the fraction.

For tax years beginning after 2014, New York shifted to a market-based apportionment approach. The Budget Bill's approach to factor representation of GILTI, however, could be considered inconsistent with the principles upon which market-based apportionment is based. If a CFC were, instead, a domestic entity included in the taxpayer's Article 9-A combined return, the apportionment would take into account the entity's New York receipts, and the denominator would include all of the entity's relevant business receipts. Including "net GILTI" in the denominator is a very different approach from including all of the receipts related to the generation of GILTI. The example below indicates the potentially substantial difference in a corporation's New York tax liability if net GILTI is included in the allocation factor, as compared to the CFC's receipts.

Example 1: Assume that a corporation subject to Article 9-A has the following items of income and receipts:

- $1,000,000 of business income on total business receipts of $10,000,000. Under the relevant customer sourcing apportionment rules, assume that 50% of the receipts are attributable to customers in New York and are includable in the numerator of the apportionment factor, while the entire $10,000,000 would be included in the denominator; and
- $1,000,000 of gross GILTI (before the IRC § 250 deduction), associated with $10,000,000 of receipts attributable to non-New York customers, and $500,000 of net GILTI.

Case 1(A) - Taxing GILTI Consistent with the Budget Bill's Proposal: Under the Budget Bill's proposal, the total income included in the corporation's business income, before apportionment, is $1,500,000 ($1,000,000 plus net GILTI of $500,000). The apportionment factor would be computed by including $5,000,000 in the numerator (50% of $10,000,000) and $10,500,000 in the denominator, resulting in an apportionment factor of 47.62% and apportioned business income to NYS of $714,286.

Case 1(B) – Removing GILTI from the Apportionment Factor: If GILTI, although included in the tax base, were not included in the denominator of the receipts factor, the apportionment factor would be computed by including $5,000,000 in the numerator and $10,000,000 in the denominator, resulting in an apportionment factor of 50% and an apportioned business income of $750,000. This would result in greater taxable income in NYS, as compared to the Budget Bill proposal.

Case 1(C) – Including the CFC's Receipts in the Apportionment Factor: Had the CFC that generated the GILTI been a domestic affiliate, with full inclusion of the entity's receipts in the apportionment factor denominator, the result could be dramatically different than the results under the Budget Bill proposal. While the total income included in the corporation's business income, before apportionment, would arguably be $2,000,000 (because there would be no Section 250 deduction if this were earned by a domestic corporation), the apportionment factor would be computed by including $5,000,000 in the numerator and $20,000,000 in the denominator. Accordingly, there would be an apportionment factor of 25% and apportioned business income of $500,000. This assumes, though, that none of the CFC's gross receipts would have been apportioned to NYS; to the extent the CFC's customers were in NYS, the result would differ.

This example illustrates that the inclusion of net GILTI in the denominator offers some factor representation relief but potentially much less than if inclusion of the CFC's factors were allowed, as would be the case if the CFC had been a domestic subsidiary. This impact is most evident where the CFC does not have receipts attributable to New York customers. If the CFC did have such receipts attributable to NY customers, they should be included in the numerator of the apportionment factor, which could ultimately result in a larger tax liability than including just net GILTI. However, such approach, again, would be consistent with inclusion of a domestic subsidiary.

Example 1 compares the results of the Budget Bill's proposal to a full look-through approach. However, it is also worth comparing the results of the Budget Bill approach to an approach whereby New York State decouples from the federal tax rules and excludes GILTI altogether. The following example goes to this point:

Example 2: Take the same facts as above, but also assume that the corporation in the example has $1,000,000 of other income from domestic sources. In addition, assume none of the items relating to this $1,000,000 of other income are includible in either the numerator or the denominator of the apportionment factor because such income represents dividends and net gains from sales of stock:

Case 2(A) - Decoupling from GILTI: If New York decoupled from the federal GILTI provisions, the corporation's apportionment factor would be: $5,000,000/$10,000,000, or 50%. The taxpayer in this example has $2,000,000 of domestic taxable income, and half ($1,000,000) would be apportioned to New York. GILTI would not be taxed.

Case 2(B) - Taxing GILTI Consistent with the Budget Bill's Proposal: As described in Case 1(A) above, under the Budget Bill, net GILTI is included in the denominator of the apportionment factor. This means the corporation's apportionment factor becomes $5,000,000/$10,500,000 or 47.62%. Applying this apportionment factor to the corporation's total business income of $2,500,000 ($1,000,000 of domestic business income, plus $1,000,000 of dividends and net gains from sales of stock, plus $500,000 of net GILTI) results in $1,190,476 being taxable in NYS.

Effectively, $190,476 of incremental income is being taxed in NYS, as compared to de-coupling from the federal rules.

Under the facts in this Case 2(B), the amount of incremental income subject to NYS tax increases as the net GILTI increases. For example, if the corporation's net GILTI were $1,500,000 rather than $500,000, the corporation's income subject to NYS tax would increase from $1,190,476 to $1,521,739.

The Budget Bill proposes an approach which appears to make certain assumptions. The first assumption is that net GILTI is a unique and special category of income in and of itself, and should be reflected in the apportionment factor, but without looking through to where the CFC's own income is earned using a market-based approach. In some respects, the Budget Bill's approach is taxpayer-favorable. While only net GILTI is included in the denominator, 100% of the income is considered not to be derived from New York sources (i.e., it is excluded from the numerator). On the other hand, the Budget Bill's approach is generally less taxpayer-favorable than decoupling.

The Budget Bill proposal seemingly attempts to apply a "rough justice" approach. We do believe there are major challenges with this approach. Apart from the potential distortions noted above, the fact that the states are taking altogether different approaches from one another to GILTI could lead to distortive results overall.

Further, we acknowledge that, as with the other sourcing rules included in Article 9-A, there is unlikely to be a single methodology that will result in the fair apportionment of income to New York for all taxpayers. To account for this systematic reality, the Tax Law provides that the Commissioner may require, and that taxpayers may request, an alternative apportionment method in limited circumstances. Specifically, N.Y. Tax Law § 210-A states that

> [i]f it shall appear that the apportionment fraction… does not result in a proper reflection of the taxpayer's business income or capital within the state, the commissioner is authorized in his or her discretion to adjust it, or the taxpayer may request that the commissioner adjust it, by (a) excluding one or more items in such determination, (b) including one or more other items in such determination, or (c) any other similar or different method calculated to effect a fair and proper apportionment of the business income and capital reasonably attributed to the state. The party seeking the adjustment shall bear the burden of proof to demonstrate that the apportionment fraction determined pursuant to this section does not result in a proper reflection of the taxpayer's business

income or capital within the state and that the proposed adjustment is appropriate.

This alternative apportionment provision remains available to address any potential distortive effects of the Budget Bill proposal on a taxpayer's business income and business capital.

If the Budget Bill's proposal is adopted, one could argue that the New York State Department of Taxation and Finance (the "Department') should be amenable to taxpayers employing the existing alternative apportionment authority when the statutory apportionment formula's inclusion of net GILTI in the denominator of the apportionment factor does not properly reflect the taxpayer's New York business income or business capital. Under this view, the Department could consider incorporating into its existing alternative apportionment draft regulations examples to guide taxpayers seeking alternative apportionment arising from the net GILTI inclusion proposed by the Budget Bill. On the other hand, given that GILTI is taxable in the hands of minority shareholders, this approach could lead to an uneven playing field in that minority shareholders would not likely find themselves in a position to prove and take advantage of alternative apportionment.

II. Part D: Decouple from the IRC Federal Basis for NYS Manufacturing Test

A. Current Law

Under Article 9-A of the Tax Law, a "qualified New York manufacturer" is subject to tax at a rate of zero percent on its business income base and to other beneficial rates for purposes of the tax on business capital and the fixed dollar minimum tax.[9] A "qualified New York manufacturer" is a manufacturer that (i) has property in New York that is described in section 210-B.1(b)(i)(A) of the Tax Law (*i.e.*, property that qualifies for the New York Investment Tax Credit)

[9] *See* Tax Law §§ 210(1)(a)(vi), (b).

and either (a) the adjusted basis of such property for federal income tax purposes at the close of the tax year is at least $1,000,000 ("NYS Property Basis Test"), or (b) all of its real and personal property is located in New York; and (ii) is principally engaged in qualifying activities (the "NYS Principally Engaged Test").[10] A taxpayer or, in the case of a combined report, a combined group, shall be "principally engaged" in qualifying activities for purposes of the NYS Principally Engaged Test if, during the taxable year, more than 50% of the gross receipts of the taxpayer or combined group, respectively, are derived from receipts from the sale of goods produced by such qualifying activities.[11] A taxpayer, or in the case of a combined report, a combined group, that does not satisfy the NYS Principally Engaged Test may still be a qualified New York manufacturer if the taxpayer or combined group employs at least 2,500 employees in manufacturing in New York during the tax year and has property in the state used in manufacturing with an adjusted basis for federal income tax purpose at the close of the tax year of at least $100,000,000.[12]

For purposes of the New York City business corporation tax, a "qualified New York manufacturing corporation" is subject to tax on its business income at rates ranging from 4.425% to 8.85%, depending on the amount of its business income.[13] A "qualified New York manufacturing corporation" is (i) a manufacturing corporation principally engaged in the manufacturing and sale of tangible personal property (the "NYC Principally Engaged Test"), and (ii) has property in the state described in Code § 11-654(1)(k)(5) and either (a) the adjusted basis of such property for federal income tax purposes at the close of the tax year is at least $1,000,000

[10] *Id.*

[11] Tax Law §§ 210(1)(a)(vi), (b).

[12] *Id.*

[13] *See* New York City Admin. Code § 11-654(1)(k).

("NYC Property Basis Test") (collectively, with the NYS Property Basis Test above, the "Property Basis Tests"), or (b) more than 50% of its real and personal property is located in the state.[14] A taxpayer or, in the case of a combined report, a combined group, shall be "principally engaged" in the manufacturing and sale of tangible personal property for purposes of the NYC Principally Engaged Test if, during the tax year, more than 50% of the gross receipts of the taxpayer or combined group, respectively, are derived from receipts from the sale of goods produced by such activities.

B. Proposed Changes

Part D of the Budget Bill would amend the definitions of "qualified New York manufacturer" and "qualified New York manufacturing corporation" by changing the measure of property located in the state for purposes of the Property Basis Tests from adjusted basis for federal income tax purposes to adjusted basis for New York State tax purposes. Specifically, Part D proposes to amend sections 210(a)(vi) and 210(b)(2) of the Tax Law, and 11-654(1)(k)(4)(ii) of the Code to use the adjusted basis of property for "New York State tax purposes" instead of the adjusted basis of property for "federal income tax purposes."

C. Comments

The proposed changes to decouple the Property Basis Tests from adjusted basis for federal income tax purposes are necessary as a result of the TCJA. Under the TCJA, IRC § 168(k) was amended to allow taxpayers to immediately expense 100% of the cost of certain newly acquired property. This immediate expensing reduces the adjusted basis of such property for federal income tax purposes to zero in the year of purchase. Accordingly, it would be virtually impossible for

[14] *See id.* at §§ 11-654(1)(k)(4)(i), (ii).

New York State or City taxpayers to utilize the advantages offered by IRC § 168(k) for federal income tax purposes, while also using that same property to satisfy the Property Basis Tests.

The Budget Bill proposes to use the adjusted basis that is used for New York State tax purposes. However, we note that neither the Tax Law nor the Code include a definition of New York-specific "adjusted basis." We recommend that a taxpayer's adjusted basis for New York State tax purposes be reduced by the amount of any depreciation deductions allowed under the Tax Law rather than being reduced by the amount of any depreciation or expense deductions allowed under the IRC.. Because Tax Law § 208(9)(b) and Code § 11-652(8)(b)(16) decouple from IRC § 168(k), the Tax Law does not incorporate the concept of immediate expensing. Thus, any adjusted basis of newly acquired property under this definition would not be zero in the year of purchase. For clarity and avoidance of doubt, we recommend that the Budget Bill be amended to include an explicit definition of adjusted basis for New York State tax purposes as proposed above.

III. Part F: Extend the Three-Year Gift Addback Rule

A. Current Law

i. *Lifetime Gifts*

New York does not have a gift tax, and its estate tax exclusion has lagged behind the federal exclusion. Part X of Chapter 59 of the Laws of 2014 (Chapter 59) instituted broad estate tax reform, including a new requirement applicable to certain gifts made on or after April 1, 2014, by a decedent who was a New York resident at the time of the gift. The new provision said if a New York decedent died within 3 years of making a taxable gift, such gift had to be included in the decedent's New York gross estate. This requirement was added to deter New York residents from transferring large amounts of wealth shortly before death solely to take advantage of the higher federal estate tax thresholds, while at the same time reducing their otherwise taxable New York estate. This gift addback provision was made inapplicable to decedents dying on or after January 1, 2019, because on that date the New York and federal estate tax exemption thresholds were expected to coincide, eliminating the incentive for deathbed gifts.

B. Proposed Changes

i. *Lifetime Gifts*

The New York and federal estate tax exclusions did not coincide on January 1, 2019 due to a provision in the TCJA which doubled the federal exclusion as of January 1, 2018. As a result, there is a difference of more than $5 million per individual between federal and state estate tax thresholds. This gap revives the need for the limited gift add back in order to prevent revenue losses from deathbed gifts. Part F of the Budget Bill would extend the sunset to decedents dying on or after January 1, 2026, the date the estate tax amendments made by the TCJA are set to expire.[15]

C. Comments

The New York State Executive Budget Memorandum in Support of the Governor's Fiscal Year 2020 Executive Budget (the "Support Memorandum") claims that the Budget Bill's proposed extension of the three-year "add-back" provisions under Tax Law § 954(a)(3) is necessary due to the difference between the current gift and estate tax basic exclusion amount available under the IRC and the applicable credit amount available for New York State estate tax purposes.[16] For calendar year 2019, the basic exclusion amount for federal gift and estate tax purposes is $11.4 million, and the applicable credit amount available for New York estate tax purposes is

[15] *See* FY 2020 Executive Budget Memorandum in Support, p. 13.

[16] *Id.*

$5.74 million. According to the Support Memorandum, because New York does not impose a gift tax, absent the three-year add-back, residents are incentivized to take advantage of the increased federal gift tax exemption by making up to $11.4 million in tax-free gifts prior to death.[17] Therefore, New York State loses out on the estate tax that would have been payable on the $11.4 million had the gift not been made.[18] By enacting the Budget Bill's proposal, New York State hopes to deter residents from making such gifts by drawing them back into the New York gross estate.[19] The three-year add-back under the Budget Bill's proposal would expire in 2026, when the federal basic exclusion amount is expected to align with the applicable credit for New York estate tax purposes.[20]

While the Support Memorandum is correct in its assertion that the three-year add-back will deter New York residents from making certain lifetime gifts, the tax incentive to make lifetime gifts is not driven by the excess of the federal basic exclusion amount over the New York applicable credit amount. Indeed, even if an individual makes a gift that is limited to the New York applicable credit amount, the individual will save on New York estate tax by making a gift if there is no add-back rule. Likewise, gifts beyond the federal basic exclusion amount may lead to substantial estate tax savings absent the add-back. Simply put, the misalignment of the federal basic exclusion amount and the New York State applicable credit amount does not appear to rationalize the three-year add-back. The perceived abuse addressed by the three-year add-back relates to so-called "deathbed gifts." Because New York has no gift tax, prior to the enactment of

[17] FY 2020 Executive Budget Memorandum in Support, p. 13.

[18] *Id*.

[19] *Id*.

[20] FY 2020 New York State Executive Budget, Revenue, Article VII Legislation, Subpart F, Section 1.

the three-year add-back, a New York domiciliary could reduce his or her aggregate estate and gift tax by making a gift immediately prior to death. The add-back rule closes off this planning strategy by including such gifts within the New York gross estate.

Though the three-year add-back rule prevents individuals from avoiding New York estate tax via deathbed gifts, the add-back causes additional federal estate tax. Under Section 2058 of the IRC, a federal estate tax deduction is allowed for any estate taxes paid to any state, but only to the extent the property taxed at the state level is included in the decedent's gross estate for federal estate tax purposes.[21] Because the gift is not otherwise includible in the decedent's gross estate for federal estate tax purposes,[22] the amount of New York estate tax incurred on a gift that is added back to the decedent's gross estate for New York estate tax purposes will not be deductible at the federal level.[23] Given the period covered by the add-back – three years – and the adverse estate

[21] *See* I.R.C. § 2058(a).

[22] The New York three-year add-back applies only to gifts not otherwise included in the decedent's federal gross estate. *See* Tax Law § 954(a)(3).

[23] Section 2053(a)(3) allows a deduction for claims against the estate; however, as the deduction is not available for tax on the three-year add-back, as a claim, to be deductible, it would have to be a personal obligation of the decedent existing at the time of the decedent's death. The chart below depicts the difference in the combined effective gift and estate tax rate (assuming a 16% New York estate tax rate and a 40% federal gift and estate tax rate) with respect to (i) a testamentary disposition, (ii) a lifetime gift which is subject to add-back, and (iii) a lifetime gift which is not subject to add-back:

	No Lifetime Gift; Testamentary Disposition	Lifetime Gift with Add-back	Lifetime Gift without Add-back
Combined Effective Gift & Estate Tax Rate on Transfer	49.6%	56.0%	40.0%

tax consequences, there is a negative effect on persons who might make gifts absent the three-year add-back. Yet, the absence of a New York gift tax suggests that, as a policy matter, New York does not want to discourage residents from making gifts.

We recommend that, in determining how best to formulate tax legislation, New York focus on the underlying policy considerations. The add-back was designed to discourage "deathbed" transfers which would reduce the New York Estate Tax, and there is no suggestion that New York intended to increase the total federal and New York estate tax above what would be due absent the gift. The goal of discouraging "deathbed" transfers should be balanced against the negative effect on individuals who otherwise would make gifts. Accordingly, we recommend that New York consider limiting the add-back to gifts made within one year prior to death to target gifts that are more likely intended to avoid New York estate tax on the eve of an expected death.[24] Alternatively, if New York maintains an add-back which extends beyond one year prior to death, we recommend that New York consider reducing the estate tax inclusion with respect to gifts made more than one year prior to death. For example, New York may consider including in a resident's gross estate

The interplay between the New York add-back and Section 2058 of the IRC results in a combined effective gift and estate tax rate of 56.0% on the added-back lifetime gift, as compared to a 49.6% combined effective gift and estate tax rate had the individual not made the lifetime gift.

[24] There are instances in the tax law where the measuring period is one year. For example, under Section 1014(e) of the IRC, if appreciated property is transferred to a decedent by gift within one year of death and such property passes from the decedent to the donor at the decedent's death, there is no step up in basis at death. *See* I.R.C. § 1014(e). Additionally, some states that include gifts in contemplation of death in the decedent's gross estate for state tax purposes have adopted rules with lookbacks of less than three years. *See*, e.g., Me. Rev. Stat. tit. 36 § 4102(7)(C) and Pa. Stat. § 9107(c)(3), applying a one-year lookback; Md. Code, Tax-Gen § 7-201(d)(1)(iii) and Vt. Stat. tit. 32 § 7402(14)(C), applying a two-year lookback. Five states other than New York have adopted a three-year lookback. *See*, e.g., Iowa Code § 450.3(2); Ky. Rev. Stat. § 140.020(2); Minn. Stat. § 291.016, subd.2; Neb. Rev. Stat. § 77-2002(2); N.J. Rev. Stat. § 54:34-1.c.

100% of the value of gifts made within one year prior to death, while including only 50% of the value of gifts made between one and two years prior to death and 25% of the value of gifts made between two and three years prior to death. By limiting the add-back to one year prior to death (or limiting the adverse tax consequences for gifts that occur more than one year prior to death), the rule would continue to deter individuals from making deathbed gifts solely to avoid New York estate tax, while mitigating the relatively harsh tax consequences for those who make gifts followed by death beyond one year after the gift.

Finally, for the reasons discussed, we do not see a policy rationale for sunsetting the add-back rule, as the potential advantages of deathbed gifts are created by the lack of New York gift tax and exist regardless of the relative sizes of the federal and New York exclusion amounts. Consequently, we recommend that consideration be given to eliminating the expiration date of the add-back rule.

IV. Part G: Eliminate Internet Tax Advantage

Part G of the Budget Bill proposes a major change to the way sales and use taxes would be collected for sales made through so-called “marketplace providers.” The marketplace proposal would shift the burden of collecting sales tax from the retailer to the “marketplace provider” that “facilitates sales of tangible personal property.” The Budget Bill’s proposal also has the effect of increasing the reach of New York’s authority to require the collection of sales tax on online sales made by out-of-state sellers through marketplace providers with New York State nexus. Additionally, it would shift responsibility for the collection of sales tax for sales by an in-state seller to the marketplace provider in regard to particular sales.

A. Current Law

Under current law, the responsibility to collect and remit sales taxes on taxable sales is limited to "vendors."[25] A vendor is defined as a person "making sales" that has a sufficient connection to New York State to require the vendor to collect and remit sales tax on sales to customers in the State.[26] In certain circumstances, an agent of the vendor can be treated as a "co-vendor," with joint responsibility for collecting and remitting the sales tax.[27] When sales tax is not collected by the vendor on a taxable sale, the purchaser is obligated to remit use tax with respect to the use of the purchased property.[28]

Because vendors are defined as the persons actually making sales, a party that merely facilitates a sale between a seller and a buyer through a physical or online marketplace forum is not a vendor and does not have tax collection responsibilities, even if such party has nexus with New York. The responsibility for collecting sales tax lies with the seller itself. Critically, an out-of-state seller that does not otherwise have nexus with New York does not establish nexus by selling goods through an online marketplace with nexus in New York, and is not required to collect and remit sales tax on sales made through an online marketplace.[29] This does not relieve New York purchasers from liability for use tax, however,[30] and use tax is generally acknowledged to be

[25] Tax Law §§ 1131(1), 1132(a)(1).

[26] Tax Law § 1101(b)(8).

[27] *Id.* at § 1101(b)(8)(ii)(A).

[28] *Id.* at § 1110.

[29] *Id*. at § 1101(b)(8)(v)(A).

[30] *Id.* at § 1110.

underreported.[31] In an effort to increase use tax compliance, and in lieu of having purchasers compute the use tax on each individual purchase, New York offers a simplified method whereby residents can elect on their personal income tax return to pay an estimated aggregate use tax on all purchases costing less than $1,000 each, which estimate is based on the residents' taxable income.[32]

B. Proposed Changes

Part G of the Budget Bill would alter the structure of the current law by placing the burden of collecting tax on sales facilitated through an online or physical marketplace on the "marketplace provider." Under the proposal, a "marketplace provider" is defined as any person who "facilitates a sale of tangible personal property" by a "marketplace seller." A marketplace provider facilitates sales when it (i) "provides the forum" in which, or by means of which, the sale takes place, and (ii) such person or an affiliate of such person either collects the receipts paid by a customer to a marketplace seller for the sale of tangible personal property or contracts with a third party to collect such receipts.[33] A "forum" includes an internet website, catalog or similar forum, or a physical forum, such as a "shop, store, or booth." The proposal would apply to sales made on or after September 1, 2019.

C. Comments

[31] *See* Memorandum in Support, Part G, stating that the proposal will increase revenues by $125,000,000 in 2020 and $250,000,000 annually thereafter.

[32] NYS Form IT-201i (2018), p. 27

[33] Persons are affiliated if one person has an ownership interest of more than 5%, whether directly or indirectly, or where a greater than 5% ownership interest is held directly or indirectly in each of such persons by another person or group of other persons that are affiliated. Budget Bill, Part G § 1.

At the outset we note that in June of last year, the U.S. Supreme Court issued its decision in the matter of *South Dakota v. Wayfair, Inc.* 138 S. Ct. 2080, which fundamentally changed the underlying constitutional jurisprudence that had resulted in New York's inability to directly impose sales tax on many Internet sales. New York now treats as a vendor responsible for sales tax collection any person that for the immediately preceding four sales tax quarters satisfied the following:

1. The cumulative total of the person's gross receipts from sales of tangible personal property delivered into the state exceeded $300,000, and
2. Such person made more than 100 sales of tangible personal property delivered in the state.[34]

The proposals contained in Section G of the Budget Bill were originally introduced in earlier budget bills prior to the *Wayfair* decision, which expanded nexus to include certain out-of-state sellers making sales into New York.[35] Given the recent seismic shift in the application of the U.S. Constitutional limitations to taxation, we recognize that the landscape in which this proposal is being made has changed substantially.

i. *Marketplace Provider Rules Generally*

Though we note that the number of states with marketplace statutes is growing, the proposed approach in the Budget Bill would nevertheless significantly differ from the general nationwide practices as to the party responsible for collecting sales tax on sales facilitated through third-

[34] NYS N-19-1 (January 2019) (citing Tax Law §§ 1101(b)(8)(i)(E), 1101(b)(8)(iv)).

[35] *See* New York State FY 2015-2016 Executive Budget, Part X.

parties.[36] The proposal would impose significant compliance obligations and potential tax liabilities on marketplace providers. Marketplace providers will be required to undertake a greater administrative burden, as under the proposal the designation of collection responsibility is mandatory—if a marketplace provider facilitates sales, the marketplace provider will be responsible for sales tax compliance for those sales.[37] Specifically, marketplace providers will be tasked with determining the taxability of each sale. This may be especially difficult in the case of goods excluded from the tax base and transactions involving purchasers providing exempt certificates. We note that administering the casual sale rules also may be particularly difficult. Indeed, this may be analogized to imposing a sales tax collection responsibility on in-state co-vendors (discussed below).[38] The Tax Section expresses no opinion on this provision as a policy matter, although we note that it would represent a substantial change.

The shifting of responsibility for collecting tax from the marketplace seller to the marketplace provider appears to have two major effects. First, with respect to sellers that already have nexus in New York, it would appear to relieve them of the responsibility of collecting sales tax and shift that responsibility to the marketplace provider.[39] Second, it appears to provide a mechanism for the collection of sales tax for sales by sellers that do not have any nexus with New

[36] For states with similar statutes, see Cal. Civ. Code § 1739.7; Iowa Code § 423.14A; Minn. Stat. § 297A.66; S.D. Codified Laws § 10-65-1 to §10-65-8.

[37] Budget Bill, Part G § 3.

[38] *See, e.g.*, TSB-A-86(13)S (N.Y.S. Dep't of Taxation & Fin., Mar. 26, 1986) (ruling that a household appliance telephone ordering service is responsible for collecting and remitting sales tax as a co-vendor on sales made on behalf of out-of-state suppliers).

[39] We note that under the proposal, in order to be relieved of responsibility for collecting sales tax, the seller must obtain a "completed certificate of collection" from the marketplace provider which states that the marketplace provider will collect the sales tax. *See* Budget Bill, Part G § 3.

York because the marketplace provider would be responsible for collecting and remitting the tax on sales made by both in-state and out-of-state sellers.

ii. *Nexus*

New York's recently issued *Wayfair* guidance discussed above applies to "vendors." The Department finds support for its position in Tax Law § 1101(b)(8)(i)(e), which includes within the definition of a vendor a person systematically soliciting business in New York to the extent that "solicitation satisfies the nexus requirements of the [U.S.] Constitution." The Budget Bill does not seek to impose collection obligations on marketplace providers by including them within the definition of a vendor. Rather, the proposal creates the new classification of persons (i.e. "marketplace providers") that are included within the definition of "persons required to collect tax." As such, the current guidance as applied to vendors does not explicitly apply to marketplace providers. The Budget Bill's proposal does not include any language to establish when a marketplace provider will be deemed to have nexus with New York. We urge the Department to amend the definition of a marketplace provider to include applicable nexus standards. We suggest that the same nexus standards described above that are applicable to vendors be adapted to this situation. Specifically, the marketplace provider would have nexus when the cumulative total of the person's receipts from sales of tangible personal property delivered into the state exceeded $300,000, and such person made more than 100 sales of tangible personal property delivered in the state.

To the extent the Department wishes to impose the same nexus standards that it does on out-of-state vendors, we also request clarity as to how the $300,000 in gross receipts and 100 transactions tests would apply to marketplace providers. Specifically, it is unclear whether the economic nexus standard would apply to the receipts and sales of the marketplace provider itself, or would be based on the cumulative receipts and sales of the marketplace sellers, including the sales of third parties the marketplace provider helps to facilitate.

Further, we note the deletion of language from prior proposals that would have stated that a person who facilitates sales exclusively by means of the Internet is not a marketplace provider if its annual sales have been no more than $150,000,000 for every calendar year after 2016.[40] We note that the Support Memorandum references that the tax will apply to "large" marketplace providers, but no such limitation appears in the statute.

iii. *Scope of Application*

The proposed marketplace requirements are limited to sales of tangible personal property. We note that for purposes of New York's sales and use tax, tangible personal property includes computer software,[41] therefore bringing within the ambit of the marketplace provider provisions those online marketplaces that sell software applications and computer games. Prior versions of proposed marketplace reporting requirements also included sales of occupancies or admissions, which are not part of the Budget Bill's proposal.[42]

Under the proposed definition, an entity is a "marketplace provider" only if it collects the receipts paid by a customer. We understand that there are "peer-to-peer" online marketplaces where the buyer has the ability to pay the seller directly, resulting in the marketplace provider not collecting such receipts. It appears that such sales are excluded from the application of this section, especially in light of the deletion of language that has been present in former marketplace

[40] New York State FY 2017-2018 Executive Budget, Part AA.

[41] Tax Law § 1101(b)(6).

[42] New York State FY 2015-2016 Executive Budget, Part X.

reporting proposals that provided that the term "marketplace provider" included organizations that arrange for exchange of messages between customers and sellers.[43]

We also understand that there are companies that create and manage websites that are branded in the name of the selling business and may provide the types of services identified in the definition of a "marketplace provider." For example, in addition to creating a website for the seller, such companies may also collect the receipts from the seller's customers through the website and remit them to the seller. If the intent of the proposal is to treat as a "marketplace provider" an entity that facilitates sales through a website address that is specific to a single business, rather than a website address that identifies a marketplace, then we recommend that the proposal make that clear.

iv. *Other Matters*

The Budget Bill states that a marketplace seller would generally be relieved from its duties to collect tax if it has received in good faith a properly completed certificate of collection from the marketplace provider certifying its compliance. It then goes on to provide that the Department may (i) develop a contractual provision or approve a contractual provision developed by the marketplace provider which, if included in the contract, will have the same effect as the certificate of collection, and (ii) provide by regulation or otherwise that inclusion of such provision in the publicly available agreement between the marketplace provider and the marketplace seller will have the same effect as the certificate of collection. We note that this provision differs from the rules applicable for other sales tax exemptions. For example, a certificate of exemption must be obtained from a non-profit organization; it is not sufficient to recite in the contract that the organization is non-profit. We are unclear as to the meaning and scope of the prong requiring

[43] *Id*.

inclusion of the contractual provision in a publicly available agreement and suggest that this be clarified.

The Budget Bill also states that the Department may provide by regulation or otherwise that a marketplace seller will be relieved of duty to collect tax for sales facilitated by a marketplace provider only if such marketplace provider is not on a list on the department's website of marketplace providers whose certificates of authority have been revoked at the commencement of the applicable quarterly period. We are concerned about the potential burden on smaller sellers of needing to check this list on such a frequent basis and would suggest that an annual period be considered to account for the potential burden on small sellers.

v. *Alternative Co-Vendor Approach*

One alternative to the Budget Bill's approach that could achieve the apparent policy objectives would be to amend the Tax Law to permit a marketplace provider to be treated as a co-vendor under Tax Law § 1101(b)(8)(ii). Under existing law, the Department has the authority to treat any "salesman, representative, peddler or canvasser" as the seller's agent, and thus as jointly liable for collecting and remitting the sales tax.[44] By allowing the Department to treat the marketplace provider as a co-vendor, the marketplace seller would remain the party primarily responsible for collecting and remitting the tax, but where the Department determines it would be efficient for administration of the tax, the marketplace provider could be held jointly responsible. Under this approach, whether or not a marketplace seller has New York nexus, the marketplace provider could be treated as responsible for collecting the sales tax upon reasonable notice by the Department.

vi. *Effective Date*

[44] Tax Law § 1101(b)(8)(ii).

We note that the 30-day amendments to the Budget Bill accelerate the effective date of the proposal from September 1, 2019, to June 1, 2019. We do not comment on whether such acceleration would impose an undue compliance burden on affected marketplace providers, but we urge that consideration be given to that question before proceeding with the accelerated effective date.

V. Part O: Permanently Extend the Tax Shelter Provisions and Update Tax Preparer Penalties

A. Current Law

i. *Tax Shelter Provisions*

Tax Law § 25 contains New York's tax shelter penalty and reporting requirements. These requirements are modelled after the federal rules for disclosure of a reportable transaction. The Tax Law requires that any taxpayer who enters into a reportable or listed transaction, as those terms are defined by IRC § 6011 and corresponding treasury regulations, must attach a duplicate of the taxpayer's federal reportable transaction disclosure statement to the taxpayer's New York return for the taxable year at issue.[45] Additional disclosure requirements are provided for taxpayers, and material advisors, who have participated in "New York reportable transactions", *i.e.*, New York listed transactions, New York confidential transactions, and New York transactions with contractual protection.[46] Failure to properly report any of these transactions subjects taxpayers and certain advisors to enhanced penalties and extended statutes of limitations for assessment.[47]

[45] Tax Law § 25(a)(1).

[46] *Id.* at § 25(a)(2); 20 NYCRR § 2500.3.

[47] *See, e.g.,* Tax Law §§ 683(c)(11); 685(p), (q), and (r); Tax Law §§ 25(f)(1)-(3).

ii. *Tax Preparer Penalties*

The current tax preparer penalties, found in Tax Law § 685(aa), are scheduled to expire on July 1, 2019. The provisions provide for penalties of $1,000 per violation against the tax return preparer if there is an understatement of liability due to (i) a position for which there was not a reasonable belief that the tax treatment in that position was more likely than not the proper treatment, (ii) the income tax preparer knew or reasonably should have known of such position, and (iii) the position was not adequately disclosed. The Tax Law also provides for penalties of $5,000 per violation if the tax return preparer acted willfully or with reckless or intentional disregard of rules or regulations.

Tax Law § 658 also requires tax return preparers to sign returns and claims for refund and to furnish certain identifying information on returns and claims for refund. The Tax Law previously had penalty provisions for tax return preparers who failed to comply with these requirements, but those penalty provisions were repealed in 2009.[48]

B. Proposed Changes

i. *Tax Shelter Provisions*

Part O, section 1 of the Budget Bill would make the tax shelter penalty and reporting requirements currently in effect permanent.

ii. *Tax Preparer Penalties*

Part O of the Budget Bill would amend the preparer penalty provisions of Tax Law §§ 685(aa) and (u) to strengthen the Department's ability to enforce the Tax Laws by imposing penalties against tax return preparers who take return positions that (i) cause the understatement

[48] *See* L. 2009, c. 59 legislation; pt. VV, § 3.

of tax or improperly increase a claim for refund, (ii) fail to sign a return or claim for refund, or (iii) fail to furnish the tax return preparer's identifying number on tax returns.

Specifically, Part O, section 2 of the Budget Bill would replace the current version of Tax Law § 685(aa) to provide for penalties of between $100 and $1,000 for every return on which an understatement of liability or increased claim for refund is due to a position where the preparer "knew, or reasonably should have known, that said position was not proper, and such position was not adequately disclosed on the return or in a statement attached to the return." The Budget Bill further provides for a penalty of between $500 and $5,000 if the tax return preparer takes a position on an income tax return that understates the tax liability or increases a claim for refund resulting from the preparer's reckless or intentional disregard of the law, rules, or regulations.[49]

Next, Part O, section 3 would add a new section to Tax Law § 685(u) providing for penalties for failure to sign a return or claim for refund. Preparers would be subject to a penalty of $250 for each failure to sign a return or claim for refund (unless such failure was due to reasonable cause and not willful neglect). The maximum amount of penalties for each year is $10,000, unless the taxpayer was penalized under this provision in the preceding calendar year, in which case the penalty is increased to $500 per violation with no cap.

Part O, section 3 would also add a new section to Tax Law § 685(u) providing for penalties against tax return preparers who fail to furnish identifying numbers. The penalty would be $100 for each failure, up to a total of $2,500 each year. If the tax return preparer has been penalized under this provision in the preceding calendar year, the penalty is increased to $250 per violation with no cap.

[49] Please note that the text of proposed § 658(aa)(4) says "tax return prepared," but this appears to be a typographical error and should say "tax return preparer."

C. Comments

i. *Tax Shelter Provisions*

We support making Tax Law § 25, and related penalty and statute of limitations provisions, permanent. The transactions covered by these provisions are those that have the most potential for abuse. The disclosure requirements, penalties, and extended statutes of limitations provide the Department with the tools that it needs to identify and examine these transactions, and where appropriate, curtail abusive transactions.

We note, however, that in 2005, along with Tax Law § 25, New York enacted a provision imposing penalties for promoting abusive tax shelters. This provision is also schedule to expire and be deemed repealed as of July 1, 2019. Specifically, Tax Law § 685(bb) provides for a penalty of 50% of the gross income derived (or to be derived) by a person who promotes an abusive tax shelter. These penalties apply when a person organizes a tax shelter, makes or furnishes a statement regarding a tax benefit that the person knows or has reason to know is false or fraudulent as to any material matter, or makes or furnishes a gross valuation overstatement.

Tax Law § 685(bb) is another important enforcement tool for the Department and is not duplicated by other penalty provisions. Tax Law § 685(bb) applies to a broader category of transactions than Tax Law § 25, and it is not limited to tax return preparers, like Tax Law § 685(aa) (discussed below). In addition, the penalties under Tax Law § 685(bb), which are 50% of the fees derived from the activity, may be much greater than those under Tax Law § 685(aa), which are only up to $5,000 per violation if the tax return preparer's conduct was willful. We are unsure whether maintaining the July 1, 2019 expiration date for the penalties under Tax Law § 685(bb) was intentional. If not, we suggest that the Department consider making permanent Tax Law §

685(bb)'s powerful enforcement tool to discourage and penalize the most egregious cases of the promotion of abusive tax shelters.

ii. *Tax Preparer Penalties*

The purpose of the proposed provisions is to clarify and enhance penalties against tax return preparers who take positions that are not supported by the Tax Law, and to ensure that penalties for failing to sign returns (or claims for refund) and failing to furnish identification numbers apply to all tax preparers (and not only those required to be registered with the Department under Tax Law § 32).

Through the enactment of Tax Law § 32, New York has already taken significant action to improve tax preparation services for New Yorkers. A task force report issued by the Department cited "serious problems within the tax preparer industry and the impact of these problems on consumers of tax preparation and related services."[50] The report pointed to studies by the Office of the Treasury Inspector General for Tax Administration and the General Accounting Office finding that returns prepared by unlicensed tax return preparers "often contained inaccuracies with significant tax consequences such as sizable unjustifiable refunds," and that many of these errors were due to "willful or reckless omissions or misstatements."[51] In response, New York created a registered return preparer program in 2014, and issued regulations governing standards for conduct for all tax return preparers pursuant to Tax Law § 32.

The proposed legislation will further aid the Department in enforcing the Tax Law and ensuring that New York taxpayers receive high quality tax return preparation services and are not

[50] New York State, *Report of the Task Force on Regulation of Tax Return Preparers*, for submission to the Department of Taxation and Finance, the Governor, and the Legislature (Sept. 28, 2011), at p. 3.

[51] *Id.* at pp. 3-4.

taken advantage of by unscrupulous preparers. We support this effort, but have a few comments regarding the proposed tax preparer penalties in Part O, section 1 of the Budget Bill (to be codified at Tax Law § 685(aa)).

First, the proposed statute penalizes tax return preparers for taking positions that are "unreasonable," a standard which is met if the preparer "knew, or reasonably should have known, that said position was *not proper*."[52] We have concerns as to whether this is an administrable standard for penalties. It does not indicate the level of certainty that is required before a preparer can take a position on a tax return, and suggests that anytime a position is disallowed, the preparer could be subject to penalties. We do not believe that this is the standard that the Legislature should impose, as there can be good faith disagreements regarding the interpretation of the Tax Law or the particular facts and circumstances supporting a return position.

Tax Law § 685(aa) is modelled after IRC § 6644. Under IRC § 6694, the general definition of an "unreasonable position," is:

> (A) In general.--Except as otherwise provided in this paragraph, a position is described in this paragraph unless there is or was substantial authority for the position.
> (B) Disclosed positions.--If the position was disclosed . . . and is not a position to which subparagraph (C) applies [tax shelters and reportable transactions], the position is described in this paragraph unless there is a reasonable basis for the position.[53]

Similarly, Circular 230, which contains regulations governing practice before the Internal Revenue Service, cross-references this definition of "unreasonable position," in 31 C.F.R. § 10.34, "Standards with respect to tax returns and documents, affidavits and other papers."

[52] Budget Bill, Part O, § 2; Proposed Tax Law § 685(aa)(1) (emphasis added).

[53] IRC § 6694(a)(2)(A) and (B).

For tax return preparers who are certified public accountants, the American Institute of Certified Public Accountants ("AICPA") describes a similar standard in its Statements on Standards for Tax Services.[54] Statement 1, Tax Return Positions, provides that "a member may prepare or sign a tax return that reflects a position if (i) the member concludes there is a reasonable basis for the position and (ii) the position is appropriately disclosed."

The concepts of substantial authority, reasonable basis, and adequate disclosure found in these provisions have been developed by the courts and taxing authorities under New York and federal law. As noted above, New York has already issued regulations governing tax return preparers under Tax Law § 32. Those regulations provide that

> [a] tax return preparer may not willfully, recklessly, or through gross incompetence… advise a client to take a position on a tax return or claim for refund, or prepare a portion of a tax return or claim for refund containing a position that: (a) lacks a reasonable basis; (b) is an unreasonable position; or (c) is a willful attempt by the tax return preparer to understate the liability for tax or a reckless or intentional disregard of rules or regulations by the tax return preparer.[55]

The proposed standard found in the Budget Bill that the preparer knew or reasonably should have known that the position was "not proper" is inconsistent with 20 NYCRR § 2600-4.3(h), as well as the federal and industry standards. Moreover, there is no guidance as to whether "not proper" is intended to be a higher or lower standard than that described in the New York regulations. In order to avoid confusion as to both the applicable standard for return positions, and in the enforcement of the preparer penalties, we recommend that the "not proper" language be removed from the proposed statute, and instead, language similar to IRC § 6694 be included to the

[54] http://www.aicpa.org/InterestAreas/Tax/Resources/StandardsEthics/StatementsonStandardsforTaxServices/DownloadableDocuments/SSTS,%20Effective%20January%201,%202010.pdf

[55] 20 NYCRR § 2600-4.3(h)(1)(ii).

effect that the position either must be supported by substantial authority, or have a reasonable basis and be adequately disclosed.

Second, although the definition of "tax return preparer" encompasses preparers of all New York tax returns, including income tax, estate tax, sales tax and use tax, and other tax returns,[56] the proposed statute only appears to provide for penalties for unreasonable positions on *income* tax returns. We recommend that the reference to "income tax" be eliminated so that the provision applies to all returns, as it is in the interest of the Department and the public to ensure the standards for return positions are satisfied on all returns, not only income tax returns. This would be consistent with federal law. Specifically, IRC § 6694 was amended in 2007 to expand its application to all tax return preparers, and not just income tax preparers.[57]

VI. Part X: Exclude from Entire Net Income Certain Contributions to the Capital of a Corporation

A. Current Law

As part of the TCJA certain changes were made to IRC §118, which generally provides that the gross income of a corporation does not include any contribution to its capital. Prior to the change in law, there was an exclusion from this provision where contributions in aid of construction or any other contribution from a customer or potential customer were not considered a contribution to capital and thus were included in the receiving corporation's gross income.

[56] Part O, § 3 of the Budget Bill defines "tax return preparer," by reference to Tax Law § 658(g), which states, in relevant part, that "the term 'tax return preparer' means any person who prepares for compensation, or who employs or engages one or more persons to prepare for compensation any return or claim for refund. The preparation of a substantial portion of a return or claim for refund shall be treated as if it were the preparation of such return or claim for refund. . . Tax Law § 658(g)(5).

[57] *See* Small Business and Work Opportunity Act of 2007, Pub L No 110-28, 121 Stat. 190, § 8246(a)(2)(F)(i)(I) & (II) (May 25, 2007); IRC § 6694.

The TCJA added a new exclusion from the general rule, whereby any contribution by any governmental entity or civic group (other than a contribution made by a shareholder as such) is also not considered a contribution to capital and is included in the receiving corporation's gross income.

Currently, corporations follow IRC §118 when determining their Article 9-A or Article 33 tax liability and their New York City business corporation tax, general corporation tax, or banking corporation tax liability because the starting point for the computation of these tax bases is federal gross income. Accordingly, the federal limitations specifying that a contribution by a governmental entity or a civic group to a corporation is included in gross income will apply for New York State and City purposes. As a result, this provision results in certain state and local tax incentives awarded to corporations being subject to tax.

B. Proposed Changes

Part X of the Budget Bill would decouple Article 9-A and Article 33 taxes, as well as New York City general corporation tax from IRC § 118, resulting in the capital contributions a corporation receives from a governmental entity or a civic group being excluded from a taxpayer's gross income subject to tax in New York.

C. Comments

The Tax Section does not take a position on whether decoupling from IRC §118 is advisable. However, if this provision passes, it would be advisable for the exclusion from gross income to be applied not just for purposes of Article 9-A and Article 33 taxes and the New York City general corporation tax. The decoupling from this provision should also be applied to the definitions of entire net income in the New York City business corporation tax (Code § 11-652 et seq.) and the New York City banking corporation tax (Code § 11-641 et seq.).

VII. Part Y: Close the Carried Interest Loophole

A. Current Law

The Tax Law has no special provisions dealing with income from a carried interest. In general, partnership income that is taxed to the partners has the same character in the hands of the partners as it had in the hands of the partnership, regardless of how the partner acquired his or her partnership interest. For example, partnership investment income, including long-term capital gains, flows through to the partners and is treated the same in their hands even if one or more partners acquired their partnership interest in exchange for services rendered to the partnership or other partners.[58]

A carried interest is an interest in a partnership that is disproportionately high relative to the partner's capital contribution. It is common for the organizers of an investment partnership to contribute a small amount of the partnership's capital but to receive a much higher interest in partnership profits. Arguably, this disproportionate interest is received in exchange for services rendered in organizing and/or operating the partnership. Nevertheless, New York State, mirroring the federal income tax treatment, has treated income from a carried interest just like any other partnership income that is taxed to the partners.

Until the enactment of the TCJA, the IRC contained no special provisions for carried interest income and the Internal Revenue Service treated the income as retaining the character that it had in the hands of the partnership. The TCJA amended IRC § 1061 to provide, in general, that

[58] References to partnerships and partners include limited liability companies and their members to the extent that they are treated as partnerships and partners for income purposes.

a partner who received a partnership interest in connection with the performance of substantial services would not treat long-term capital gains realized by the partnership as long-term capital gains unless the property sold by the partnership had been held by the partnership for more than three years. IRC § 1061 does not treat carried interest income as income received in exchange for services or as business income; its only effect is to convert what otherwise might have been long-term capital gains to short-term capital gains.

B. Proposed Changes

Part Y of the Budget Bill would add a new section 44 to the Tax Law and would amend sections 208.6(a), 617(b), 631(d), and 632(b) to change the treatment of carried interest income. The provisions are intended to "close the carried interest loophole" by treating carried interest income as income from a trade or business and not as capital gains. One consequence of this recharacterization would be that carried interest income would be taxable to a nonresident of New York to the extent that the partnership's income was attributable to New York sources. In addition, the Budget Bill would impose a 17% "carried interest fairness fee" on a portion of carried interest income. The fee would remain in effect until the IRC is amended to treat the provision of investment management services for federal tax purposes substantially the same as under the Tax Law.

C. Comments

An identical proposal was included in New York's FY 2018-2019 Executive Budget.[59] The Tax Section again takes no position with respect to whether carried interest income should be

[59] *See* New York State FY 2018-2019 Executive Budget, Part M.

treated as business income or should be given favorable tax treatment. For the benefit of the reader, we have restated our comments regarding this proposal.[60]

The Budget Bill applies the new regime to income that a partner is deemed to have received from "investment management services." Section 44 defines this phrase as including investment advice regarding the purchase or sale of securities as defined in section 475(c)(2) of the IRC, real estate held for rental or investment, and certain partnership interests, including managing, acquiring, or disposing of such assets, arranging financing with respect to the acquisition of such assets, and related activities.

The operative provision of section 44 indicates that a partner who performs investment management services for a partnership will not be treated as a partner with respect to the partner's distributive share of income, gain, loss, and deduction, including guaranteed payments, "that is in excess of the amount such distributive share would have been if the partner had performed no investment management services for the partnership." That excess amount will be treated as a business receipt for services and for purposes of the personal income tax as income attributable to a trade, business, profession, or occupation. Similar provisions would apply to an S corporation shareholder. An exception would be provided for certain real estate businesses. A partner or shareholder will not be deemed to be providing investment management services if at least 80% of the average fair market value of the partnership's assets consists of real estate held for rental or investment.

It may be difficult to determine whether a partner received all or part of a partnership interest in exchange for investment management services. It does not automatically follow that an interest that is disproportionate to a partner's capital contribution is received in exchange for

[60] *See* Report of the Tax Section of the New York State Bar Association, Report No. 1391 (Mar. 9, 2018) at 12-16.

investment management services or, for that matter, for any services. For example, the organizers of a partnership might be willing to give a particularly prestigious individual a disproportionately high partnership interest because the person's name may enhance the partnership's reputation or ability to attract other investors or otherwise assist in relations with private or public organizations. Other partners might simply strike a hard bargain and succeed in negotiating for a partnership interest that is disproportionately high relative to their capital contributions.

The new regime applies to income received by a partner for services performed by that partner. As written, it would not apply to income received by a partner who received a partnership interest as a gift from a person who performed services for the partnership (*e.g.*, the service provider's spouse or children).

Section 44(c) provides for "an additional tax, referred to as the 'carried interest fairness fee'." This fee is equal to 17% of the amount treated as business income under section 44(b). This fee will remain in effect until "federal legislation has been enacted that treats the provision of investment management services for federal tax purposes substantially the same as provided in this section." It is not clear what kind of federal legislation would be needed to result in a termination of the fee. The bill converts investment income to business income. If Congress wanted to completely eliminate favorable treatment for capital gains realized by partnerships that had partners with carried interests, it could do so by expanding on the approach taken by the TCJA and simply providing that all long-term capital gains realized by a partnership will be treated as short-term capital gains to the extent that they are passed through to carried interests. That would eliminate any federal preference for carried interest income, but it would not treat that income as business income as the New York statute does. It would still be investment income for other purposes of the federal tax laws. That would arguably not result in treatment "substantially the same as provided" in the New York law.

The carried interest provisions take effect only if Connecticut, New Jersey, Massachusetts, and Pennsylvania all adopt legislation "having substantially the same effect as this act." It is unclear what this phrase means. In the unlikely event that all four states adopt some kind of legislation dealing with carried interest income, they could take different approaches. They could recharacterize carried interest income as business income but not impose a punitive "fairness fee", or they could impose a "fee" that was much lower than New York's fee.

Our only new comment regarding the proposed carried interest provision pertains to the proposal's effective date, which is contingent upon similar proposals being enacted by Connecticut, New Jersey, Massachusetts, and Pennsylvania. Since the original proposition of the carried interest provision in the fiscal year 2018-2019 Executive Budget, New Jersey has enacted a similar tax on carried interest. New Jersey's law will levy a 17% carried interest tax on general partners of investment funds once New York, Connecticut and Massachusetts have enacted legislation having the same effect. It is unclear whether New Jersey's legislation has "substantially the same effect" as the carried interest proposal in the Executive Budget. No similar proposal has yet been enacted by Connecticut, Massachusetts, or Pennsylvania.

VIII. Part Z: Various Technical Changes to the Tax Law and the New York City Administrative Code

Part Z of the Budget Bill includes a number of proposed technical changes intended to clarify various provisions of the Tax Law and the Code. The provisions are intended to ensure that tax statutes are clear, accurate and up to date with the most recent provisions in corresponding federal, state, and city tax provisions. The corrections are also intended to ensure that the language conforms to legislative intent. We welcome the added clarity that these changes bring to the Tax Law and the Code. We suggest additional changes to ensure complete clarification of the application of that provision.

A. Current Law

Tax Law § 213-b(a) relates to estimated payments of franchise tax and metropolitan transportation business tax surcharge for S-corporations. Further, Tax Law § 213-b(e) states that if an estimated payment exceeds the taxpayer's corresponding liability, interest shall be paid from the date of payment to the fifteenth day of the third month following the close of the taxable period.

B. Proposed Changes

Part Z, § 4 of the Budget Bill proposes to remove provisions in Tax Law § 213-b(a) related to the requirements for S-corporations to make estimated payments of metropolitan transportation business tax surcharge. The provisions would be removed because S-corporations are not subject to the metropolitan transportation business tax surcharge. Part Z, § 5 of the Budget Bill also proposes to amend Tax Law § 213-b(e) for purposes of determining the end date for interest paid to taxpayers on estimated tax overpayments from the third month to the fourth month following the close of the taxable period. This amendment conforms to changes in related return due dates.

C. Comments

In order to further clarify the franchise tax estimated payment requirements for S-corporations, we recommend that Tax Law §213-b(a) is further amended to state that "[p]rovided, however, that every taxpayer that <u>is subject to the tax imposed by section two hundred nine of this chapter that</u> is <u>a New York</u> S corporation must pay with the report . . ." This will ensure clarification that the estimated payments are related to the franchise tax.

IX. Part VV: Enact the Cannabis Regulation and Taxation Act

A. Current Law

The use of cannabis for *recreational* purposes is currently illegal in the state of New York. The use of *medical* cannabis, however, is legal in New York under § 3362 of the Compassionate Care Act.[61] To obtain medical cannabis, a patient must be diagnosed with one of several serious conditions, and the patient must receive certification from a medical professional.[62] Additionally, the patient must register with the Department of Health's Medical Marijuana Program and obtain a Registry Identification Card.[63]

The current excise tax on medical cannabis is seven percent of the gross receipts from medical marijuana sold or furnished by a registered organization to a certified patient or designated caregiver.[64] The law defines "gross receipt" as the amount charged for the provision of medical cannabis, without any deduction for: the cost of materials, labor, or services; other costs, interest, or discount paid; or any other expenses.[65]

B. Proposed Changes

Part VV of the Budget Bill proposes to legalize the recreational use of cannabis, and Article 20-C of the Tax Law would impose a number of requirements on prospective cannabis businesses, including taxation, registration and renewal, and keeping returns secret. Additionally, Article 20-C enumerates penalties in the case that a person violates one of the provisions.

[61] Pub. Health Law § 3362.

[62] *Id.* at § 3361.

[63] *Id.* at § 3363.

[64] Tax Law § 490(2).

[65] *Id.* at § 490(1).

Under Taw Law § 493, New York would impose a tax on the cultivation of cannabis flower and cannabis trim at the rate of one dollar per dry-weight gram of cannabis flower, and twenty-five cents per dry-weight gram of cannabis trim. The tax distinguishes between cultivators and wholesalers. If the wholesaler is not the cultivator, the wholesaler collects the tax from the cultivator at the time of transfer to the wholesaler. If the wholesaler is the cultivator, the wholesaler pays the tax at the time of sale or transfer to the retail dispensary. If the cultivator is the retail dispensary, the tax accrues at the time of sale to the retail customer.

A twenty percent excise tax would also be imposed on a wholesaler for the transfer of cannabis from a wholesaler to a retail dispensary. If the wholesaler is not a retail dispensary, the tax is computed based on the invoice price charged by the wholesaler to a retail dispensary. If the wholesaler is a retail dispensary, the tax is twenty percent of the price charged to the retail customer, and it accrues at the time of sale to the customer. The transfer by wholesaler to the retailer is also subject to an additional two percent county tax. Lastly, as in the case of medical cannabis, recreational cannabis is exempt from sales tax.

As discussed in more detail below, the Budget Bill also proposes to modify the taxpayer secrecy provisions under Article 20-B, Excise Tax on Medical Marihuana, by removing any references to the sharing of information with the federal government. Similarly, § 496 of Article 20-C, as proposed by the Budget Bill, does not address whether New York intends to share the information it obtains with the federal government.

C. Comments

i. *Interaction of IRC § 280E with the Proposed Cannabis Legislation*

IRC § 280E states:

> No deduction or credit shall be allowed for any amount paid or incurred during the taxable year in carrying on any trade or business

> if such trade or business (or the activities which comprise such trade or business) consists of trafficking in controlled substances (within the meaning of schedule I and II of the Controlled Substances Act) which is prohibited by Federal law or the law of any State in which such trade or business is conducted.

Currently, New York law follows IRC § 280E through its conformity to the IRC. As a result, cannabis businesses may not claim the same deductions that other businesses may because the federal government continues to list cannabis as a Schedule I drug. New York's conformity with the IRC puts an additional fiscal burden on cannabis businesses, which appears inconsistent with New York's position that cannabis is a legitimate business undertaking. The Legislature may therefore want to consider following in the footsteps of some other states, such as Washington and Colorado, that have decoupled from IRC § 280E.

ii. *Taxpayer Secrecy Provisions in Regard to the Federal Government*

The current taxpayer secrecy statute contained in Article 20-B, the excise tax on medical marihuana, gives the Department discretion not to share such taxpayer information with the Internal Revenue Service. The statute also explicitly prohibits the Department from sharing any of the taxpayer information with the Internal Revenue Service, unless the Internal Revenue Service agrees "not to divulge or make known in any manner the information so supplied."[66] Presumably, this language is designed to prevent the Internal Revenue Service from sharing this information with any law enforcement agencies.

Notably, the Budget Bill seeks to remove from § 491 of Article 20-B references to the Internal Revenue Service. The taxpayer secrecy provisions under the proposed Article 20-C also make no mention of the Internal Revenue Service. The proposed language is, therefore, silent as to what happens if the Internal Revenue Service requests New York tax returns pertaining to

[66] Tax Law § 491.

medical and recreational cannabis. This ambiguity raises two issues. On the one hand, the silence could be interpreted as New York's Commissioner *not* having the discretion to share tax return information with the federal government. On the other hand, the implication could be that restrictions on sharing tax return information do not apply with respect to the Internal Revenue Service at all. Given that cannabis—in all forms—remains illegal under federal law, this distinction might be of critical importance to cannabis businesses. We recommend that the Legislature provide additional clarity regarding the proposed omission of the reference to the Internal Revenue Service in the context of taxpayer secrecy.

iii. *The Imposition of the Twenty Percent Tax*

In the Budget Bill, the tax base amount subject to the twenty percent tax depends on whether a wholesaler and a retailer are two separate entities or a single entity. In the separate entity context, the twenty percent tax is imposed on the wholesale price and in the single entity context, the twenty percent tax is imposed on the retail price.

We assume that the difference in timing and the tax base amount subject to the twenty percent tax is because a wholesale price may not be available where a wholesaler and a retailer are one and the same. We note that the proposal would likely result in materially different tax amounts collected due to the margins built into the retail price. Possibly, the proposed statute would treat similarly situated taxpayers differently, resulting in a future constitutional challenge.

It is unclear whether any such potential arrangements would create arm's-length pricing issues. In any event, to avoid any disparity in the imposition of the tax, the Legislature may want to consider imposing an excise tax at a lower rate on the retail price regardless of the operating structure of the cannabis business. Further, given the relatively new nature of the proposed taxes, we welcome the Department promulgating regulations to further clarify the Department's position.

STATE OF NEW YORK

S. 1509 A. 2009

SENATE - ASSEMBLY

January 18, 2019

IN SENATE -- A BUDGET BILL, submitted by the Governor pursuant to article seven of the Constitution -- read twice and ordered printed, and when printed to be committed to the Committee on Finance

IN ASSEMBLY -- A BUDGET BILL, submitted by the Governor pursuant to article seven of the Constitution -- read once and referred to the Committee on Ways and Means

AN ACT to amend part U of chapter 61 of the laws of 2011, amending the real property tax law and other laws relating to establishing standards for electronic tax administration, in relation to making permanent provisions relating to mandatory electronic filing of tax documents; and repealing certain provisions of the tax law and the administrative code of the city of New York relating thereto (Part A); to amend the economic development law, in relation to the employee training incentive program (Part B); to amend the tax law and the administrative code of the city of New York, in relation to including in the apportionment fraction receipts constituting net global intangible low-taxed income (Part C); to amend the tax law and the administrative code of the city of New York, in relation to the adjusted basis for property used to determine whether a manufacturer is a qualified New York manufacturer (Part D); to amend part MM of chapter 59 of the laws of 2014 amending the labor law and the tax law relating to the creation of the workers with disabilities tax credit program, in relation to extending the effectiveness thereof (Part E); to amend the tax law in relation to the inclusion in a decedent's New York gross estate any qualified terminable interest property for which a prior deduction was allowed and certain pre-death gifts (Part F); to amend the tax law, in relation to requiring marketplace providers to collect sales tax (Part G); to amend the tax law, in relation to eliminating the reduced tax rates under the sales and use tax with respect to certain gas and electric service; and to repeal certain provisions of the tax law and the administrative code of the city of New York related thereto (Part H); to amend the real property tax law, in relation to the determination and use of state equalization rates (Part I); to amend the real property tax law and local finance law, in relation to local option disaster assessment relief (Subpart A); to amend the real property tax law, in relation to authorizing agreements

EXPLANATION--Matter in ***italics*** (underscored) is new; matter in brackets [-] is old law to be omitted.

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for assessment review services (Subpart B); to amend the real property tax law, in relation to the training of assessors and county directors of real property tax services (Subpart C); to amend the real property tax law, in relation to providing certain notifications electronically (Subpart D); to amend the real property tax law, in relation to the valuation and taxable status dates of special franchise property (Subpart E); and to amend the real property tax law, in relation to the reporting requirements of power plants (Subpart F) (Part J); to repeal section 3-d of the general municipal law, relating to certification of compliance with tax levy limit (Part K); to amend the tax law, in relation to creating an employer-provided child care credit (Part L); to amend the tax law, in relation to including gambling winnings in New York source income and requiring withholding thereon (Part M); to amend the tax law, in relation to the farm workforce retention credit (Part N); to amend the tax law, in relation to updating tax preparer penalties; to amend part N of chapter 61 of the laws of 2005, amending the tax law relating to certain transactions and related information and relating to the voluntary compliance initiative, in relation to eliminating the expiration thereof; and to repeal certain provisions of the tax law, relating to tax preparer penalties (Part O); to amend the tax law, in relation to extending the top personal income tax rate for five years (Part P); to amend the tax law and the administrative code of the city of New York, in relation to extending for five years the limitations on itemized deductions for individuals with incomes over one million dollars (Part Q); to amend the tax law, in relation to extending the clean heating fuel credit for three years (Part R); to repeal subdivision (e) of section 23 of part U of chapter 61 of the laws of 2011 amending the real property tax law and other laws relating to establishing standards for electronic tax administration (Part S); to amend the cooperative corporations law and the rural electric cooperative law, in relation to eliminating certain license fees (Part T); to amend the tax law, in relation to a credit for the rehabilitation of historic properties for state owned property leased to private entities (Part U); to amend the tax law, in relation to exempting from sales and use tax certain tangible personal property or services (Part V); to amend the mental hygiene law and the tax law, in relation to the creation and administration of a tax credit for employment of eligible individuals in recovery from a substance use disorder (Part W); to amend the tax law and the administrative code of the city of New York, in relation to excluding from entire net income certain contributions to the capital of a corporation (Part X); to amend the tax law, in relation to establishing a conditional tax on carried interest (Part Y); to amend the tax law, the administrative code of the city of New York, and chapter 369 of the laws of 2018 amending the tax law relating to unrelated business taxable income of a taxpayer, in relation to making technical corrections thereto (Part Z); to amend the real property tax law, in relation to tax exemptions for energy systems (Part AA); to amend the racing, pari-mutuel wagering and breeding law, in relation to employees of the state gaming commission (Part BB); to amend the racing, pari-mutuel wagering and breeding law, in relation to the thoroughbred and standardbred breeding funds (Part CC); to amend the racing, pari-mutuel wagering and breeding law, in relation to the office of the gaming inspector general; and to repeal title 9 of article 13 of the racing, pari-mutuel wagering and breeding law relating to the gaming inspector general (Subpart A); to amend the racing, pari-mutuel wager-

~~(e) sections twenty-one and twenty-one-a of this act shall expire and be deemed repealed December 31, 2019~~].

§ 6. This act shall take effect immediately.

PART B

Section 1. Subdivision 3 of section 441 of the economic development law, as amended by section 1 of part L of chapter 59 of the laws of 2017, is amended to read as follows:

3. "Eligible training" means (a) training provided by **the business entity or** an approved provider that is:

(i) to upgrade, retrain or improve the productivity of employees;

(ii) provided to employees in connection with a significant capital investment by a participating business entity;

(iii) determined by the commissioner to satisfy a business need on the part of a participating business entity;

(iv) not designed to train or upgrade skills as required by a federal or state entity;

(v) not training the completion of which may result in the awarding of a license or certificate required by law in order to perform a job function; and

(vi) not culturally focused training; or

(b) an internship program in advanced technology [~~or~~]**,** life sciences**, software development or clean energy** approved by the commissioner and provided by **the business entity or** an approved provider, on or after August first, two thousand fifteen, to provide employment and experience opportunities for current students, recent graduates, and recent members of the armed forces.

§ 2. Paragraph (b) of subdivision 1 of section 442 of the economic development law, as amended by section 2 of part L of chapter 59 of the laws of 2017, is amended to read as follows:

(b) The business entity must demonstrate that it is **conducting eligible training or** obtaining eligible training from an approved provider;

§ 3. Paragraph (a) of subdivision 2 of section 443 of the economic development law, as added by section 1 of part O of chapter 59 of the laws of 2015, is amended to read as follows:

(a) provide such documentation as the commissioner may require in order for the commissioner to determine that the business entity intends to **conduct eligible training or** procure eligible training for its employees from an approved provider;

§ 4. This act shall take effect immediately.

PART C

Section 1. Section 210-A of the tax law is amended by adding a new subdivision 5-a to read as follows:

5-a. Net global intangible low-taxed income. Notwithstanding any other provision of this section, net global intangible low-taxed income shall be included in the apportionment fraction as provided in this subdivision. Receipts constituting net global intangible low-taxed income shall not be included in the numerator of the apportionment fraction. Receipts constituting net global intangible low-taxed income shall be included in the denominator of the apportionment fraction. For purposes of this subdivision, the term "net global intangible low-taxed income" means the amount required to be included in the taxpayer's federal gross income pursuant to subsection (a) of section 951A of the

internal revenue code less the amount of the deduction allowed under clause (i) of section 250(a)(1)(B) of such code.

§ 2. Section 11-654.2 of the administrative code of the city of New York is amended by adding a new subdivision 5-a to read as follows:

5-a. Notwithstanding any other provision of this section, net global intangible low-taxed income shall be included in the receipts fraction as provided in this subdivision. Receipts constituting net global intangible low-taxed income shall not be included in the numerator of the receipts fraction. Receipts constituting net global intangible low-taxed income shall be included in the denominator of the receipts fraction. For purposes of this subdivision, the term "net global intangible low-taxed income" means the amount required to be included in the taxpayer's federal gross income pursuant to subsection (a) of section 951A of the internal revenue code less the amount of the deduction allowed under clause (i) of section 250(a)(1)(B) of such code.

§ 3. This act shall take effect immediately and shall apply to taxable years beginning on or after January 1, 2018.

PART D

Section 1. Subparagraph (vi) of paragraph (a) of subdivision 1 of section 210 of the tax law, as amended by section 11 of part T of chapter 59 of the laws of 2015, is amended to read as follows:

(vi) for taxable years beginning on or after January first, two thousand fourteen, the amount prescribed by this paragraph for a taxpayer [~~which~~] **that** is a qualified New York manufacturer, shall be computed at the rate of zero percent of the taxpayer's business income base. The term "manufacturer" shall mean a taxpayer [~~which~~] **that** during the taxable year is principally engaged in the production of goods by manufacturing, processing, assembling, refining, mining, extracting, farming, agriculture, horticulture, floriculture, viticulture or commercial fishing. However, the generation and distribution of electricity, the distribution of natural gas, and the production of steam associated with the generation of electricity shall not be qualifying activities for a manufacturer under this subparagraph. Moreover, in the case of a combined report, the combined group shall be considered a "manufacturer" for purposes of this subparagraph only if the combined group during the taxable year is principally engaged in the activities set forth in this paragraph, or any combination thereof. A taxpayer or, in the case of a combined report, a combined group shall be "principally engaged" in activities described above if, during the taxable year, more than fifty percent of the gross receipts of the taxpayer or combined group, respectively, are derived from receipts from the sale of goods produced by such activities. In computing a combined group's gross receipts, intercorporate receipts shall be eliminated. A "qualified New York manufacturer" is a manufacturer [~~which~~] **that** has property in New York [~~which~~] **that** is described in clause (A) of subparagraph (i) of paragraph (b) of subdivision one of section two hundred ten-B of this article and either (I) the adjusted basis of such property for [~~federal income~~] **New York state** tax purposes at the close of the taxable year is at least one million dollars or (II) all of its real and personal property is located in New York. A taxpayer or, in the case of a combined report, a combined group, that does not satisfy the principally engaged test may be a qualified New York manufacturer if the taxpayer or the combined group employs during the taxable year at least two thousand five hundred employees in manufacturing in New York and the taxpayer or the combined

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MEMORANDUM IN SUPPORT

A BUDGET BILL submitted by the Governor in Accordance with Article VII of the Constitution

AN ACT to amend part U of chapter 61 of the laws of 2011, amending the real property tax law and other laws relating to establishing standards for electronic tax administration, in relation to making permanent provisions relating to mandatory electronic filing of tax documents; and repealing certain provisions of the tax law and the administrative code of the city of New York relating thereto (Part A); to amend the economic development law, in relation to the employee training incentive program (Part B); to amend the tax law and the administrative code of the city of New York, in relation to including in the apportionment fraction receipts constituting net global intangible low-taxed income (Part C); to amend the tax law and the administrative code of the city of New York, in relation to the adjusted basis for property used to determine whether a manufacturer is a qualified New York manufacturer (Part D); to amend part MM of chapter 59 of the laws of 2014 amending the labor law and the tax law relating to the creation of the workers with disabilities tax credit program, in relation to extending the effectiveness thereof (Part E); to amend the tax law in relation to the inclusion in a decedent's New York gross estate any qualified terminable interest property for which a prior deduction was allowed and certain pre-death gifts (Part F); to amend the tax law, in relation to requiring marketplace providers to collect sales tax (Part G); to amend the tax law, in relation to eliminating the reduced tax rates under the sales and use tax with respect to certain gas and electric service; and to repeal certain provisions of the tax law and the administrative code of the city of New York related thereto (Part H); to amend the real property tax law, in relation to the determination and use of state equalization rates (Part I); to amend the real property tax law and local finance law, in relation to local option disaster assessment relief (Subpart A); to amend the real property tax law, in relation to authorizing agreements for assessment review services (Subpart B); to amend the real property tax law, in relation to the training of assessors and county directors of real property tax services (Subpart C); to amend the real property tax law, in relation to providing certain notifications electronically (Subpart D); to amend the real property tax law, in relation to the valuation and taxable status dates of special franchise property (Subpart E); and to amend the real property tax law, in relation to the reporting requirements of power plants (Subpart F) (Part J); to repeal section 3-d of the general municipal law, relating to certification of compliance with tax levy limit (Part K); to amend the tax law, in relation to creating an employer-provided child care credit (Part L); to amend the tax law, in relation to including gambling winnings in New York source income and requiring withholding thereon (Part M); to amend the tax law, in relation to the farm workforce retention credit (Part N); to amend the tax law, in relation to updating tax preparer penalties; to amend part N of chapter 61 of the laws of 2005, amending the tax law relating to certain transactions and related information and relating to the voluntary compliance initiative, in relation to eliminating the expiration thereof; and to repeal certain provisions of the tax law, relating to tax preparer penalties (Part O); to amend the tax law, in relation to extending the top personal income tax rate for five years (Part P); to amend the tax law and the administrative code of the city of New York, in relation to extending for five years the limitations on itemized deductions for individuals with incomes over one million dollars (Part Q); to amend the tax law, in relation to extending the clean heating fuel credit for three years (Part R); to repeal subdivision (e) of section 23 of part U of chapter 61 of the laws of 2011 amending the real property tax law and other laws relating to establishing standards for electronic tax administration (Part S); to amend the cooperative corporations law and the rural electric cooperative law, in relation to eliminating certain license fees (Part T); to amend the tax law, in relation to a credit for the rehabilitation of historic properties for state owned property leased to private entities (Part U); to amend the tax law, in relation to exempting from sales and use tax certain tangible personal property or services (Part V); to amend the mental hygiene law and the tax law, in relation to the creation and administration of a tax credit for employment of eligible individuals in recovery from a substance use disorder (Part W); to amend the tax law and the administrative code of the city of New York, in relation to excluding from entire net income certain contributions to the capital of a corporation (Part X); to amend the tax law, in relation to establishing a conditional tax on carried interest (Part Y); to amend the tax law, the administrative code of the city of New York, and chapter 369 of the laws of 2018 amending the tax law relating to unrelated business taxable income of a taxpayer, in relation to making technical corrections thereto (Part Z); to amend the real property tax law, in relation to tax exemptions for energy systems (Part AA); to amend the racing, pari-mutuel wagering and breeding law, in relation to employees of the state gaming commission (Part BB); to amend the racing, pari-mutuel wagering and breeding law, in relation to the thoroughbred and standardbred breeding funds (Part CC); to amend the racing, pari-mutuel wagering and breeding law, in relation to the office of the gaming inspector general; and to repeal title 9 of article 13 of the racing, pari-mutuel wagering and breeding law relating to the gaming inspector general (Subpart A); to amend the racing, pari-mutuel wagering and breeding law, in relation to appointees to the thoroughbred breeding and development fund (Subpart B); to amend the public officers law and the racing, pari-mutuel wagering and breeding law, in relation to the Harry M. Zweig memorial fund (Subpart C); and to amend the tax law, in relation to the prize payment amounts and revenue distributions of lottery game sales, and use of unclaimed prize funds (Subpart D)(Part DD); to amend the tax law, in relation to commissions paid to the operator of a video lottery facility; to repeal certain provisions of such law relating thereto; and providing for the repeal of certain provisions upon expiration thereof (Part EE); to amend the racing, pari-mutuel wagering and breeding law, in relation to the deductibility of promotional credits (Part FF); to amend the racing, pari-mutuel wagering and breeding law, in relation to the operations of off-track betting corporations (Part GG); to amend the racing, pari-mutuel wagering and breeding law, in relation to licenses for simulcast facilities, sums relating to track simulcast, simulcast of out-of-state thoroughbred races, simulcasting of races run by out-of-state harness tracks and distributions of wagers; to amend chapter 281 of the laws of 1994 amending the racing, pari-mutuel wagering and breeding law and other laws relating to simulcasting and chapter 346 of the laws of 1990 amending the racing, pari-mutuel wagering and breeding law and other laws relating to simulcasting and the imposition of certain taxes, in relation to extending certain provisions thereof; and to amend the racing, pari-mutuel wagering and breeding law, in relation to extending certain provisions thereof (Part HH); to amend the racing, pari-mutuel wagering and breeding law, in relation to equine drug testing standards (Part II); to amend part EE of chapter 59 of the laws of 2018, amending the racing, pari-mutuel wagering and breeding law, relating to adjusting the franchise payment establishing an advisory committee to review the structure, operations and funding of equine drug testing and research, in relation to the date of delivery for recommendations; and to amend the racing, pari-mutuel wagering and breeding law, in relation to the advisory committee on equine drug testing, and equine lab testing provider restrictions removal (Part JJ); to amend the racing, pari-mutuel wagering and breeding law, in relation to state gaming commission occupational licenses (Part KK); to amend the real property tax law and the tax law, in relation to the determination of STAR tax savings (Part LL); to amend the tax law, in relation to cooperative housing corporation information returns (Part MM); to amend the tax law, in relation to making a technical correction to the enhanced real property tax circuit breaker credit (Part NN); to amend the tax law, in relation to mobile home reporting requirements (Part OO); to amend the real property tax law and the tax law, in relation to eligibility for STAR exemptions and credits (Part PP); to amend the real property tax law and the tax law, in relation to authorizing the disclosure of certain information to assessors (Part QQ); to amend the real property tax law and the tax law, in relation to the income limits for STAR benefits (Part RR); to amend the real property tax law, in relation to clarifying certain notices on school tax bills (Part SS); to amend the real property tax law and the tax law, in relation to making the STAR program more accessible to taxpayers (Part TT); to amend the public health law, in relation to increasing the purchasing age for tobacco products and electronic cigarettes from eighteen to twenty-one; prohibiting sales of tobacco products and electronic cigarettes in all pharmacies; prohibiting the acceptance of price reduction instruments for both tobacco products and electronic cigarettes; prohibiting the display of tobacco products or electronic cigarettes in stores; clarifying that the department of health has the authority to promulgate regulations that restrict the sale or distribution of electronic cigarettes or electronic liquids that have a characterizing flavor, and the use of names for characterizing flavors; prohibiting smoking inside and on the grounds of all hospitals licensed or operated by the office of mental health; taxing electronic liquid; and requiring that electronic cigarettes be sold only through licensed vapor products retailers; to amend the general business law, in relation to the packaging of vapor products; to amend the tax law, in relation to imposing a supplemental tax on vapor products; to amend the state finance law, in relation to adding revenues from the supplemental tax on vapor products to the health care reform act resource fund; and repealing paragraph (e) of subdivison 1 of section 1399-cc of the public health law relating to the definitions of nicotine, electronic liquid and e-liquid (Part UU); relating to constituting a new chapter 7-A of the consolidated laws, in relation to the creation of a new office of cannabis management, as an independent entity within the division of alcoholic beverage control, providing for the licensure of persons authorized to cultivate, process, distribute and sell cannabis and the use of cannabis by persons aged twenty-one or older; to amend the public health law, in relation to the description of cannabis; to amend the vehicle and traffic law, in relation to making technical changes regarding the definition of cannabis; to amend the penal law, in relation to the qualification of certain offenses involving cannabis and to exempt certain persons from prosecution for the use, consumption, display, production or distribution of cannabis; to amend the tax law, in relation to providing for the levying taxes on cannabis; to amend the criminal procedure law, the civil practice law and rules, the general business law, the state finance law, the executive law, the penal law and the vehicle and traffic law, in relation to making conforming changes; to repeal sections 221.10 and 221.30 of the penal law relating to the criminal possession and sale of cannabis; to amend chapter 90 of the laws of 2014 amending the public health law, the tax law, the state finance law, the general business law, the penal law and the criminal procedure law relating to medical use of marihuana, in relation to the effectiveness thereof; to repeal paragraph (f) of subdivision 2 of section 850 of the general business law relating to drug related paraphernalia; and making an appropriation therefor (Part VV); and to amend the tax law, in relation to imposing a special tax on passenger car rentals outside of the metropolitan commuter transportation district (Part WW)

PURPOSE:

This bill contains provisions needed to implement the Revenue portion of the FY 2020 Executive Budget.

This memorandum describes Parts A through WW of the bill which are described wholly within the parts listed below.

Part A – Make the e-File Mandate Permanent

Purpose:

This bill would consolidate and make permanent current electronic filing and payment mandates.

Summary of Provisions and Statement in Support:

Section 29 of the Tax Law was added in 2008 to consolidate and improve the administration of the Tax Department's various electronic filing and payment mandates. These provisions are currently set to expire on December 31, 2019, after which the Tax Law would revert to several similar legacy e-filing requirements that remain on the books. This bill would make Tax Law § 29 permanent and would repeal the other legacy e-filing statutes.

By making the § 29 electronic filing and payment mandates permanent, this bill would ensure that the State and its taxpayers can continue to benefit from the efficiencies and cost savings that e-file and e-pay allow. Notably, with e-file, return errors can be detected and corrected before the return is submitted, and taxpayers can receive an official acknowledgement when their returns have been received. Moreover, e-filed tax returns and electronic payments can be processed more efficiently and cost-effectively than paper filings, often resulting in faster refunds and payment postings.

Budget Implications:

Enactment of this bill would be necessary to implement the FY 2020 Executive Budget.

Effective Date:

The bill would take effect immediately.

Part B – Expand the Employee Training Incentive Program (ETIP) Credit

Purpose:

This bill would amend the Employee Training Investment Program ("ETIP") in the Economic Development Law to expand the definition of eligible training.

Summary of Provisions and Statement in Support:

The bill would amend Economic Development Law §§ 441, 442, and 443, respectively, to allow business entities to receive the tax credit associated with ETIP if they conduct training and are otherwise eligible. It also would expand the definition of eligible training to include an internship program in software development or the development of renewable or clean energy.

To date, ETIP has been underutilized by the business community because of the limitations associated with the requirement that applicants must procure training services from a third-party provider to be eligible to receive tax credits. The proposed legislation would remove this requirement, allowing business entities to become eligible for the ETIP tax credit if they conduct otherwise eligible training activities.

Budget Implications:

Enactment of this bill is necessary to implement the FY 2020 Executive Budget because it would allow the Employee Training Incentive Program to be better utilized.

Effective Date:

This bill would take effect immediately.

Part C - Provide a Sourcing Rule for GILTI Apportionment

Purpose:

This bill would codify a receipts factor rule for the net amount of global intangible low-taxed income ("GILTI") included in business income.

Summary of Provisions and Statement in Support:

Internal Revenue Code ("IRC") § 951A(a) requires GILTI, as defined in IRC § 951A(b)(1), to be included in federal gross income. IRC § 250(a)(1)(B)(i) allows certain taxpayers a deduction for part of this income. (For real estate investment trusts, regulated investment companies and New York S corporations the income is included, but the deduction is not available; therefore, the net amount equals the total amount of GILTI.)

The net amount of GILTI is included in entire net income under Article 9-A. Where such amount is taxable business income, it should be included in the business apportionment factor to properly reflect the taxpayer's business income and capital in the state. Since the apportionment statute currently has no sourcing rule for this income, the Commissioner has authorized a discretionary adjustment to the apportionment rules so that 100% of the net amount of GILTI be included in the denominator of the apportionment fraction, with zero in the numerator, and has required that this amount be reported on the receipts factor discretionary adjustment line.

This legislation would codify the Commissioner's discretionary adjustment to establish a permanent statutory sourcing rule for GILTI by adding a new subdivision 5-a to Tax Law § 210-A, and to New York City Administrative Code § 11-654.2, to define "net global intangible low-taxed income" and require that the net amount be added to the denominator of the apportionment fraction, with zero added to the numerator.

Budget Implications:

Enactment of this bill is necessary to implement the FY 2020 Executive Budget because it would codify current tax treatment of GILTI.

Effective Date:

This bill would take effect immediately and apply to taxable years beginning on or after January 1, 2018.

Part D - Decouple from IRC Federal Basis for NYS Manufacturing Test

Purpose:

This bill would decouple New York State from the federal adjusted basis for property used to determine whether a manufacturer is a qualified New York manufacturer.

Summary of Provisions and Statement in Support:

The test for determining whether a manufacturer is a qualified New York manufacturer—for purposes of the reduced corporate business income base tax rate, the reduced tax rate and cap on the capital tax base, lower fixed dollar minimum tax amounts, and the manufacturer's real property tax credit—includes thresholds set at the amount of the taxpayer's basis in its property in New York State.

Currently, the statutory test uses the federal adjusted basis of the taxpayer's property in the state. Recent federal law has increased the limitation on the amount expended on property that taxpayers may elect to treat as an expense under the Internal Revenue Code, potentially reducing the federal adjusted basis of such property. As a result, the basis amount used for purposes of the manufacturing test may not properly reflect the extent of the taxpayer's ownership of manufacturing property in New York State.

This legislation would amend Tax Law § 210(1)(a)(vi) and (b)(2); and New York City Administrative Code § 11-654(1)(k)(4)(ii) to use the New York State adjusted basis, instead of the federal adjusted basis:

Budget Implications:

Enactment of this bill is necessary to implement the 2020 Executive Budget. It has no impact on the State's Financial Plan.

Effective Date:

This bill would take effect immediately and apply to taxable years beginning on or after January 1, 2018.

Part E - Extend the Workers with Disabilities Tax Credit for Three Years

Purpose:

This bill would extend the sunset dates for the corporate and personal income tax credits for qualified employers that employ individuals with developmental disabilities. until January 1, 2023.

Summary of Provisions and Statement in Support:

The bill would amend section 5 of part MM of Chapter 59 of the Laws of 2014 to extend the repeal date for the corporate and personal income tax credits provided for in Tax Law §§ 210-B and 606, respectively, for qualified employers that employ individuals with developmental disabilities until January 1, 2023.

The current corporate and personal income tax credits for qualified employers that employ individuals with developmental disabilities expire January 1, 2020.

Budget Implications:

Enactment of this bill is necessary to implement the FY 2020 Executive Budget because it would decrease All Funds revenue by $4 million annually in FY 2022 through FY 2024.

Effective Date:

This bill would take effect immediately.

Part F – Extend Three-Year Gift Addback Rule & Require Binding NYS QTIP Election

Purpose:

This bill would amend the estate tax to require an executor to make a qualified terminable interest property (QTIP) election on a decedent's New York State estate tax return in order to claim a marital deduction for such property passing to the decedent's spouse, whether or not a federal estate tax return was required to be filed. The bill would expressly require inclusion of the value of QTIP property remaining in the surviving spouse's New York estate if a previous marital deduction was allowed on a New York return with respect to the transfer of such property to the spouse.

The bill would also extend to January 1, 2026, the expiration of the requirement that gifts that are taxable for federal gift tax purposes and that are made within three years of death are to be added back when calculating the decedent's New York gross estate.

Summary of Provisions and Statement in Support:

Generally, as a result of a QTIP election in the estate of the first spouse to die, the QTIP property that passes in trust to a surviving spouse is eligible for the marital deduction and excluded from the estate of the first spouse, and subsequently included in the estate of the surviving spouse.

Part X of Chapter 59 of the Laws of 2014 (Chapter 59) instituted broad estate tax reform, including the addition of new Tax Law § 955(c), which specifies the manner by which a QTIP election is made by the transferring spouse's estate for New York estate tax purposes. The election must be reflected directly on the New York estate tax return and must match the election taken on a required federal estate tax return or, if no federal return is required, it may be independently taken on the New York return.

Historically, New York has determined whether a QTIP election has been made by looking at the actual federal estate tax return filed for the estate of the first spouse to die or, if a federal estate tax return is not required to be filed, by looking to a pro forma federal return that is required to be filed with a New York estate tax return. However, in a recent Surrogate's court decision (*Matter of Evelyn Seiden*, Surrogate's Court, NY County, October 9, 2018), the court ignored the election made on the pro forma federal return filed for the estate of the first spouse because the first spouse died in 2010, when there was no federal estate tax in effect (The federal estate tax for the year 2010 was repealed by Section 501 of the Economic Growth and Tax Relief Reconciliation Act of 2001). Under Tax Law § 954(c)'s cross referencing provisions, a resident decedent's New York gross estate is defined by the decedent's federal gross estate, which under IRC § 2044 includes property for which a marital deduction was previously allowed. However, the Surrogate's court found that, since there was no federal estate tax in 2010, there could be no previously allowed marital deduction to trigger IRC § 2044's inclusion of the property in the surviving spouse's New York gross estate as per Tax Law § 954. As a result, New York estate tax was not paid by either estate on the property that would have been covered by the QTIP election.

In light of the fact that New York's estate tax will continue to diverge from the federal estate tax in effect in future years, it is important to clarify the manner by which a QTIP election must be reflected on a transferring spouse's New York estate tax return, in order to avoid inconsistent elections and potential revenue loss to the State. This bill would address this issue first by amending Tax Law § 954 to require that any QTIP property that benefited from a previous New York marital deduction must be included in the surviving spouse's New York gross estate, whether the QTIP election was made on the transferring spouse's New York estate tax return or via a federal pro forma return if an actual federal return was not otherwise required. In addition, this bill would amend Tax Law § 955 to require that the QTIP election for New York estate tax purposes be made on the New York estate tax return of the transferring spouse.

Chapter 59 also required certain gifts made on or after April 1, 2014, by a decedent who was a New York resident at the time of the gift to be included in the decedent's New York gross estate. This requirement was added to deter New York residents from transferring large amounts of wealth shortly before death solely to take advantage of the higher federal estate tax thresholds, while at the same time reducing their otherwise taxable New York estate. This gift addback provision was made inapplicable to decedents dying on or after January 1, 2019, because on that date the New York and federal estate tax thresholds were expected to coincide, eliminating the incentive for deathbed gifts. However, due to the enactment of the federal Tax Cuts and Jobs Act of 2017, there is a difference of approximately $5 million per individual between federal and state estate tax thresholds. This gap revives the need for the limited gift add back in order to prevent revenue losses from deathbed gifts. This bill would extend the sunset to decedents dying on or after January 1, 2026, the date the estate tax amendments made by the federal act are set to expire.

Budget Implications:

Enactment of this bill is necessary to implement the FY 2020 Executive Budget because it would preserve estate tax revenue.

Effective Date:

This bill would take effect immediately; provided however that section 1 would apply to estates of decedents dying on or after January 1, 2019 and sections 2 and 3 would apply to estates of decedents dying on or after April 1, 2019.

Part G – Eliminate Internet Tax Advantage

Purpose:

This bill would amend the Tax Law to require marketplace providers to collect sales tax on taxable sales of tangible personal property that they facilitate.

Summary of Provisions and Statement in Support:

This bill would require marketplace providers to collect sales tax on taxable sales of tangible personal property that they facilitate. It would ease sales tax collection burdens for many small businesses in the State, streamline the tax collection process, improve taxpayer compliance, and result in a level playing field for New York's "Main Street" retailers that compete with out-of-state sellers that do not collect tax on sales to New York customers made through marketplace providers.

The sales tax is a tax on the customer that is collected by the seller. The Department has long had the authority to impose a tax-collection responsibility on a party that facilitates a sale by, among other things, collecting the sales price and tax due from the customer, such as auctioneers, consignment shops and stores with leased departments. This bill builds on that concept by treating large marketplace providers that facilitate sales of tangible personal property as persons required to collect tax on such sales, thereby requiring them to perform all the duties of a vendor, including collecting the tax, filing a tax return, and remitting the tax collected. The bill defines a "marketplace provider" as a person who collects the purchase price, and provides the forum, physical or virtual, where the transaction occurs. To minimize the number of persons who have tax collection responsibilities, the bill relieves sellers using marketplace providers of any such responsibilities, as long as the seller receives in good faith a certification from the marketplace provider on a form authorized by the Department that the marketplace provider is collecting the tax on such transactions. In fact, a seller of tangible personal property that makes all of its sales through marketplace providers who certify that they will collect the tax would have no New York sales tax collection and remittance responsibilities.

Sales tax collection by the marketplace provider would reduce the number of small sellers that need to register for tax, improve tax compliance by reducing the number of persons who handle sales tax payments before they are remitted to the Department, and reduce the compliance burden of small registered vendors.

The bill would be effective immediately and apply to sales made on or after September 1, 2019.

Budget Implications:

Enactment of this bill is necessary to implement the FY 2020 Executive Budget because it would increase All Funds receipts by $125 million in FY 2020 and $250 million annually thereafter.

Effective Date:

This bill would take effect immediately and would apply to sales made on September 1, 2019.

Part H – Discontinue the Energy Services Sales Tax Exemption

Purpose:

This bill would repeal the exemption from sales and use taxes for receipts from transportation, transmission, or distribution of gas or electricity when provided by someone other than the vendor of the gas or electricity.

Summary of Provisions and Statement in Support:

Tax Law §§ 1101(b) and 1105(b) impose sales tax on the transportation, transmission, or distribution of gas or electricity. Tax Law § 1105-C reduces the rate of tax on the transportation, transmission or distribution of gas and electricity to zero where it is sold separately from the commodity. This provision was enacted to promote competition after the utility deregulation of the late 1990s by providing an incentive for customers to purchase gas and electricity from third-party energy service companies, often referred to as energy service companies (ESCOs). Consequently, customers who purchase gas or electric service from a utility company pay sales tax on the transportation, transmission or delivery, while customers who purchase from an ESCO do not.

Today, competition among ESCOs is well developed. New York utilities offer multiple alternative ESCO gas and electricity suppliers. This exemption perpetuates unequal treatment among utility customers. For example, a business purchasing its electricity from a local utility company will pay sales tax on its total electric or gas bill, while another business purchasing gas or electricity from an ESCO will pay sales tax only on the gas or electricity, and not on the transportation, transmission or distribution of that gas or electricity.

This bill would remove this disparity by repealing the exemption for transportation, transmission and distribution charges associated with gas and electricity purchased from an ESCO. As a result, sales tax would apply to charges for transporting, transmitting, or distributing taxable gas or electricity, whether the commodity is purchased from an ESCO or a utility company. The bill would also clarify that transportation, transmission and distribution charges are taxable even if sold separately from gas or electricity.

New York City de-coupled from the State's exemption in 2009 and currently imposes its 4.5% sales tax on the transportation, transmission or distribution of taxable gas and electricity, regardless of the type of entity from which the commodity is purchased. This would remain unchanged. Although the bill would repeal New York City's separate authorization and imposition of sales tax on these services, they would remain taxable because the New York City local sales tax follows the state sales tax except where specific exceptions are authorized and adopted.

Budget Implications:

Enactment of this bill is necessary to implement the 2020 Executive Budget because it would increase All Funds receipts by $96 million in FY 2020 and $128 million annually thereafter.

Effective Date:

This bill would take effect June 1, 2019, and would apply to sales made and services rendered on or after that date, whether or not under a prior contract.

Part I – Continue efforts to avoid large, unexpected tax shifts due to equalization rate changes

Purpose:

This bill would provide additional tools for school districts and local governments to avoid large, unexpected tax shifts due to equalization rate changes.

Summary of Provisions and Statement in Support:

A series of measures were recently enacted into law in response to situations where there had been large and unexpected increases in school tax bills due to equalization rate changes (*see* Chapters 115, 116, 132 of the Laws of 2018). This bill would recognize the value of those efforts and supplement them in several respects.

Section 1 of this bill would make a technical correction to the recent law that requires assessors to provide notice to various local officials when the equalization rate differs from the locally stated level of assessment (LOA) by "five percentage points" or more (Real Property Tax Law §1204(3), as amended by L.2018, c.115). This is appropriate and effective where the LOA is at or close to 100%, but less so when the LOA is low. For example, where the LOA is 10%, the "five percentage points" standard means that a notice would only be required where the equalization rate was below 5% or above 15%, representing a net disparity of 50%. The intent was presumably to require notice in such an instance where the rate is less than 9.5% or above 10.5%, a net disparity of 5%. To achieve this, this bill would replace "five percentage points" with "five percent."

Section 2 of the bill would provide that when the Commissioner of Taxation and Finance has confirmed the locally stated level of assessment, he or she shall establish it as the final State equalization rate for the city, town or village as soon thereafter as is practicable. When the State and the local assessor agree up front as to what the local level of assessment is, as they do in the vast majority of cases, there is no need for a tentative rate or administrative review period. However, the law was never updated to recognize the collaborative approach the Department now takes, so these cumbersome and time-consuming mandates are still on the books. Eliminating them will make it possible for the vast majority of equalization rates to be finalized in May or June or each year, allowing school authorities to see the impacts on their tax bills much earlier and giving them time to look for ways to ameliorate those impacts.

Section 3 would allow a school district to ameliorate equalization rate impacts by directing school taxes to be apportioned based upon average property values over either a three-year or a five-year period. Current law requires the calculation to be based solely on current values, which under certain circumstances can cause dramatic tax shifts within the school district. This averaging option would enable school districts to avoid these sudden shifts, reducing or eliminating the "sticker shock" their taxpayers might otherwise experience.

Budget Implications:

Enactment of this bill is necessary to implement the FY 2020 Executive Budget.

Effective Date:

This bill would take effect immediately.

Part J – Make real property tax administration more effective and efficient

Purpose:

This bill would make real property tax administration more effective and efficient in various respects. In particular, it would:

A. Allow local governments to provide real property tax assessment relief when a disaster is declared without the State Legislature having to pass special legislation.
B. Allow a county and an assessing unit to agree that the local legislative body of a count shall appoint the members of the Board of Assessment Review that will hear and resolve assessment complaints within that assessing unit.
C. Allow the Tax Department to approve assessor and county director training courses for credit without obliging the State to pay for the expenses of attendees, when the provider so requests.
D. Allow the Tax Department to send certain statutory notices by email and/or by a website posting, rather than by postal mail.
E. Changes the valuation date and taxable status date for special franchise property to eliminate the need for mid-year reporting.
F. Require electric generating facilities to annually report inventory, revenue, and expense data to the Tax Department to assist the Department in valuing these highly complex properties.

Each of these objectives is embodied in a separate subpart of this bill, resulting in six subparts in total. A detailed description of each follows.

SUBPART A: Authorize Local Option Assessment Relief Upon the Declaration of a State Disaster Emergency

Summary of Provisions and Statement in Support:

In the past several years, an unusual number of powerful storms have caused widespread damage to properties in New York. These storms, and the resulting damage, have prompted the legislature to adopt special legislation allowing local governments to reduce the assessed value of damaged properties. For example, Superstorm Sandy resulted in the Superstorm Sandy Assessment Relief Act (Chapter 424 of the Laws of 2013); severe weather led to the enactment of the Mohawk Valley and Niagara County Assessment Relief Act (Part T of Chapter 55 of the Laws of 2014); and extensive flooding resulted in the enactment of the Lake Ontario and Connected Waterways Assessment Relief Act (Part B of Chapter 85 of the Laws of 2017). This proposal would allow local governments to provide real property assessment relief as soon as a disaster emergency is declared. The State Legislature would no longer need to enact special legislation for this purpose, so impacted property owners could obtain relief sooner, especially when a disaster occurs after the end of the legislative session.

Under existing law, real property is valued by local governments as of a specific "valuation date" – generally the date the prior year's final assessment roll was finalized, *i.e.* July 1. A property's value can be adjusted by the local assessor to account for a disaster emergency after the valuation date until the "taxable status date" – generally March 1. However, after the taxable status date, an assessor can only adjust property values to correct certain specific factual or clerical errors: even if a disaster results in a 100% loss of all improvements to a property, if it occurs after the taxable status date a property owner would still have to pay tax on the parcel as it was valued on the taxable status date.

Under this proposal, counties, cities, towns, assessing villages, and school districts could, at local option, grant assessment relief to properties that are damaged as a result of a disaster emergency even if the damage occurs after the taxable status date. An eligible municipality that opts in has the further option of offering relief to those whose buildings and other property improvements lost less than 50% of their value. If the municipality opts into the legislation without opting to offer relief at levels below 50%, the relief would only be available to those whose buildings and other property improvements lost 50% or more of their value.

Budget Implications:

Enactment of this bill is necessary to implement the FY 2020 Executive Budget.

Effective Date:

This subpart would take effect immediately.

SUBPART B: Authorize the creation of county-level Boards of Assessment Review at local option

Summary of Provisions and Statement in Support:

Each assessing unit has a Board of Assessment Review (BAR) that is responsible for hearing and resolving assessment complaints for that assessing unit. County Directors of Real Property Tax Services provide training and support to BAR members. They report that staffing issues commonly afflict BARs, particularly in small towns, where it can be difficult to find enough qualified people willing to devote the time that the position requires. If a BAR is short-staffed and/or some of its members have personal conflicts, then, in the worst case scenario, Grievance Day could not be held due to the lack of a quorum.

Under Real Property Tax Law (RPTL) § 579, counties are authorized to provide assessment-related services to assessing units by entering into an inter-municipal agreement for that purpose pursuant to Article 5-G of the General Municipal Law. Specifically, where the county and the assessing unit have an inter-municipal agreement so providing, the county may value property (appraisal services), may process exemption applications (exemption services), and may even fully assume the assessing function (assessment services).

County Directors have recommended that counties be permitted to set up BARs for assessing units at local option, in the belief it will make BARs more professional and greatly reduce the problems they commonly encounter. This bill would expand RPTL § 579 to allow a county and an assessing unit to agree to do so.

Budget Implications:

Enactment of this bill is necessary to implement the FY 2020 Executive Budget.

Effective Date:

This subpart would take effect immediately.

SUBPART C: Allow assessor training courses to be approved for credit without obliging the State to pay for the expenses of attendees, at the provider's request

Summary of Provisions and Statement in Support:

Assessors and county directors of real property tax services are required by law to take courses of training as approved by the Tax Department. The State must reimburse them for the travel and other actual and necessary expenses associated with the courses that they successfully complete.

Since the funds available for this purpose are limited, the Department must ensure that these dollars go as far as possible. As a practical matter, this means that the Department does not grant credit for courses offered to assessors during the Annual Meeting of the Association of Towns in New York City each February. The content of these courses is not the obstacle. The obstacle is that State reimbursement would be required if the courses were approved for credit, and the cost of travel, lodging and meals associated with this event make State reimbursement unfeasible.

Some assessors, recognizing the State's fiscal concerns, but believing this training is worthwhile nonetheless, informally asked the Department if it could find a way to provide credit for this particular program without also providing reimbursement. As much as the Department might like to do so, it cannot under the law as it currently reads. This bill would modify the law to allow the Department to approve assessor training courses for credit only, without committing the State to reimburse attendees for their expenses, where the provider asks the Department to do so.

The bill would also clarify that persons who have been appointed to serve as assessors, but whose term of office has not yet begun, may receive reimbursement for successfully completing training. The law explicitly allows reimbursement for training taken by elected assessors prior to the start of their terms (Real Property Tax Law § 318(4)). It similarly provides reimbursement to appointees to the position of county director of real property tax services prior to the start of their terms (RPTL § 1530(3)(f)). In context, then, the failure of the law to provide for reimbursement to appointed assessors prior to the start of their terms is clearly an oversight.

Budget Implications:

Enactment of this bill is necessary to implement the FY 2020 Executive Budget.

Effective Date:

This subpart would take effect immediately.

SUBPART D: Allow certain statutory notices to be sent by email and/or by a website posting, rather than by postal mail

Summary of Provisions and Statement in Support:

Upon the determination of tentative equalization rates, tentative special franchise assessments, tentative telecommunications ceilings and the like, the Tax Department is required to mail notice of the determination to the affected assessing unit and, if applicable, to the affected property owner. This bill would provide that, as of January 1, 2020, these notices could be provided by email or by a website posting, rather than by postal mail. Assessors who prefer to receive these notices by postal mail would be entitled to continue receiving postal mail, as long as they so notify the Commissioner in writing. The Commissioner would be required to prescribe a form for this purpose.

The Commissioner would also be required to send a notice by postal mail to assessors, municipal CEOs and special franchise and railroad property owners by November 30, 2019, advising them of the provisions of this new law. The copy to be sent to assessors would include a copy of the opt-out form.

The enactment of this bill would largely relieve the Department of a costly and labor-intensive printing and mailing mandate that, in this day and age, serves no purpose. Most assessors, and all special franchise, telecommunications and railroad companies, have ready access to email and consistently use it to conduct business. However, those assessors who do not have the ability or desire to switch to a fully electronic notification system would not be obliged to do so.

Budget Implications:

Enactment of this bill is necessary to implement the FY 2020 Executive Budget.

Effective Date:

This subpart would take effect immediately.

SUBPART E: Change Special Franchise Taxable Status Date

Summary of Provisions and Statement in Support:

Under RPTL § 302(4), utility companies that own special franchise property generally have their special franchise property valued as of July 1 of the prior year. This valuation date results in companies reporting their inventory data (used to assist in the valuation of property) to the Tax Department in the middle of the year. This mid-year reporting is not only burdensome, but can be problematic for both utility companies and the Tax Department because mid-year data is often incomplete and must be supplemented at a later date. Furthermore, RPTL § 606(2) arguably conflicts with RPTL § 302(4) by providing that, in any assessing unit that has completed a revaluation since 1953, special franchise property is valued based on the valuation date of the assessing unit.

This bill would amend both of the above-referenced RPTL provisions to provide that special franchise property is to be inventoried and valued as of January 1 of the prior year. This would eliminate the complications caused by mid-year reporting, and would resolve any conflict between the valuation dates contained in RPTL §§ 302(4) and 606(2).

Budget Implications:

Enactment of this bill is necessary to implement the FY 2029 Executive Budget.

Effective Date:

This subpart would take effect on January 1, 2020.

SUBPART F: Require Filing of Electric Generating Facility Inventory and Income Report

Summary of Provisions and Statement in Support:

Under existing law, no real property transfer report (RP-5217) is required to be filed when electric generating facilities (power plants) are sold because those transactions almost universally involve equity sales, i.e., a purchase of the business entity that owns the power plant, not the power plant itself. Since no real property is conveyed, no deed is required to be filed, and therefore the only indication of the sales price is on a tax return subject to secrecy provisions.

The Tax Department is required by law to provide advisory appraisals to local governments in certain situations. It is not uncommon for local governments to ask for assistance in valuing electric generating facilities. Due to a lack of publicly available information about power plant sales prices and inventory, it is exceedingly difficult for both local assessors and the Tax Department to value power plants. This legislation would provide the Tax Department with the information needed to accurately value electric generating facilities.

Budget Implications:

Enactment of this bill is necessary to implement the FY 2020 Executive Budget.

Effective Date:

This subpart would take effect on January 1, 2020.

Part K – Technical cleanup related to repeal of tax freeze credit program

Purpose:

This bill would repeal certain tax cap compliance reporting requirements that were left in place when the obsolete tax freeze credit statutes were repealed in 2018.

Summary of Provisions and Statement in Support:

Former Tax Law § 606(bbb), former General Municipal Law § 3-d and former Education Law § 2023-b collectively constituted the enabling legislation for the tax freeze credit program. Since the program was applicable only to taxable years 2014, 2015 and 2016, these statutes were repealed by sections 1, 1-a and 1-b of part E of Chapter 59 of the Laws of 2018, effective April 15, 2020.

At the same time, sections 2 and 3 of part E of Chapter 59 of the Laws of 2018 enacted a new General Municipal Law § 3-d and Education Law § 2023-b, also effective April 15, 2020, in order to preserve the reporting requirements that had been contained within the original statutes. It has been determined that the reporting requirement preserved by the new General Municipal Law § 3-d serves no statutory purpose. Therefore, this bill would repeal that statute, retroactive to the date on which it was initially enacted

Budget Implications:

Enactment of this bill is necessary to implement the FY 2020 Executive Budget.

Effective Date:

This bill would take effect immediately and be deemed to have been in full force and effect on and after April 12, 2018, the date on which Chapter 59 of the Laws of 2018 took effect.

Part L – Create the NYS Employer-Provided Child Care Credit

Purpose:

This bill would create the NYS Employer-Provided Child Care Credit to assist employers in providing quality child care services to their employees.

Summary of Provisions and Statement in Support:

Under Internal Revenue Code § 45F, employers are allowed a credit for qualifying expenditures paid or incurred in providing child care alternatives for their employees. This bill would provide a similar state tax credit for New York employers to provide child care for their employees located in New York. The credit would be equal to 25% of qualified child care expenditures related to a child care facility located in New York, plus 10% of qualified child care resources and referral expenditures, attributable to employees working in New York, and, like the federal credit, would be capped at $150,000 per taxable year. Qualified child care expenditures include operating costs of a qualified child care facility of the taxpayer or under contract with another taxpayer, as well as amounts paid or incurred to acquire, construct, rehabilitate, or expand property used as part of a care facility of the taxpayer. Qualified child care resource and referral expenditures are amounts paid or incurred under a contract to provide child care resource and referral services to an employee of the taxpayer.

Budget Implications:

Enactment of this bill is necessary to implement the FY 2020 Executive Budget because it would decrease All Funds revenue by $1 million annually beginning in FY 2022.

Effective Date:

This bill would take effect immediately and apply to taxable years beginning on or after January 1, 2020.

Part M – Include Certain NYS Gambling Winnings in Nonresident NYS Income

Purpose:

This bill would include gambling winnings in excess of $5,000 from wagering transactions within New York State in the definition of nonresident New York Source income, and add a requirement that withholding occur on gambling winnings when such withholding is required at the federal level.

Summary of Provisions and Statement in Support:

The bill would amend Tax Law § 631(b) to add gambling winnings from wagering transactions within New York State in excess of $5,000 to the categories of New York source income that are taxable to nonresidents of New York State. The statute also amends Tax Law § 671(b) to require withholding on gambling winnings from wagering transactions occurring in New York State when such proceeds are subject to withholding under I.R.C. § 3402.

Most other states include gambling winnings from within their states as source income for nonresidents. By taxing these winnings, New York would garner revenue that is currently exported to other states.

Budget Implications:

Enactment of this bill is necessary to implement the FY 2020 Executive Budget because it would increase All Funds revenue by $1 million annually beginning FY 2021.

Effective Date:

This bill would take effect immediately and apply to taxable years beginning on or after January 1, 2019.

Part N – Make Technical Changes to the Farm Workforce Retention Credit

Purpose:

This bill would amend to the farm workforce retention credit to allow the credit for the same farming activities eligible for the farmers school tax credit.

Summary of Provisions and Statement in Support:

Tax Law § 42 provides a farm workforce retention credit to individuals and corporations that is equal to $250–$600 per employee depending on the taxable year for which the credit is claimed. This bill would expand the credit to additional farming operations that are currently eligible to receive the farmers' school tax credit (Tax Law § 606[n]), such as cider production and Christmas tree farming, by conforming the definition of "federal gross income from farming" in Tax Law § 42 to the definition used in Tax Law § 606(n). Additionally, because licensed "farm cideries" and "farm wineries" may have operations in urban, non-agricultural areas of the state, the bill would also allow the farm workforce retention credit to be available to these entities, but only for those employees who are employed on qualified agricultural property as defined in Tax Law § 606(n). These amendments recognize the increasing diversity of agriculture and the growing significance of certain value-added enterprises in New York State. This bill would encourage economic development and job creation and retention in rural communities.

Budget Implications:

Enactment of this bill is necessary to implement the FY 2020 Executive Budget because it will promote equitable treatment of farm businesses.

Effective Date:

This bill would take effect immediately and apply to taxable years beginning on or after January 1, 2019.

Part O – Permanently Extend the Tax Shelter Provisions and Update Tax Preparer Penalties

Purpose:

This bill would make permanent the current tax shelter reporting and penalty provisions and would update the tax preparer penalties for preparers who do not sign returns or who take unreasonable positions on returns.

Summary of Provisions and Statement in Support:

New York's tax shelter penalty and reporting requirements, which are modeled after the federal tax shelter provisions in the Internal Revenue Code, were first added to the Tax Law as temporary provisions in 2005, and have been renewed several times thereafter on a temporary basis. This bill would make these tax shelter penalty and reporting requirements permanent.

This bill would also update the Tax Law provisions governing penalties for tax preparers to 1) clarify the penalties against preparers who take positions on returns or claims that are not properly supported by the Tax Law; and 2) ensure that the penalties for failing to sign a return and for failing to provide a required identification number on a return apply to all tax preparers, regardless of whether they are required to be registered with DTF pursuant to Tax Law § 32.

Budget Implications:

Enactment of this bill is necessary to implement the FY 2020 Executive Budget.

Effective Date:

This bill would take effect immediately.

Part P – Extend Higher PIT Rates for Five Years

Purpose:

This bill would extend the top tax bracket under the personal income tax law for five years.

Summary of Provisions and Statement in Support:

This bill would amend the Tax Law to extend for five years the top tax bracket under the personal income tax. Currently the top tax bracket, with a rate of 8.82%, is scheduled to expire for taxable years beginning after 2019. This bill would extend the higher bracket for taxable years 2020, 2021, 2022, 2023 and 2024.

Budget Implications:

Enactment of this bill is necessary to implement the 2020 Executive Budget because it would increase All Funds revenue by $771 million in FY 2020, $3.6 billion in FY 2021, $4.8 billion in FY 2022, and $5.5 billion in FY 2023.

Effective Date:

This bill would take effect immediately.

Part Q – Extend PIT Limitation on Charitable Contributions for Five Years

Purpose:

This bill would extend, for five years, the charitable deduction limitation under the NYS and NYC personal income tax for individuals with adjusted gross income of more than $10 million.

Summary of Provisions and Statement in Support:

This bill would amend Tax Law § 615(g) to extend, for five years, the current limitation on the itemized charitable contribution deduction for individuals with adjusted gross income of more than $10 million. Under current law, the NY itemized charitable deduction is limited to 50% of the federal deduction for individuals with adjusted gross income between $1 million and $10 million, and to 25% of the federal deduction for individuals with adjusted gross income over $10 million. The 25% limitation is set to expire at the end of 2019, after which all individuals with adjusted gross income over $1 million will be subject to the 50% limitation.

This bill will extend the current 50%/25% limitation structure through 2024 and make conforming amendments to NYC Administrative Code §11-1715(g).

Budget Implications:

Enactment of this bill is necessary to implement the FY 2020 Executive Budget because it would increase All Funds revenue by $86 million in FY 2021, $175 million in FY 2022, and $180 million in FY 2023.

Effective Date:

This bill would take effect immediately.

Part R – Extend the Clean Heating Fuel Credit for three years

Purpose:

This bill would extend the sunset dates for the corporate and personal income tax credits for purchasing bioheating fuel for residential purposes until January 1, 2023.

Summary of Provisions and Statement in Support:

The bill would amend Tax Law §§ 210-B and 606 to extend the sunset date for the corporate and personal income tax credits, respectively, for purchasing bioheating fuel for residential purposes until January 1, 2023. The credit is equal to $.01 per percent of biodiesel fuel not to exceed 20 cents per gallon, purchased by the taxpayer.

The current corporate and personal income tax credits for the purchase of bioheating fuel expire January 1, 2020. This extension supports the use of clean energy in homes.

Budget Implications:

Enactment of this bill is necessary to implement the FY 2020 Executive Budget because it would decrease All Funds revenue by $6 million annually in FY 2022 through FY 2024.

Effective Date:

This bill would take effect immediately.

Part S – Extend Authorization to Manage Delinquent Sales Tax Vendors Permanently

Purpose:

This bill would make permanent certain provisions concerning the segregated sales tax account program.

Summary of Provisions and Statement in Support:

Vendors are required by law to collect, truthfully account for, and pay over sales tax moneys, and to file returns. Where the Tax Commissioner deems it necessary to protect sales tax revenues, a noncompliant vendor may be required to deposit the sales tax it collects into a segregated account, in trust for the State, until otherwise notified.

Part U of Chapter 61 of the Laws of 2011 expanded the Commissioner's authority with respect to the segregated accounts program by amending Tax Law § 1137 to authorize the Commissioner to debit segregated accounts, to require a vendor to deposit the sales tax moneys at least weekly, and to require the vendor to obtain a bond if the vendor failed to comply. Part U also amended Tax Law § 1134 to authorize the Commissioner to suspend or revoke a vendor's sales tax certificate of authority if the vendor did not comply with the segregated accounts program's requirements.

The segregated account provisions added by Part U expire on December 1, 2019. Since their implementation in 2011, these provisions have improved vendor compliance and reduced the need to pursue costly collection actions when sales tax collected by vendors is not remitted timely to the Department. This bill would repeal the sunset date to allow the current provisions to remain in place and ensure the Department may continue to safeguard sales tax revenues collected by noncompliant vendors.

Budget Implications:

Enactment of this bill is necessary to implement the FY 2020 Executive Budget because it preserves the cost savings from the segregated account program.

Effective Date:

This bill would take effect immediately.

Part T – Repeal License Fees on Certain Co-Ops

Purpose:

This bill would amend the cooperative corporations law and the rural electric cooperative law to eliminate a ten-dollar annual fee paid by cooperative corporations and rural electric cooperatives.

Summary of Provisions and Statement in Support:

The bill would amend Cooperative Corporations Law § 77(3) and Rural Electric Cooperative Law § 66, respectively, to make the ten-dollar annual fee in lieu of franchise or license or corporation taxes, in the case of a cooperative corporation, and the ten-dollar annual fee in lieu of franchise, excise, income, corporation, and sales and compensating use taxes, in the case of a rural electric cooperative, not payable after January 1, 2020.

These fees are not cost-effective as DTF incurs costs to perpetuate and process the forms and filings, but has collected only $250 in fees in the last two years.

Budget Implications:

Enactment of this bill is necessary to implement the 2020 Executive Budget to reduce the administrative burden on DTF.

Effective Date:

This bill would take effect immediately.

Part U – Expand the Current Historic Rehabilitation Credit

Purpose:

This bill would allow the credit for rehabilitation of historic properties to be claimed for qualified rehabilitation projects undertaken within a state park, state historic site, or other land owned by the state, that is under the jurisdiction of and leased to private entities by the Office of Parks, Recreation and Historic Preservation (OPRHP), regardless of the census tract location of the rehabilitation project.

This bill, therefore, would incentivize private sector investment in unused and underutilized historic properties owned by the State in such locations.

Summary of Provisions and Statement in Support:

This bill would amend Tax Law §§ 210-B(26)(e), 606(oo)(5) and 1511(y)(5) to allow a taxpayer subject to tax under Article 9A, the Business Corporation Franchise Tax, Article 22, the Personal Income Tax and Article 33, the Insurance Corporation Franchise Tax, to claim a tax credit for the rehabilitation of historic properties under the jurisdiction of OPRHP that is a qualified rehabilitation project, regardless of the property's census tract location.

Under current law, one of the requirements to qualify for the rehabilitation of historic properties tax credit is that the property must be located within an eligible census tract. Presently, many properties under OPRHP jurisdiction could benefit from rehabilitation through private sector investment using tax credit incentives but the properties are located outside of qualified census tracts. This amendment would allow properties across the State leased to businesses, such as at the Gideon Putnam Hotel in Saratoga Spa State Park, the bathhouses at Jones Beach, and the historic estate buildings at Knox Farm State Park outside of Buffalo, to be eligible for the tax credit which, in turn, would spur interest in investing in their rehabilitation. Promoting investment to rehabilitate and reuse historic properties is the best way to preserve them for future generations.

Budget Implications:

Enactment of this bill is necessary to implement the 2020 Executive Budget.
Effective Date:

This bill would take effect immediately and apply to taxable years beginning on or after January 1, 2020.

Part V – Extend certain sales tax exemption related to the Dodd-Frank Protection Act.

Purpose:

To extend for two years the exemption from sales and use tax certain sales or services transacted between certain financial institutions and their subsidiaries.

Summary of Provisions and Statement in Support:

This bill would extend the sales tax exemption provided to financial institutions that are required under the Dodd-Frank Wall Street Reform and Consumer Protection Act to create subsidiaries and then transfer the property or services to those subsidiaries without the transfer being considered a taxable sale. The bill would extend the date by which transfers must be made, or a binding contract entered into, from June 30, 2019 to June 30, 2021.

Budget Implications:

Enactment of this bill is necessary to implement the FY 2019-20 Executive Budget because it continues the date by which transfers can occur until June 30, 2021.

Effective Date:

This bill would take effect immediately.

Part W – Employer Recovery Hiring Tax Credit

Purpose:

This bill would amend the Mental Hygiene Law and the Tax Law in relation to the creation and administration of a tax credit for the employment of eligible individuals in recovery from a substance use disorder.

Summary of Provisions and Statement in Support:

Individuals with a history of substance use disorder face many obstacles in sustaining their recovery. Understanding that a significant barrier to maintaining their recovery is access to employment opportunities, this tax credit would incentivize businesses to hire individuals with such a history. New York's investment through a tax credit would also assist the State by creating a recovery-oriented culture in businesses and local communities.

The bill would add a new Mental Hygiene Law § 32.38 and amend Tax Law §§ 210-B, 606, and 1511 to establish the Recovery Tax Credit program to provide tax incentives to certified employers for employing eligible individuals in recovery from a substance use disorder in part-time and full-time positions in New York State. The credit would be administered by the Office of Alcoholism and Substance Abuse Services. The bill would authorize the allocation of $2 million in refundable tax credits computed on a 1 dollar per hour worked per eligible employee basis, with a minimum requirement for each employee of 500 creditable hours worked and a cap for each employee of 2000 creditable hours worked. Qualifying employers must have a formal working relationship with a local recovery community organization and eligible employees must demonstrate they have completed a course of treatment for a substance use disorder and are in a state of wellness. The credit may be claimed only one time for each eligible employee.

Budget Implications:

Enactment of this bill is necessary to implement the FY 2020 Executive Budget because it would decrease All Funds revenue by $2 million annually beginning in FY 2022.

Effective Date:

This bill would take effect immediately and apply to taxable years beginning on and after January 1, 2020 and apply with respect to those eligible individuals hired after the act takes effect.

Part X – Exclude from Entire Net Income Certain Contributions to the Capital of a Corporation

Purpose:

This bill would amend the Tax Law and the New York City Administrative Code to exclude from entire net income certain contributions to the capital of a corporation.

Summary of Provisions and Statement in Support:

As part of the federal Tax Cuts and Jobs Act, effective December 22, 2017, Internal Revenue Code § 118(b) was amended to include contributions by a governmental entity or civic group to the capital of a corporation in federal gross income. Because of New York's federal conformity, in New York, this resulted in the inclusion of entire net income. Government grants treated as contributions to capital under the Internal Revenue Code are a useful economic development tool. This bill would restore New York's favorable non-tax treatment of these contributions by amending Tax Law §§ 208(9)(a) and 1503(b) and New York City Administrative Code § 11-602(8)(a) to exclude from entire net income any contributions to the capital of a corporation by any governmental entity or civic group.

Budget Implications:

Enactment of this bill is necessary to implement the 2020 Executive Budget. It has no impact on the State's Financial Plan.

Effective Date:

This bill would take effect immediately and apply to taxable years beginning on or after January 1, 2018.

Part Y – Close the carried interest loophole

Purpose:

This bill would close the carried interest tax loophole at the State level by taxing the carried interest income of hedge fund and private equity investors as ordinary earned income.

Summary of Provisions and Statement in Support:

Currently, the carried interest tax loophole in the Internal Revenue Code ("IRC") allows hedge fund investment managers and private equity investors to classify their distributive share of partnership or S corporation income received in exchange for investment management services as capital gains. As capital gains, these investment management fees, which can be sizeable, typically qualify as long-term capital gains for federal income tax purposes and are therefore taxed at a much lower rate than ordinary income. (This is typically referred to as carried interest.) Further, as a result of the federal characterization of these fees as capital gains from intangible assets, non-resident partners are not taxed on that income at the state level. (H.R. 1, enacted as Public Law 115-97, did not adequately address this problem because it only recharacterizes some of these gains as short term capital gains rather than ordinary income.)

This bill would recharacterize for New York State purposes the investment management income earned by partners and shareholders of hedge funds and private equity firms and would subject the amount of that income in excess of what the partner or shareholder would have received if it had not provided investment management services to tax as income earned from a trade or business.

In addition, the excess amount of income that is treated as income from a trade or business would be subject to a special 17 percent carried interest fairness fee. The fee would remain in effect until the IRC is amended to treat the provision of investment management services for federal tax purposes substantially the same as under this legislation. This bill would take effect only if Connecticut, New Jersey, Massachusetts and Pennsylvania enact legislation having substantially the same effect as this bill.

The recharacterization of the investment management income earned by partners and shareholders of hedge funds from capital gains to income earned from a trade or business would correct this inequity in the tax system at the State level until the problem is addressed at the federal level.

Budget Implications:

Enactment of this bill is necessary to implement the FY 2020 Executive Budget because it represents the first step necessary to achieve tax treatment parity between carried interest and other forms of earned income.

Effective Date:

This bill would take effect when the states of Connecticut, New Jersey, Massachusetts and Pennsylvania enact legislation having substantially the same effect as this act, and the enactments by such states have taken effect in each state and shall apply for taxable years beginning on or after such date; provided, however, if such enactments are already in effect in the states of Connecticut, New Jersey, Massachusetts and Pennsylvania, this act shall take effect immediately and shall apply for taxable years beginning on or after January 1, 2019; provided the Commissioner of Taxation and Finance shall notify the Legislative Bill Drafting Commission upon enactment of such legislation by the states of Connecticut, New Jersey, Massachusetts and Pennyslvania in order that such commission may maintain an accurate and timely effective database of the official text of the laws of the state of New York in furtherance of effectuating the provisions of section 44 of the Legislative Law and section 70-b of the Public Officers Law.

Part Z – Make technical corrections to various provisions of the Tax Law and the New York City Administrative Code

Purpose:

This bill would make technical corrections to various provisions of the Tax Law and the New York City Administrative Code.

Summary of Provisions and Statement in Support:

This bill would make needed technical corrections to various provisions of the Tax Law and the New York City Administrative Code.

- Section 1 would amend Tax Law § 43(a)(3) to clarify that if a taxpayer is a partner in a partnership that is a life sciences company or a shareholder of a New York S corporation that is a life sciences company, then the life sciences research and development tax credit is applied at the level of the entity. This bill would also correct two erroneous references in Tax Law § 43(c)(2) and (5).

- Section 2 would amend Tax Law § 209(5) to remove an outdated reference to the Internal Revenue Code ("IRC"). As part of the Tax Cuts and Jobs Act (TCJA), IRC § 857(b)(3) was amended to remove subparagraph (A), the *alternative tax on capital gains*, for real estate investment trusts ("REITs"). This bill would remove a reference to this now non-existent amount from the Tax Law § 209(5) definition of entire net income for REITs.

- Section 3 would amend Tax Law § 211(8)(a) to remove a reference to a provision of law, in Tax Law § 210, that was repealed by New York's corporate tax reform, effective 1/1/15, and also a reference to the *issuer's allocation percentage*, which is no longer used.

- Sections 4 and 5 would amend Tax Law § 213-b to remove an unnecessary provision related to estimated payments of the tax imposed under Tax Law § 209-B (the "MTA surcharge") that refers to S corporations, since the MTA surcharge does not apply to S corporations; to correct a reference to *New York S corporations*; and to correct *third month* to *fourth month* for the end date for interest paid to taxpayers on estimated tax overpayments, consistent with the change in return due dates enacted by Chapter 60 of the Laws of 2016.

- Section 6 would amend Tax Law § 1503 to revise the treatment of *policyholders surplus accounts*, reflecting changes to federal law, under TCJA, for taxable years 2018-2025.

- Sections 7 and 8 would amend New York City Administrative Code §§ 11-525 and 11-676 to replace *preceding* with *second preceding*, consistent with the change made by Chapter 60 of the Laws of 2016 to use the second preceding year's tax for purposes of estimated tax payments.

- Section 9 would amend the effective date of Chapter 369 of the Laws of 2018. TCJA amended the federal unrelated business income tax (UBIT) to include amounts paid by a non-profit to its employees for certain commuter transportation benefits in the non-profit's unrelated business taxable income. This change applies to amounts paid on or after December 31, 2017. Because New York's UBIT is federally conformed, Chapter 369 of the Laws of 2018 was enacted to decouple from the federal requirement to include these fringe benefits in taxable income. However, the Chapter 369 applies only to taxable years beginning on or after January 1, 2018. Thus, if a non-profit has a taxable year that begins after January 1, (eg. June 1), without this change in the Chapter 369 effective date, fringe benefits payments made by the non-profit between January 1, 2018 and the beginning of its next taxable year will be required to be included in New York unrelated business taxable income.

<u>Budget Implications</u>:

Enactment of this bill is necessary to implement the 2020 Executive Budget. It has no impact on the State's Financial Plan.

<u>Effective Date</u>:

This bill would take effect immediately.

Corrections would be deemed to have been in full force and effect as of the effective date of the following legislation: for section one, Part K of Chapter 59 of the Laws of 2017; for sections two and six, Part KK of Chapter 59 of the Laws of 2018; for section three, Part A of Chapter 59 of the Laws of 2014; for sections four, five, seven and eight, Part Q of Chapter 60 of the Laws of 2016; and for section 9, Chapter 369 of the Laws of 2018.

Part AA – Allow an Exemption from Real Property Taxation for Qualified Energy Systems

Purpose:

The purpose of this bill is to exempt certain energy systems from local taxation requirement that the owner of property that comprises or includes an energy system enter into a PILOT agreement, if the property meets the eligibility requirements.

Summary of Provisions and Statement in Support:

Section 1 of this bill would amend Real Property Tax Law § 487 to add a new subdivision 10 that would, beginning April 1, 2019, exempt specified energy systems – specifically, a solar or wind energy system, farm waste energy system, microhydroelectric energy system, fuel cell electric generating system, microcombined heat and power generating equipment system, and electric energy storage system as such terms are defined in paragraphs (b), (f), (h), (j), (l) and (n) of RPTL § 487(1), respectively, (collectively, "energy system") – from local taxation, and any requirement that the owner of property that comprises or includes an energy system enter into a PILOT agreement, if:

(1) the energy system is installed on real property that is owned or controlled by the State or a State Entity; and
(2) the State or a State Entity has agreed to purchase the energy produced by such energy system, or the environmental credits or attributes created by virtue of such energy system's operation, in accordance with a written agreement with the owner or operator of such energy system.

The project owners would need to file applications with the local assessor.

Section 2 of the bill contains the bill's effective date clause, which provides that the act would take effect immediately.

Budget Implications:

Enactment of this bill is necessary to implement the FY 2020 Executive Budget.

Effective Date:

This bill would take effect immediately.

Part BB – Gaming Commission Employment Restrictions

Purpose:

This bill would allow the Gaming Commission to waive the existing pre-employment restriction in certain cases.

Summary of Provisions and Statement in Support:

This bill would amend section 107 of the Racing, Pari-Mutuel Wagering and Breeding Law to add that the Gaming Commission may waive for good cause any pre-employment restriction of a prospective employee, by adopting a resolution at a properly noticed public meeting. Under current law, applicants who have held a gaming occupational license are disqualified from Gaming Commission employment for three years from the date the license is terminated.

Budget Implications:

Enactment of this bill is necessary to implement the FY 2020 Executive Budget because it would allow the Gaming Commission to hire the most talented candidates.

Effective Date:

This bill would take effect immediately.

Part CC – Retired Racehorse Aftercare

Purpose:

This bill would authorize the Thoroughbred and Standardbred Breeding Funds to make contributions for the ongoing care of retired horses.

Summary of Provisions and Statement in Support:

This bill amends sections 254 and 332 of the Racing, Pari-Mutuel Wagering and Breeding Law, to allow the Thoroughbred and Standardbred Breeding Funds to voluntarily contribute monies for the support and promotion of ongoing care of retired racehorses.

Budget Implications:

Enactment of this bill is necessary to implement the FY 2020 Executive Budget.

Effective Date:

This bill would take effect immediately.

Part DD – Make Technical Changes to Gaming Provisions

Purpose:

This bill would make technical changes to the Racing, Pari-Mutuel, Wagering and Breeding Law, the Public Officer's Law, and the Tax Law, in order to clarify existing laws.

Summary of Provisions and Statement in Support:

This bill would:

- Move the Gaming Inspector General Statute from Article 13 of the Racing, Pari-Mutuel Wagering and Breeding Law to Article 1 (Subpart A);
- Allow for an alternative form of designation for Gaming Commission members to the Thoroughbred Breeding Fund (Subpart B);
- Clarify that Cornell University's Harry M. Zweig Memorial Fund for Equine Research can accept gifts from donors, and ensures the fund's board members are indemnified under the Public Officers Law (Subpart C); and
- Expand the allowable use of the lapsed prized fund to allow supplemental prizes on more games, allow continuing promotional campaigns, and align the prize payment amounts and revenue distributions for all lottery games (Subpart D).

Budget Implications:

Enactment of this bill is necessary to implement the FY 2020 Executive Budget because it makes technical changes to gaming provisions, such as preserving the revenue stream for education generated from promotions supported through the lapsed prize fund.

Effective Date:

This bill would take effect immediately.

Part EE – Simplify Video Lottery Gaming (VLG) Rates and Eliminate Additional Commission Provisions

Purpose:

This bill would simplify the current VLG distribution structure and eliminate the current additional commission provisions and instead offer an additional commission rate commensurate to the operator commission loss for those impacted VLG facilities.

Summary of Provisions and Statement in Support:

This bill would repeal and replace subparagraphs (ii) and (iii) of paragraph 1 of subdivision b of §1612 of the Tax Law and add three new paragraphs, 1-a, 1-b, and 1-c. Clauses (A) through (D) of paragraph 1 would simplify the VLG rate structure; Subparagraph (iii) would provide an additional commission rate for those qualifying VLG facilities. Paragraph 1-a would simplify the capital awards distribution; Paragraph 1-b would include the free play allowance language; and Paragraph 1-c would clarify that marketing would now be funded out of the vendor's fee.

Currently, VLG revenues are distributed for gaming administration, operator commission, racing support payments, marketing allowance, capital awards and the remaining amount is directed to education. The distribution formulas change based on certain net machine income (NMI) levels (which vary by facility). Under this bill, the VLT rates would now be based on four categories (VLTs impacted by gaming facilities, those impacted by Native American casinos, those facilities or machines run by OTBs and the larger VLTs). The distribution formulas would no longer change based on NMI levels.

Under current law, there is a separate distribution for capital award monies and for marketing allowance. Marketing allowance is set at either eight or ten percent of NMI and most facilities receive four percent of NMI (capped at $2.5 million) for capital awards. Under this bill, the marketing allowance and capital awards will now be included as part of the operator commission. The amount spent on marketing would shift from Commission directive to operator discretion. For capital awards, the Commission would simply approve projects and the reimbursement process would be eliminated. Up to $2 million could be used for constructing a turf course at the Finger Lakes racetrack.

Three VLG facilities (Finger Lakes, Saratoga and Monticello) are currently eligible to receive an additional commission to be "held harmless" from the impact of a nearby competing casino. However, based on current law, the Finger Lakes and Saratoga facilities will receive an amount in excess of being held harmless. The proposed language would eliminate these provisions and instead offer these facilities an additional commission rate that would reduce their current windfalls, while ensuring they still have an incentive to perform. This part would also extend current financial relief for Vernon Downs via an additional commission rate.

Budget Implications:

Enactment of this bill is necessary to implement the FY 2020 Executive Budget because it would increase State VLG revenue by $5 million in FY 2020 and annually thereafter.

Effective Date:

This bill would take effect immediately, provided, however, that the additional commission rates shall expire and be deemed repealed on March 31, 2023.

Part FF – Impose a Statutory Cap on Casino Free Play.

Purpose:

This bill would establish a statutory cap on free play for casinos.

Summary of Provisions and Statement in Support:

The Commission and the four upstate casinos have reached agreements that limit casino free play allowance to 19 percent per year. If the casino free play exceeds 19 percent, the amount in excess is deemed taxable gross gaming revenue (GGR) and the casino must remit the tax due to the State. This bill would codify existing practice into law until FY 2023. Beginning FY 2024, the casino and video lottery facilities free play disparity would be reconciled to 15 percent.

Section 1 would amend Racing, Pari-Mutuel Wagering and Breeding Law (PML) §1301(25) to eliminate a reference to unrestricted promotional gaming credits not being taxable for the purposes of determining gross gaming revenue.

Section 2 would amend PML § 1351 by adding a new subdivision 2 to accomplish the following:

- Establish a 19 percent cap on casino free play for fiscal years 2019 through 2023. For fiscal years 2019 and 2020, the nineteen percent would be an aggregate amount.
- Beginning FY 2024 and annually thereafter the free play cap would be reduced to 15 percent to align with that of the Video Lottery Gaming (VLG) facilities.
- Free play would be excluded from the calculation of GGR and any tax owed on free play above the cap would be due within 30 days of fiscal year end.
- Only free play credits issued pursuant to a written plan approved by the Gaming Commission shall be not taxable and the Gaming Commission may suspend the approval of any plan when it is jointly determined with the Budget Director that the use of free play credits under such plan is not effectively increasing revenue.

Budget Implications:

Enactment of this bill is necessary to implement the 2020 Executive Budget because it would preserve casino tax revenues that are directed to education and certain localities.

Effective Date:

This bill would take effect immediately.

Part GG – Impose Off-Track Betting Reforms

Purpose:

This bill would improve operations of regional off-track betting (OTB) corporations by enhancing board oversight, allowing combined operations, and authorizing an additional tele-theater in certain locations.

Summary of Provisions and Statement in Support:

This bill amends sections 502, 503 and 1009 of the Racing, Pari-Mutuel Wagering and Breeding Law to strengthen the oversight responsibilities of regional off-track betting corporation board members, authorize regional off-track betting corporation to combine pari-mutuel wagering operations, and permits an OTB to operate a tele-theater at a casino.

This bill would require the preparation of detailed financial information for the review of the members of any regional off-track betting corporation board of directors at least seven days prior to a meeting and require the board to meet at least quarterly. The bill would also allow for operational efficiencies by authorizing OTBs to combine pari-mutuel wagering operations. Finally, the bill would allow a tele-theater at a destination resort.

Budget Implications:

Enactment of this bill is necessary to implement the FY 2020 Executive Budget because it improves off-track betting corporate management and increases operational efficiencies.

Effective Date:

This bill would take effect immediately.

Part HH – Extend certain tax rates and certain simulcasting provisions for five years.

Purpose:

This bill would extend for five years various provisions of the Racing, Pari-Mutuel Wagering and Breeding Law.

Summary of Provisions and Statement in Support:

Section 1 would amend Racing, Pari-Mutuel Wagering and Breeding Law (PML) § 1003(a) to extend the June 30, 2019 expiration date for in-home simulcasting.

Section 2 would amend PML § 1007(3)(d) to extend the current percentage of total pools allocated to purses that a track located in Westchester County receives from a franchised corporation, which currently is scheduled to expire on June 30, 2019.

Section 3 would amend the opening paragraph of PML § 1014, to continue the provisions allowing simulcasting of out-of-state thoroughbred races on any day the Saratoga thoroughbred track is operating, which currently are scheduled to expire on June 30, 2019.

Section 4 would amend PML § 1015(1) to extend the provisions governing the simulcasting of races conducted at out-of-state harness tracks, which currently are scheduled to expire on June 30, 2019.

Section 5 would amend the opening paragraph of PML §1016(1) to continue the provisions governing the simulcasting of out-of-state thoroughbred races on any day the Saratoga thoroughbred track is closed, which currently are scheduled to expire on June 30, 2019.

Section 6 would amend the opening paragraph of PML §1018 to extend the current distribution of revenue from out-of-state simulcasting during the Saratoga meet, which expired on September 8, 2018.

Section 7 would amend § 32 of chapter 281 of the Laws of 1994 to extend the current amount of off-track betting wagers on New York Racing Association, Inc. (NYRA) pools dedicated to purse enhancement, which currently are scheduled to expire on June 30, 2019.

Section 8 would amend § 54 of chapter 346 of the Laws of 1990 to continue binding arbitration for disagreements. These provisions currently are scheduled to expire on June 30, 2019.

Section 9 would amend PML § 238(1)(a) to continue the current distribution of revenue from on-track wagering on NYRA races, which currently is scheduled to expire on December 31, 2019.

Extending these provisions would maintain the pari-mutuel betting and simulcasting structure that is currently in place in New York State. The provisions extended by sections one through six of this bill were first enacted in 1994 and section seven was enacted in 1990. These provisions were extended numerous times since their original enactment, most recently in FY 2019.

Budget Implications:

Enactment of this bill is necessary to implement the FY 2020 Executive Budget because it maintains the current pari-mutuel betting structure in New York State.

Effective Date:

This bill would take effect immediately.

Part II – Mid-Atlantic Drug Compact

Purpose:

This bill would authorize entry into the Mid-Atlantic Drug Compact, to enhance and standardize equine drug testing, and maintain the integrity of the racing industry.

Summary of Provisions and Statement in Support:

A new Article XI-a is added to the Racing, Pari-Mutuel Wagering and Breeding Law authorizing the Gaming Commission to participate in the compact.

The Compact:

- Enables member states to act jointly to create more uniform, effective, and efficient rules relating to drugs and medications for racehorses;
- Becomes effective as soon as any two states enact substantially similar compact language. It would allow for one delegate for each member state;
- Provides that rules shall take effect by super majority vote (80% of delegates);
- Would require the adoption, amendment, and rescission of by-laws to govern its conduct;
- Would allow the delegates to establish breed specific equine drug and medication rules;
- Directs the publication in each member state of each equine drug rule proposed, conducts a review of public comments received in response to such proposed rule, consults with national industry stakeholders, and votes on the adoption of the proposed compact rule;
- Dissolves when the withdrawal of a member state reduces compact membership to one state.

Budget Implications:

Enactment of this bill is necessary to implement the FY 2020 Executive Budget because it provides standardization of equine drug testing rules across all member states.

Effective Date:

This bill would take effect immediately

Part JJ – Extend Advisory Committee on Equine Drug Testing and Remove the Morrisville Equine Drug Lab Restriction

Purpose:

This bill would extend the equine drug testing advisory committee for an additional year, and allow the Gaming Commission to procure a qualified equine testing lab through a competitive process.

Summary of Provisions and Statement in Support:

The current language establishes an advisory committee only through 2018. The current law also requires the Gaming Commission to use a "state college within the state with an approved equine science program"; currently, Morrisville College is the only qualified capable provider. Removing the restrictive language will ensure that equine testing in New York is conducted at the highest level of quality at the most competitive rates.

Section 1 would amend section 2 of Part EE of Chapter 59 of the Laws of 2018 to provide a one-year extension for the advisory committee on equine drug testing to review the current state of equine drug testing in New York State, and make recommendations going forward.

Section 2 would broaden the potential number of equine drug testing laboratories that the Gaming Commission could use in support of equine drug testing programs.

Budget Implications:

Enactment of this bill is necessary to implement the FY 2020 Executive Budget because it will ensure continuity of equine testing at the most competitive rates.

Effective Date:

This bill would take effect immediately.

Part KK – Streamline Occupational Licensing for Casino Employees

Purpose:

This bill would make amendments to the Racing, Pari-Mutuel Wagering and Breeding Law to allow for the distinguishing of non-key and key casino employees, and the requirements of each for occupational licensing for employment of gaming activities.

This bill would grant the Gaming Commission with authority to provide and investigate sub-registrations and sub-licenses for applicants with a criminal history, with clearly defined restrictions.

Summary of Provisions and Statement in Support:

This bill would add a new section 104-a to the Racing, Pari-Mutuel Wagering and Breeding Law to establish the validation, and purpose of sub-registrations and sub-licenses to any persons engaging in gaming activity regulated and administered by the Gaming Commission.

This bill would also amend the Racing, Pari-Mutuel Wagering and Breeding Law for the following purposes:

- Establish the classification and definition of non-gaming employees;
- Modify the language regarding the disqualification of applicants, specifically related to applicants convicted of felony crimes;
- Allow for an occupational license to be suspended, in addition to being denied or revoked;
- Disallow the denial or revocation of a license to key employees and employees of vendors, based on conviction of certain crimes if sufficient rehabilitation has been demonstrated;
- Provide only disqualified applicants with a copy of their criminal history information;
- Subject non-gaming employees to registration requirements and modify language to give the Gaming Commission authority to deny a registration;
- Allow the applicant for registration to provide the Gaming Commission with evidence of good character, honesty, and integrity as it pertains to their criminal history and prior gaming operation association;
- Extend allowance of further investigation conducted by the Gaming Commission to licenses or registrations, and for non-gaming employees;
- Extend the necessity of an “ancillary casino vendor enterprise” license for certain casino vendors;
- Distinguish which persons associated with a casino vendor enterprise, and an ancillary casino vendor enterprise, is a key gaming employee and which is a non-key gaming employee;
- Provide specific classifications for all other key and non-key gaming employees of vendors not specified in previous subdivisions; and
- Grant the executive director rights to wave requirements of this section if the gaming license applicant proves association with a vendor is limited in scope and

addresses specific responsibilities said licensee applicant has in providing proof of such relations. The waiver may also be revoked at the discretion of the executive director.

Budget Implications:

Enactment of this bill is necessary to implement the FY 2020 Executive Budget.

Effective Date:

This bill would take effect immediately.

Part LL – Cap annual growth in STAR exemption benefits

Purpose:

This bill would impose a zero percent cap upon the growth in Basic and Enhanced STAR benefits for purposes of the STAR exemption, beginning with the 2019-20 school year. For purposes of the STAR credit, the existing 2% cap would remain intact.

Summary of Provisions and Statement in Support:

STAR was enacted in 1997 to offset rising property taxes for homeowners and to provide additional targeted property tax relief to senior citizens. Since then, five enhancements have been made that have contributed to increases in the current and projected cost of the STAR program. The costs of the STAR program increased approximately 33 percent between FY 2002 and FY 2017. The direct costs of the STAR program in FY 2017 were over $3.3 billion.

Existing law allows all STAR savings to grow at a rate not to exceed 2 percent annually, as implemented with the FY 2012 Enacted Budget. This bill would amend Real Property Tax Law §1306-a to lower the cap on the growth of tax savings under the exemption component of STAR Program, beginning with the 2019-20 school year. As a result, Basic and Enhanced STAR savings would be capped at the 2018-19 savings amounts for these exemption programs. For purposes of the STAR credit program, the existing 2% cap would remain intact.

Capping growth of the exemption program at current levels is critical for a balanced State budget. Notably, school tax levy growth has averaged below 2 percent since the enactment of the Governor's property tax cap; reducing STAR benefit growth reinforces the incentive for school districts to continue to control their costs and minimize the growth in their tax levies.

Budget Implications:

Enactment of this bill is necessary to implement the FY 2020 Executive Budget. Capping the exemption benefits would reduce General Fund spending by an estimated $106 million in FY 2020.

Effective Date:

This bill would take effect immediately.

Part MM – Allow Disclosure of Certain Information on Cooperative Housing Corporation Information Returns

Purpose:

This bill would allow the Department to share certain information reported by cooperative housing corporations with local assessors for real property tax administration purposes.

Summary of Provisions and Statement in Support:

One of the major challenges DTF has encountered in administering the STAR Credit program is that assessment records do not typically contain the names and addresses of co-op 'owners' (who technically are not property owners, but rather are shareholders with proprietary leases). This lack of information causes delays in the issuance of STAR checks to such individuals.

Under existing law, a real property transfer report (RP-5217) must be filed whenever a deed is recorded. The real property transfer report is a public record that contains basic information about sales of real property, most notably, the names of the buyers. Because cooperative housing apartment units are transferred by the sale of a share or shares in a cooperative housing corporation, those transactions do not require the filing of a deed and, therefore, do not require the filing of an RP-5217.

Most of the information reported on the RP-5217 is also reported on the TP-588 information returns that cooperative housing corporations must file annually. However, unlike RP-5217, TP-588 is not a public record. This bill would allow the disclosure of certain information reported on the TP-588 to local assessors, which would help both local assessors and DTF value co-op units for real property tax purposes. Sensitive information, such as Social security numbers and employer identification numbers, would continue to be covered by the secrecy requirements of the Tax Law and would not be shared with assessors.

Budget Implications:

Enactment of this bill is necessary to implement the FY 2020 Executive Budget.

Effective Date:

This bill would take effect on January 1, 2020.

Part NN – Clarify Calculation of New York City Enhanced Real Property Tax Circuit Breaker Credit

Purpose:

This bill would make a technical amendment to the Tax Law to clarify the calculation of the Enhanced Real Property Tax Circuit Breaker Credit applicable to New York City.

Summary of Provisions and Statement in Support:

Under existing law, the Enhanced Real Property Tax Circuit Breaker Credit specifies the amount of the credit allowable for taxable years after 2013 and prior to 2016, but does not say how the credit should be calculated now that it has been extended through 2020.

This proposal would simply clarify that the credit continues to be calculated the way it has previously been calculated until the credit expires.

Budget Implications:

Enactment of this bill is necessary to implement the FY 2020 Executive Budget.

Effective Date:

This bill would take effect immediately and would apply to taxable years beginning on and after January 1, 2016, and would expire and be deemed repealed on the date that the Enhanced Real Property Tax Circuit Breaker Credit is deemed repealed.

Part OO – Require Mobile Home Park Reporting to Tax Department

Purpose:

This bill would improve the administration of the STAR Credit program by requiring information about manufactured home parks to be reported to the Department of Taxation and Finance ("DTF").

Summary of Provisions and Statement in Support:

One of the major challenges DTF has encountered in administering the STAR Credit program is that assessment records do not typically contain the names and addresses of tenants of manufactured home parks. The lack of such information causes delays in the issuance of STAR checks to such individuals, which all parties concerned would greatly prefer to avoid.

Under existing law, owners and operators of mobile home parks must file annual reports with the Department of Housing and Community Renewal ("DHCR") that disclose: (1) the names of all park owners; (2) the names of all park tenants (3) all services provided by the park owners to the tenants; and (4) all current park rules and regulations. Reporting occurs by the submission of paper forms via mail.

This bill would amend the law so that, as of 2020, those annual reports would become quarterly statements that would go to DTF rather than DHCR, and would include information regarding whether tenants own or lease their mobile homes and such other information as DTF may deem necessary. Such information would be filed through an internet-based online system, thereby making reporting easier and less time consuming. Until DTF establishes a system for electronic filing, reports would continue to be filed with DHCR. DTF would be required to provide DHCR with a copy of the information contained in each quarterly statement within 30 days of receipt. These reports would help DTF, as well as local assessors, administer the STAR credit and STAR exemption programs.

Budget Implications:

Enactment of this bill is necessary to implement the FY 2020 Executive Budget.

Effective Date:

This bill would take effect immediately.

Part PP – Prevent STAR fraud and abuse

Purpose:

This bill would build upon the State's efforts to keep the STAR program free from fraud and abuse.

Summary of Provisions and Statement in Support:

Bill section one would expand the STAR Income Verification Program by providing that, effective with 2020 assessment rolls, the Commissioner of the Department of Taxation and Finance (DTF) would be required to annually verify that Enhanced STAR exemption recipients meet the residency and age requirements, thus requiring the same eligibility verification for the Enhanced STAR exemption that it has done for the basic STAR exemption.

Bill sections two and three would incorporate a STAR exemption anti-fraud provision into the STAR credit. In particular, the STAR exemption law provides that someone who is found to have put materially false information on a STAR exemption application is precluded from receiving the STAR exemption for six years. This bill would provide that such a person is also precluded from switching to the STAR credit during that six-year period. It would also add a similar six-year ban to the STAR credit, so that a person who provides materially false information when registering for the STAR credit would be precluded from receiving that credit for six years.

Bill section four would clarify that where a STAR check is inadvertently sent to someone whose primary residence was receiving a STAR exemption for the same year, the Commissioner may seek repayment of the check amount upon notice and demand. A notice of deficiency would not be required, since there are no questions of law or fact to be resolved in such cases. This would facilitate the recovery of the amounts due without compromising the rights of these check recipients.

Budget Implications:

Enactment of this bill is necessary to implement the FY 2020 Executive Budget.

Effective Date:

This bill would take effect immediately.

Part QQ – Disclosure of STAR-related information to assessors

Purpose:

This bill would authorize the Commissioner of Taxation and Finance to disclose certain STAR-related information to assessors, in order to facilitate the administration of STAR and other property tax exemptions.

Summary of Provisions and Statement in Support:

Bill sections one and two would allow the Commissioner to disclose certain STAR eligibility information to assessors. Namely:

1. The Commissioner is authorized to disclose the names of property owners who he or she has found are not eligible for a STAR exemption or credit. A limited explanation would be provided as well (e.g., that the owner's income exceeds the STAR limit *[the amount of his or her income would not be disclosed]*, or that the owner's primary residence is elsewhere, or in the case of Enhanced STAR, that the owners do not meet the age requirement or haven't submitted the income worksheet if required). This information would help assessors ensure that these property owners don't improperly receive

other exemptions that also have an income, residency and/or age requirement, such as the senior citizens and veterans exemptions.

2. The Commissioner is also authorized to disclose the names of property owners who are eligible for either the Enhanced STAR exemption or Enhanced STAR credit and whose federal adjusted gross income is below the maximum allowable amount set by Real Property Tax Law (RPTL) § 467(1)(b)(3) for the senior citizens exemption (currently $37,400, but $58,400 in New York City). With this data, assessors would be able to reach out to those individuals, inform them about the senior citizens exemption, and encourage them to apply. This bill would enable assessors to help ensure that lower-income senior citizens receive the full amount of property tax relief that they are entitled to receive.

Bill sections three and four would provide that when an income tax return is filed on behalf of a decedent, the Commissioner may disclose to the Director of Real Property Tax Services of the county in which the decedent resided the following information: the decedent's name, address, and date of death. The County Director would share the information with the assessor and tax collector, and if delinquent taxes are due, with the County Treasurer. Current law does not provide a mechanism to ensure ensure that assessors or other local officials are informed of a property owner's death in a timely manner. As a result, tax bills may be misdirected, causing interest and penalties to accrue, and certain exemptions – particularly, STAR and the senior citizens and veterans exemptions – may remain in place too long. This bill would close this gap in the law.

All information disclosed to local officials under this bill would only be used only for purposes of real property tax administration, and such information would be otherwise be deemed confidential, and not subject to FOIL provisions.

Budget Implications:

Enactment of this bill is necessary to implement the FY 2020 Executive Budget.

Effective Date:

This bill would take effect immediately.

Part RR – Lower Basic STAR income limit to $250,000 – Exemption Program only

Purpose:

This bill would lower the income limit for the Basic STAR exemption to $250,000, beginning with the 2019-20 school year. For purposes of the STAR credit, the existing $500,000 income limit would remain intact.

Summary of Provisions and Statement in Support:

STAR was enacted in 1997 to offset rising property taxes for homeowners and to provide additional targeted property tax relief to senior citizens. Since then, five enhancements have been made that have contributed to increases in the current and projected cost of the STAR program. The costs of the STAR program increased approximately 33 percent between FY 2002 and FY 2017. The direct costs of the STAR program in FY 2017 were over $3.3 billion.

This bill would lower the income limit for the Basic STAR exemption to $250,000, beginning with the 2019-20 school year. Higher-income homeowners with Basic STAR exemptions would be able to avoid adverse impacts by switching to the STAR credit program, where the $500,000 income limit would remain intact. Homeowners who switch from the exemption would see a difference in the amount of the benefit, rather the only difference they would see is that the STAR benefit would be delivered to them in the form of a check rather than a reduced school tax bill.

The bill would also correct a drafting oversight by making clear that the verification of income-eligibility for exemption purposes will be based primarily upon data obtained by the Tax Commissioner through the STAR registration program. The law currently only makes reference to the verification process authorized by Tax Law §171-u, which became of secondary importance once the registration program was enacted.

Budget Implications:

Enactment of this bill is necessary to implement the FY 2020 Executive Budget. Lowering the Basic STAR income limit would reduce General Fund spending by $125 million in FY 2020.

Effective Date:

This bill would take effect immediately.

Part SS – Clarify STAR check tax bill notices

Purpose:

This bill would clarify the notice that appears on the school tax bills of recipients of STAR credit checks.

Summary of Provisions and Statement in Support:

Under the 2016-2017 Enacted State Budget, the STAR exemption program was closed to new homeowners and the STAR credit program was enacted to take its place. To help promote public awareness of the program, the law requires that a notice be placed on the school tax bills of credit recipients stating that that a STAR check "will be mailed" to them. This wording is potentially confusing for some taxpayers who receive their checks <u>before</u> their school tax bills, leading such taxpayers to erroneously conclude that that they will receive a second check.

This proposal clarifies the tax bill notice by rewording it to say that a "STAR check has been or will be mailed" to them.

<u>Budget Implications</u>:

Enactment of this bill is necessary to implement the FY 2020 Executive Budget.

<u>Effective Date:</u>

This bill would take effect immediately.

Part TT – Improve the STAR administrative process to be more responsive to taxpayer needs

<u>Purpose</u>:

This bill would improve the STAR administrative provisions to be more responsive to taxpayer needs, as to (1) dispensations for "good cause" and (2) the "renunciation" process".

<u>Summary of Provisions and Statement in Support:</u>

Dispensations for "good cause" (bill § 1): As part of the 2016-2017 Enacted Budget, the STAR exemption statute was amended to provide relief to taxpayers with Enhanced STAR exemptions who fail to timely file their renewal applications. Those taxpayers may file extension requests with the Commissioner of Taxation and Finance up to the last day for paying school taxes without incurring interest or penalty, and may have their Enhanced exemptions restored if the Commissioner finds they had "good cause" for missing the filing deadline.

By its terms, this relief is available to renewal applicants, not first-time applicants. As a result, homeowners with Basic STAR exemptions who reach age 65 cannot seek similar relief if they fail to apply for Enhanced STAR by the deadline, even if they have "good cause" for the oversight. This is an unduly harsh outcome, which this bill would rectify. The bill would also expedite the process for implementing the Commissioner's determination by empowering the school district to adjust the tax bill if the tax has not yet been paid or issue a refund if it has. While there is a process to correct a host of errors, aptly named the "Correction of Errors", (Real Property Tax Law §§ 550-559), this process is cumbersome and time-consuming and serves no purpose where there is no question of fact to be resolved.

"Renunciation" reforms (bill §§ 2-4): Section two of the bill would waive the $500 processing fee for taxpayers who renounce their STAR exemptions before their tax bills are issued. The renunciation statute was enacted to accommodate taxpayers who want to give up a STAR (or other) exemption they've been receiving and repay the benefits they've received, going back up to 10 years. Since this may require local officials to retrieve and recalculate tax records for several prior years, the taxpayer is required to pay a $500 processing fee in addition to the taxes due. However, in some cases, taxpayers have sought to renounce their STAR exemptions prospectively, before the current year's school tax bills have been prepared. Because they acted promptly, there is no processing to be done in these cases, so there is no reason for them to be subjected to a processing fee. This bill would waive the $500 processing fee for taxpayers who renounce their STAR exemptions before their tax bills are issued.

Section three of the bill would also clarify that when a STAR exemption is renounced, the amount to be repaid is the "tax savings" shown on the taxpayer's school tax bill(s), which may not always equal the property's taxable assessed value times the school tax rate because the law has provided for the past several years that the STAR tax savings in any school district may not grow by more than two percent from one year to the next. Lastly, section four of the bill would make it easier for a taxpayer to renounce a STAR exemption in order to switch to the STAR credit by allowing the switch to occur even when the payment is made after the end of the taxable year in certain cases. This provision is warranted because there have been instances where a taxpayer has submitted a renunciation application during the desired taxable year, but due to processing delays, the taxpayer did not receive a final determination until the next taxable year. As long as the taxpayer pays the amount due within the time prescribed by law, their attempt to switch to the credit would be honored.

<u>Budget Implications</u>:

Enactment of this bill is necessary to implement the FY 2020 Executive Budget.

<u>Effective Date:</u>

This bill would take effect immediately.

Part UU – Enacts a comprehensive tobacco policy

<u>Purpose</u>:

This bill would implement various new regulations, restrictions and protections with regard to the use of tobacco and electronic cigarettes (e-cigarettes) and vapor products, as well as imposes a 20 percent tax on vapor products, for the benefit of the health and wellbeing of New Yorkers.

Summary of Provisions and Statement in Support:

To protect the health of New Yorkers from a multibillion dollar industry that produces a product that when used as directed, kills up to half its users by (1) raising the minimum sales age for tobacco products from 18 to 21; (2) prohibiting sales of tobacco products in all pharmacies; (3) prohibiting the acceptance of price reduction instruments for both tobacco products and e-cigarettes; (4) prohibiting the display of tobacco products or e-cigarettes in stores; (5) clarifying that the Department has the authority to promulgate regulations that prohibit or restrict the sale or distribution of electronic cigarettes (e-cigarettes) or electronic liquids (e-liquids) that have a characterizing flavor, or the use of names for characterizing flavors intended to appeal to minors; (6) prohibiting smoking inside and on the grounds of all hospitals licensed or operated by the Office of Mental Health (OMH); (7) impose a 20 percent excise tax on vapor products; and (8) requiring that electronic cigarettes be sold only through licensed tobacco retailers.

Comprehensive tobacco control policy action would prevent death and disease associated with tobacco use, as well as save the State money due to the high cost of health care expenses for tobacco-related illnesses, estimated at $10.4 billion annually, including $3.3 billion in Medicaid costs. Smoking prematurely kills over 28,000 New Yorkers each year - more people than alcohol, AIDS, car crashes, illegal drugs, murders, and suicides combined. In a 2012 report on youth tobacco use, the US Surgeon General characterized tobacco use as a pediatric epidemic.

New York has a comprehensive Clean Indoor Air law, the highest state cigarette tax in the nation ($4.35 per pack) and a comprehensive tobacco control program. New York is one of the leading innovators addressing tobacco control in the US, however tobacco use continues to be the #1 cause of preventable death in our state due to its insidious addictive nature and industry marketing tactics.

The tobacco industry continues to invest over $9 billion annually marketing cigarettes and scientific evidence establishes that tobacco industry marketing causes youth tobacco use. The industry devotes countless resources to keep existing customers and recruit new customers, most of whom are youth, while undermining the proven effective public health measures already put in place.

In addition to combustible tobacco products, e-cigarettes (including vapor products) and similar devices are emerging as the latest public health threat to youth and young adults. Uptake of vapor products by youth is dramatically increasing and more high school age youth are now using vapor products than smoking combustible cigarettes. Dual use by youth and adults is common, showing that they are not substituting vapor products for cigarettes but using both to maintain and strengthen addiction.

Budget Implications:

Enactment of this bill is necessary to implement the FY 2020 Executive Budget because it would increase All Funds revenue by $2 million in FY 2020 and $19 million thereafter.

Tobacco Minimum Sales Age: Retailers may incur costs for signage updates in accordance with the Adolescent Tobacco Use Prevention Act however the department has provided signage in the past; and as the prevalence of tobacco initiation is reduced in youth and young adults, over time, tobacco sales and tax revenue collected will decline.

There will likely be costs to DTF to register e-cigarette retailers and any cost associated with additional enforcement inspections, but it is difficult to assess the dollar amount given no reliable information on the number of e- cigarette retailers. These costs will also likely be offset by the additional tax revenue generated by taxing electronic cigarettes.

Effective Date: This bill would be effective 180 days after it becomes law except that section 16 shall become law on the first day of a sales tax quarterly period next commencing 180 days after this act shall have become law.

Part VV – Enact the Cannabis Regulation and Taxation Act.

Purpose:

This bill would create and amend existing laws to legalize adult-use cannabis, consolidate governance of all forms of cannabis and create a regulatory structure to oversee the licensure, cultivation, production, distribution, sale and taxation of cannabis within New York State.

Summary of Provisions and Statement in Support:

This bill would create the cannabis control law, which would create a new section for adult-use and hemp cannabis while merging existing law for medical cannabis. Regulation of cannabis benefits public health by enabling government oversight of the production, testing, labeling, distribution, and sale of marijuana. The creation of a regulated cannabis program would enable New York State to control licensure, ensure quality control and consumer protection, set age and quantity restrictions and do so through a comprehensive regulatory framework.

This bill would establish the Office of Cannabis Management (OCM) within the Division of Alcohol Beverage Control, and consolidate governance of adult-use, medical and hemp cannabis. The powers of this new office include but are not limited to: the establishment of cultivation and processing standards; the licensure of all business entities in the production and distribution chain; the inspection and enforcement of program standards and the development and issuance of program regulations.

Article 3 governs New York State's Medical Cannabis Program, designed to comprehensively regulate the manufacture, sale and use of medical cannabis while striking a balance between potentially relieving the pain and suffering of those in desperate need of treatment and protecting the public against risks to health and safety. The Office of Cannabis Management will supervise the continued expansion of the medical cannabis program and promote reforms that expand patient access and product affordability while encouraging research opportunities.

Article 4 of the bill would regulate and control the cultivation, processing, manufacturing, distribution and sale of cannabis products for adults over 21 years of age. This bill would utilize a three-tier market structure (similar to the alcohol model) for the adult-use cannabis industry. In general, the model prohibits vertical integration and would be coupled with licensing limits and supply management to control market concentration and encourage social equity applicant participation.

This bill would establish a robust social equity program to actively encourage members of communities who have been disproportionally impacted by the policies of prohibition to participate in the new industry through the implementation of a social equity licensing and incubator program – providing technical assistance, training, loans and mentoring to social equity applicants. Additionally, this bill would create a program to review and seal prior cannabis convictions and eliminate the collateral consequences of conviction while also ensuring the enforcement framework of legalization does not replicate the arrest disparities and criminalization of prohibition.

Article 5 of the bill would provide a regulatory framework to comprehensively regulate hemp cannabis including the licensing, cultivation, processing, extracting and distribution. Hemp grown and used for industrial or food purposes (such as fiber or seed) will continue to be regulated by the Department of Agriculture and Markets. The bill would also regulate the packaging and labeling and laboratory testing requirements of hemp cannabis products and their distribution.

This bill would amend Tax Law to add a new Article 20-C, Tax on Adult-Use Cannabis Products, to impose three taxes. The first tax is imposed on the cultivation of cannabis at the rate of $1 per dry weight gram of cannabis flower and $0.25 per dry weight gram of cannabis trim. The second tax is imposed on the sale by a wholesaler to a retail dispensary at the rate of 20 percent of the invoice price. The third tax is imposed on the same sale by a wholesaler to a retail dispensary at the rate of 2 percent of the invoice price but collected in trust for and on account of the county in which the retail dispensary is located. All wholesalers would be required to apply to the Commissioner of Taxation and Finance for a Certificate of Registration prior to commencing business and renew such registration every two years. The initial application and renewal would be subject to a fee of $600.

Revenues from the State cannabis taxes shall be deposited in the New York State Cannabis Revenue Fund and expended for the following purposes: administration of the regulated cannabis program, data gathering, monitoring and reporting, the governor's traffic safety committee, small business development and loans, substance abuse, harm reduction and mental health treatment and prevention, public health education and intervention, research on cannabis uses and applications, program evaluation and improvements, and any other identified purpose recommended by the director of the Office of Cannabis Management and approved by the Director of the Budget.

County governments would have the opportunity to opt-out of the provisions of Article 4 of the bill with the passage of a local law, ordinance or resolution by a majority vote of their governing body. If a county does not opt out, a city with a population over 100,000 in that county could elect to opt out.

The bill also would create conforming changes to a number of different laws including amending the public health law, in relation to the description of cannabis; the vehicle and traffic law, in relation to making technical changes regarding the definition of cannabis; the penal law, in relation to the qualification of certain offenses involving cannabis and to exempt certain persons from prosecution for the use, consumption, display, production or distribution of cannabis; the tax law, in relation to providing for the levying of taxes on cannabis; the criminal procedure law, the civil practice law and rules, the general business law, and the state finance law.

Budget Implications:

Enactment of this bill is necessary to implement the FY 2020 Executive Budget because it would increase All Funds revenue by $83 million in FY 2021, $85 million in FY 2022, $141 million in FY 2023 and $184 million in FY 2024.

Effective Date:

This bill would take effect immediately; provided, however, that the amendments to article of the penal law made by section fifty-five of this act shall not affect the repeal of such article and shall be deemed to be repealed therewith; provided further that the amendments to section 89-h of the state finance law made by section fifty-eight of this act shall not affect the repeal of such section and shall be deemed repealed therewith; provided further, that the amendments to section 221.00 of the penal law made by section fifteen of this act shall be subject to the expiration of such section when upon such date the provisions of section fifteen-a of this act shall take effect; provided, however, that the amendments to subdivision 2 of section 3371 of the public health law made by section sixty-one of this act shall not affect the expiration of such subdivision and shall be deemed to expire therewith; provided further, that the amendments to subdivision 3 of section 853 of the general business law made by section sixty-two of this act shall not affect the repeal of such subdivision and shall be deemed to be repealed therewith; and provided further, that the amendments to subdivision 5 of section 410.91 of the penal law made by section sixty-three of this act shall be subject to the expiration and reversion of such subdivision when upon such date the provisions of section sixty-three-a of this act shall take effect; provided however that sections 37-38 of this Act shall take effect on April 1, 2020 and shall apply on and after such date: (1) to the cultivation of cannabis flower and cannabis trim transferred by a cultivator who is not a wholesaler; (2) to the cultivation of cannabis flower and cannabis trim sold or transferred to a retail dispensary by a cultivator who is a wholesaler; and (3) to the sale or transfer of adult use cannabis products to a retail dispensary.

Part WW – Expand Supplemental Auto Rental Surcharge to Fund Upstate Public Transportation Systems

Purpose:

This bill would expand the special supplemental auto rental surcharge from the Metropolitan Commuter Transportation District (MCTD) to the remainder of the State. The additional funds would be directed to Upstate public transportation systems.

Summary of Provisions and Statement in Support:

Current law imposes a 6% auto rental tax, statewide, which is directed to the State's highway and bridge program. An additional, supplemental surcharge of 5% is imposed in the MCTD only, and is directed to Downstate public transportation systems including the Metropolitan Transportation Authority.

This bill would provide necessary assistance to Upstate transit systems by imposing the same 5% supplemental surcharge in areas of the State north of Dutchess and Orange counties and directing those funds to Upstate public transportation systems. These systems serve a population that is often skewed toward the economically disadvantaged, and are therefore heavily reliant on revenues from sources other than fares.

Budget Implications:

Enactment of this bill is necessary to implement the FY 2020 Executive Budget because it funds State appropriations for Upstate transit systems.

Effective Date:

This bill would take effect on September 1, 2019.

The provisions of this act shall take effect immediately, provided, however, that the applicable effective date of each part of this act shall be as specifically set forth in the last section of such part.

NEW YORK STATE 2018

Department of Taxation and Finance

Instructions for Form CT-3

General Business Corporation Franchise Tax Return

CT-3-I

Table of contents

Form CT-1, *Supplement to Corporation Tax Instructions*

See Form CT-1 for the following topics:

- Changes for the current tax year (general and by Tax Law Article)
- Business information (how to enter and update)
- Entry formats
  - Dates
  - Negative amounts
  - Percentages
  - Whole dollar amounts
- Are you claiming an overpayment?
- NAICS business code number and NYS principal business activity
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- Paid preparer identification numbers
- Is your return in processible form?
- Use of reproduced and computerized forms
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- Online services
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- Form CT-200-V
- Collection of debts from your refund or overpayment
- Fee for payments returned by banks
- Reporting requirements for tax shelters
- Tax shelter penalties
- Voluntary Disclosure and Compliance Program
- Your rights under the Tax Law
- Need help?
- Privacy notification

All citations are to New York State Tax Law sections unless specifically noted otherwise.

Corporate tax filing requirements

All New York C corporations subject to tax under Tax Law Article 9-A must file using the following returns, as applicable:

- Form CT-3, *General Business Corporation Franchise Tax Return*
- Form CT-3-A, *General Business Corporation Combined Franchise Tax Return*
- Form CT-3-M, *General Business Corporation MTA Surcharge Return*

Any return filed on an incorrect form, or on a form for the wrong year, except as described below, will not be processed and will not be considered timely filed. As a result, penalties and interest may be incurred.

See Form CT-3-A-I, *Instructions for Form CT-3-A*, for information as to when a combined return is permitted or required.

Use this tax return for calendar year 2018, fiscal years that begin in 2018 and end in 2019, and tax years of less than 12 months that begin on or after January 1, 2018, but before January 1, 2019.

You can also use the 2018 return if:

- you have a tax year of less than 12 months that begins and ends in 2019, and
- the 2019 return is not yet available at the time you are required to file the return.

In this case you must show your 2019 tax year on the 2018 return and take into account any tax law changes that are effective for tax years beginning **after** December 31, 2018.

For information on voluntary dissolution and surrender of authority, see *Instructions for voluntary dissolution of a New York corporation* (TR-125), and *Instructions for surrender of authority by foreign business corporation* (TR-199), on our website.

Taxpayers using a 52-53 week year – A taxpayer who reports on the basis of a 52-53 week accounting period for federal income tax purposes may report on the same basis for Article 9-A purposes. If a 52-53 week accounting period begins within seven days from the first day of any calendar month, the tax year is deemed to begin on the first day of that calendar month. If a 52-53 week accounting period ends within seven days from the last day of any calendar month, the tax period will be deemed to end on the last day of the calendar month.

Corporations subject to tax under Article 9-A

The definition of a corporation, as used in Article 9-A and in these instructions, includes associations, limited liability companies (LLCs), limited liability partnerships (LLPs), and publicly traded partnerships that are taxed as corporations under the Internal Revenue Code (IRC). For more information, see §208.1.

A business corporation subject to tax under Article 9-A includes all corporations **except:**

- insurance corporations (including for-profit HMOs required to obtain a certificate of authority under Public Health Law Article 44) (Tax Law Article 33);
- transportation and transmission corporations (other than aviation corporations, corporations principally engaged in transportation, transmission, or distribution of gas, electricity, or steam (TTD corporations), and nonelecting railroad and trucking corporations) (Tax Law Article 9);
- farmers, fruit growers, and similar agricultural cooperatives with, or without, capital stock (§209.12);
- nonstock, not-for-profit corporations, no part of the net earnings of which inures to the benefit of any officer, director, or member;
- continuing §186 taxpayers (Article 9).

Domestic corporations – A domestic corporation (incorporated in New York State) subject to tax under Article 9-A is generally liable for franchise taxes for each fiscal or calendar year, or part thereof, during which it is incorporated until it is formally dissolved with the Department of State. However, a domestic corporation that is no longer doing business, employing capital, owning or leasing property, or deriving receipts from activity, in New York State is exempt from the fixed dollar minimum tax for years following its final tax year and is not required to file a franchise tax return provided it meets the requirements listed in §209.8.

Foreign corporations – A foreign corporation (incorporated outside of New York State) is liable for franchise taxes under Article 9-A during the period in which it is doing business, employing capital, owning or leasing property, maintaining an office, or deriving receipts from activity, in New York State.

A corporation is considered to be deriving receipts in this state if it has receipts within New York of $1 million or more in a tax year (§209.1). *Receipts* means the receipts that are subject to the apportionment rules in §210-A, and the term *receipts within* *this state* means the receipts included in the numerator of the apportionment factor determined under §210-A. Also, receipts from processing credit card transactions for merchants include merchant discount fees received by the corporation (§209.1(b)).

A corporation is doing business in this state if (§209.1(c)):

- it has issued credit cards (including bank, credit, travel, and entertainment cards) to 1,000 or more customers who have a mailing address in this state as of the last day of its tax year;
- it has merchant customer contracts with merchants and the total number of locations covered by those contracts equals 1,000 or more locations in this state to whom the corporation remitted payments for credit card transactions during the tax year; **or**
- the sum of the number of customers and the number of locations equals 1,000 or more.

A foreign corporation that is a partner in a partnership should see *Corporate partners*.

A foreign corporation shall **not** be deemed to be doing business, employing capital, owning or leasing property, maintaining an office, or deriving receipts from activity, in this state by reason of (§209.2):

- the maintenance of cash balances with banks or trust companies in this state;
- the ownership of shares of stock or securities kept in this state if kept in a safe deposit box, safe, vault, or other receptacle rented for the purpose, or if pledged as collateral security, or if deposited with one or more banks or trust companies, or with brokers who are members of a recognized security exchange, in safekeeping or custody accounts;
- the taking of any action by any such bank or trust company or broker, which is incidental to the rendering of safekeeping or custodian service to the corporation;
- the maintenance of an office in this state by one or more officers or directors of the corporation who are not employees of the corporation if the corporation otherwise is not doing business in this state, and does not employ capital or own or lease property in this state;
- the keeping of books or records of a corporation in this state if such books and records are not kept by employees of the corporation and the corporation does not otherwise do business, employ capital, own or lease property, or maintain an office in this state; **or**
- any combination of the activities listed above.

All business corporations subject to tax under Article 9-A, other than New York S corporations, must file franchise tax returns using Form CT-3, unless such corporations are required or permitted to file as members of a combined group (see Form CT-3-A). A business corporation that has elected to be treated as a New York S corporation by filing Form CT-6, *Election by a Federal S Corporation to be Treated as a New York S Corporation*, must file Form CT-3-S, *New York S Corporation Franchise Tax Return*, instead of Form CT-3.

Qualified subchapter S subsidiary (QSSS) – The filing requirements for a QSSS that is owned by a federal S corporation that is a New York C corporation or a nontaxpayer corporation are outlined below.

In those instances where New York State follows federal QSSS treatment:

- the QSSS is not considered a subsidiary of the parent corporation;
- the QSSS is ignored as a separate taxable entity, and the assets, liabilities, income, and deductions of the QSSS are included with the assets, liabilities, income, and deductions of the parent for franchise tax purposes; and
- for other taxes, such as sales and excise taxes, the QSSS continues to be recognized as a separate corporation.

In the situations outlined below where the federal QSSS treatment is followed for NYS, the combined reporting rules are applied to determine if the parent (with its QSSS's activity included) files a Form CT-3, or files as a member of a combined group on a Form CT-3-A. In the situations outlined below where the federal QSSS treatment is **not** followed, the combined reporting rules must still be applied to determine if either the parent, the QSSS, or both should file as distinct members of a combined group on a Form CT-3-A.

- **Parent is a New York C corporation –** New York State follows the federal QSSS treatment if: 1) the QSSS is a New York State taxpayer; or 2) the QSSS is not a New York State taxpayer but the parent makes a QSSS inclusion election. In both cases, the parent (**with** its QSSS's activity included) files as a New York C corporation on a Form CT-3 or, if the combined filing requirements are met with one or more entities (other than the QSSS), on a Form CT-3-A. If the parent does **not** make a QSSS inclusion election when the QSSS is not a New York State taxpayer, the parent (**without** its QSSS's activity included) files as a New York C corporation on a Form CT-3 or, if the combined filing requirements are met with one or more other entities (one of which could be the QSSS), on a Form CT-3-A. In this case, both the parent and the QSSS, as separate entities, are subject to the combined reporting rules, and if the parent and QSSS are unitary they both file as distinct members of a combined group on the same Form CT-3-A.
- **Nontaxpayer parent –** New York State follows the federal QSSS treatment where the QSSS is a New York State taxpayer but the parent is not, if the parent elects to be taxed as a New York S corporation by filing Form CT-6. The parent and QSSS are taxed as a single New York S corporation, and file Form CT-3-S. If the parent does **not** elect to be a New York S corporation, the QSSS (**without** its parent's activity included) must file as a New York C corporation on a Form CT-3 or, if the combined filing requirements are met with one or more other entities (one of which could be the parent), on a Form CT-3-A.

  In this case, both the parent and the QSSS, as separate entities, are subject to the combined reporting rules, and if the parent and QSSS are unitary they both file as distinct members of a combined group on the same Form CT-3-A.
- **Exception: excluded corporation –** Notwithstanding the above rules, QSSS treatment is not allowed when the parent and QSSS file under different Articles of the Tax Law (or would file under different Articles if both were subject to New York State franchise tax); in this case, each corporation must file as a distinct entity under its applicable Article, subject to the Article 9-A or Article 33 combined reporting rules, as applicable.

Mandated New York S corporations – Shareholders of an eligible federal S corporation that have not made the election to be treated as a New York S corporation for the current tax year will be deemed to have made that election and must file Form CT-3-S if the corporation's investment income is more than 50% of its federal gross income for that year. For purposes of the mandated New York State S election, *investment income* means the sum of an eligible S corporation's gross income from interest, dividends, royalties, annuities, rents and gains derived from dealings in property, including the corporation's share of such items from a partnership, estate, or trust, to the extent such items would be includable in the corporation's federal gross income for the tax year. In determining whether an eligible S corporation is deemed to have made this election, the income of a QSSS owned, directly or indirectly, by the eligible S corporation shall be included with the income of the eligible S corporation.

Corporate partners

- If a partnership is doing business, employing capital, owning or leasing property, maintaining an office, or deriving receipts from activity, in New York State, then a corporation that is a **general** partner in that partnership is subject to tax under Article 9-A (§209.1(f)).
- If a partnership is doing business, employing capital, owning or leasing property, maintaining an office, or deriving receipts from activity, in New York State, then a corporation that is a **limited** partner of that partnership (other than a portfolio investment partnership) is subject to tax under Article 9-A if it is engaged, directly or indirectly, in the participation or in the domination or control of all or any portion of the business activities or affairs of the partnership.

An LLC or LLP that is treated as a partnership for federal income tax purposes will be treated as a partnership for New York State tax purposes.

For purposes of determining nexus, the $1 million threshold for deriving receipts is determined by combining the **general** partner's receipts in New York with the partnership's receipts in New York. Also, when a **limited** partner is engaged, directly or indirectly, in the participation or in the domination or control of all or any portion of the business activities or affairs of the partnership, other than a portfolio investment partnership, for purposes of determining nexus, the $1 million threshold for deriving receipts is determined by combining the limited partner's receipts in New York with the partnership's receipts in New York.

In instances where an LLC is treated as a partnership, other than a portfolio investment partnership, when a corporate member is **not** limited in the participation in the management of the LLC by the LLC's operating agreement, such member's receipts in New York are combined with the receipts in New York of the LLC. Where the LLC operating agreement limits a corporate member's participation in the management of the LLC but such member is engaged, directly or indirectly, in the participation in or domination or control of all or any portion of the business activities or affairs of the LLC such member's receipts in New York are combined with the receipts in New York of the LLC.

Example: *Partnership A has two general partners: Partner B who owns 60% of the partnership and Partner C who owns 40%. Partnership A has $600,000 of receipts in New York. Separately, Partner B has $700,000 of receipts in New York and Partner C has $450,000 of receipts in New York. For purposes of determining nexus only, both partners B and C would be treated as having $600,000 from the partnership. Combined with their own receipts, both general partners exceed $1 million in receipts in New York ($1.3 million for Partner B and $1.05 million for Partner C). Therefore, both general partners are subject to tax.*

Alien corporations – An alien corporation (a corporation organized under the laws of a country, or any political subdivision thereof, other than the United States, or organized under the laws of a possession, territory or commonwealth of the United States) is **not** deemed to be doing business, employing capital, owning or leasing property, maintaining an office, or deriving receipts from activity, in this state if its activities in this state are limited solely to:

- investing or trading in stocks and securities for its own account per IRC section 864(b)(2)(A)(ii);
- investing or trading in commodities for its own account per IRC section 864(b)(2)(B)(ii); **or**
- any combination of the above two activities.

An alien corporation that under any provision of the IRC is not treated as a domestic corporation as defined under IRC section 7701 and has no effectively connected income, gain, or loss, for the tax year will not be subject to tax under Article 9-A for that tax year (§209.2-a).

Other forms you may need to file

Form CT-3.1, ***Investment and Other Exempt Income and Investment Capital,*** must be filed by a corporation that has investment capital (§208.5), investment income (§208.6), other exempt income (§208.6-a), stock that generates (or could generate) other exempt income, or is required to make the addback for prior years' presumed investment capital items that failed to meet the holding period presumption.

Form CT-3.2, ***Subtraction Modification for Qualified Banks,*** must be filed to utilize the subtraction modification for qualified residential loan portfolios (§208.9(r)), the subtraction modification for community banks and small thrifts (§208.9(s)), or the subtraction modification for community banks and small thrifts with a captive real estate investment trust (REIT) (§208.9(t)).

Form CT-3.3, ***Prior Net Operating Loss Conversion (PNOLC) Subtraction,*** must be filed to calculate and utilize the PNOLC subtraction and carryforward (§210.1(a)(viii)). This form must be filed for **every** tax year for which you carry a balance of a PNOLC subtraction, even if you are unable to utilize the subtraction in a given year.

Form CT-3.4, ***Net Operating Loss Deduction (NOLD),*** must be filed to calculate and utilize the NOLD and carryforward (§210.1(a)(ix)). This form must also be filed with the amended return when the carryback of a net operating loss (NOL) for a tax year beginning on or after January 1, 2015, is claimed. This form is also used to elect to waive the carryback of a loss in the year a loss is incurred.

Form CT-3-M, ***General Business Corporation MTA Surcharge Return,*** must be filed by any corporation taxable under Article 9-A that does business, employs capital, owns or leases property, maintains an office, or derives receipts from activity, in the Metropolitan Commuter Transportation District (MCTD). The MCTD includes the counties of New York, Bronx, Kings, Queens, Richmond, Dutchess, Nassau, Orange, Putnam, Rockland, Suffolk, and Westchester. An exception applies to a qualified entity of a New York State innovation hot spot when the qualified entity is located solely within a hot spot.

Form CT-33-D, ***Tax on Premiums Paid or Payable to an Unauthorized Insurer,*** must be filed if you purchase or renew a taxable insurance contract directly from an insurer not authorized to transact business in New York State under a *Certificate of Authority* from the Superintendent of Financial Services; you may be liable for a tax of 3.6% (.036) of the premium. For more information, see Form CT-33-D.

Form CT-60, ***Affiliated Entity Information Schedule,*** must be filed if you are an Article 9-A taxpayer and you have included the activities of any of the following on your return:

- a QSSS;
- a single member LLC; **or**
- a tax-exempt domestic international sales corporation (DISC).

You must also file Form CT-60 if:

- you are a federal S corporation but are filing as a New York C corporation,
- you are a partner in a partnership,

- you are a federal QSSS where New York State does **not** follow federal QSSS treatment; **or**
- you have affiliated entities.

Tax-exempt DISCs – A corporation that qualifies as a DISC under IRC section 992(a) is exempt from tax under Article 9-A if during the year it received more than 5% of its:

- gross sales from the sale of inventory or other property purchased from its stockholders;
- gross rentals from the rental of property purchased or leased from its stockholders; or
- total receipts, other than sales or rentals, from its stockholders.

All corporate stockholders in tax-exempt DISCS must adjust each item of its receipts, expenses, assets, and liabilities, as otherwise computed under Article 9-A, by adding thereto its attributable share of each such DISC's receipts, expenses, assets, and liabilities as reportable by each such DISC to the United States Treasury for its annual reporting period ending during the current tax year of such taxpayer. The tax-exempt DISC itself has no franchise tax filing requirement.

Taxable DISCs are DISCs that do not meet the 5% test under *Tax-exempt DISCs*. Taxable DISCs must file Form CT-3 on or before the 15th day of the ninth month after the end of the tax year. Such a DISC is subject to the tax on apportioned capital or the fixed dollar minimum, whichever is larger. Write ***DISC*** after the legal name of the corporation in the address section of the return.

Form CT-186-E, *Telecommunications Tax Return and Utility Services Tax Return,* must be filed by a corporation that provides telecommunication services. The corporation must pay an excise tax on its gross receipts from the sale of telecommunication services under Article 9 section 186-e.

Form CT-222, *Underpayment of Estimated Tax by a Corporation,* must be filed to inform the Tax Department that your corporation meets one of the exceptions to reduce or eliminate the underpayment of estimated tax penalty pursuant to Tax Law, Article 27, section 1085(d).

Form CT-223, *Innovation Hot Spot Deduction,* must be filed if you are a corporation that is a qualified entity located both inside and outside a hot spot, or you are a corporate partner of a qualified entity, or both.

Form CT-224, *Public Utility, Power Producer, and Pipeline Adjustments,* must be filed to make adjustments to federal taxable income (FTI) pursuant to §208.9(c-2) and §208.9(c-3).

Form CT-225, *New York State Modifications,* must be filed if you are entering an amount on Form CT-3, Part 3, lines 2 and/or 4.

Form CT-300, Mandatory First Installment (MFI) of Estimated Tax for Corporations, must be filed to pay the MFI for tax years beginning on or after January 1, 2017, if your second preceding year's franchise tax after credits exceeds $1,000.

Form CT-399, *Depreciation Adjustment Schedule,* must be filed to compute the allowable New York State depreciation deduction if you claim: 1) the federal accelerated cost recovery system (ACRS) depreciation or modified accelerated cost recovery system (MACRS) deduction for certain property placed in service after December 31, 1980; or 2) a federal special depreciation deduction for certain qualified property described in IRC section 168(k)(2) placed in service on or after June 1, 2003, in tax years beginning after December 31, 2002.

This form also contains schedules for determining a New York State gain or loss on the disposition of ACRS/MACRS property and property for which you claimed such federal special depreciation deduction.

Form CT-400, *Estimated Tax for Corporations,* must be filed if your New York State franchise tax liability can reasonably be expected to exceed $1,000.

Most corporations are required to electronically file this form either using tax software or online, after setting up an online services account, through the department's website.

Form DTF-664, *Tax Shelter Disclosure for Material Advisors,* must be filed to assist material advisors in complying with New York State's disclosure requirements.

Form DTF-686, *Tax Shelter Reportable Transactions Attachment to New York State Return,* must be filed to assist taxpayers and persons in complying with New York State's disclosure requirements.

For more information about other taxes that may apply to you, see **Publication 20, *Tax Guide for New Businesses***.

When to file

File your return within 3½ months after the end of your reporting period. If you are reporting for the calendar year, your return is due on or before April 15. If your filing date falls on a Saturday, Sunday, or legal holiday, then you must file your return on or before the next business day.

Extensions if you cannot meet the filing deadline

If you cannot meet the filing deadline, you may request a six-month extension of time by filing Form CT-5, *Request for Six-Month Extension to File (for franchise/business taxes, MTA surcharge, or both),* and paying your properly estimated franchise tax and metropolitan transportation business tax (MTA surcharge) on or before the original due date of the return.

Most corporations are required to electronically file their extension request either using tax software or online, after setting up an online services account, through the department's website.

You may request up to two additional extensions by filing Form CT-5.1, *Request for Additional Extension of Time to File (for franchise/business taxes, MTA surcharge, or both)*. File it on or before the expiration date of the original extension or previously filed additional extension.

Where to file

NYS CORPORATION TAX
PO BOX 15181
ALBANY NY 12212-5181

Private delivery services – See Publication 55, *Designated Private Delivery Services.*

Penalties and interest

If you pay after the due date

If you do not pay the tax due on or before the original due date, you must pay interest on the amount of the underpayment from the original due date of the return (**without** regard to any extension of time for filing) to the date the tax is paid. Interest is always due, without any exceptions, on any underpayment of tax. An extension of time for filing **does not** extend the due date for payment of tax.

If you file and pay after the due date

Compute additional charges for late filing and late payment on the amount of tax minus any payment made on or before the due date (**with** regard to any extension of time for filing).

A. If you do not file a return when due, or if the request for extension is invalid, add to the tax 5% per month up to 25% (§1085(a)(1)(A)).

B. If you do not file a return within 60 days of the due date, the additional charge in item A above cannot be less than the smaller of $100 or 100% of the amount required to be shown as tax (§1085(a)(1)(B)).

C. If you do not pay the tax shown on a return when due, add to the tax ½% per month up to a total of 25% (§1085(a)(2)).

D. The total of the additional charges in items A and C may not exceed 5% for any one month, except as provided for in item B above (§1085(a)).

If you think you are not liable for these additional charges, attach a statement to your return explaining the delay in filing, payment, or both (§1085).

Note: You may compute your penalty and interest by accessing our website, or you may call and we will compute the penalty and interest for you (see *Need help?*).

If you understate your tax

If the tax you report is understated by 10% or $5,000, whichever is greater, you must pay a penalty of 10% of the amount of understated tax. You can reduce the amount on which you pay penalty by subtracting any item for which: 1) there is or was substantial authority for the way you treated it; or 2) there is adequate disclosure on the return or in an attached statement (§1085(k)).

If you underpay your estimated tax

If you can reasonably expect your New York State franchise tax liability to exceed $1,000, you must make payments of estimated tax. A penalty will be imposed if you fail to file a declaration of estimated tax or fail to timely pay the entire installment payment of estimated tax due. For complete details, see Form CT-222.

Other penalties

Strong civil and criminal penalties may be imposed for negligence or fraud.

Voluntary Disclosure and Compliance Program

Have you underreported your tax due on past returns?

Tax Law, Article 36, section 1700 authorizes the Tax Department to waive civil and criminal penalties for taxpayers who disclose and pay overdue taxes. Under the Tax Department's Voluntary Disclosure and Compliance Program, eligible taxpayers who owe back taxes can avoid monetary penalties and possible criminal charges by:

- telling the Tax Department what taxes they owe;
- paying those taxes; and
- entering an agreement to pay all future taxes.

It is easy to apply. Visit our website (see *Need help?*). Follow the prompts, answer a few questions, and submit your application electronically.

Is this an amended return?

If you are filing an amended return for any purpose, mark an ***X*** in the *Amended return* box on page 1 of the return.

If you file an amended federal return, you must file an amended New York State return within 90 days thereafter.

You **must** file using the correct year's return for the tax year being amended. Do **not** use the most current year's return if the current year is not the year being amended. If you file on the wrong year's return, it may cause the amended return to be rejected, or may cause a delay in receiving any tax benefits being claimed.

For amended returns based on changes to federal taxable income (FTI) – If your FTI has been changed or corrected by a final determination of the Commissioner of Internal Revenue, or by a renegotiation of a contract or subcontract with the United States, you must file an amended return reflecting the change to FTI within 90 days of the final federal determination (as final determination is described under the regulations of the Commissioner of Taxation and Finance).

You must attach a copy of federal Form 4549, *Income Tax Examination Changes,* to your amended return.

If you filed as part of a consolidated group for federal tax purposes but on a separate basis for New York State tax purposes, you must submit a statement indicating the changes that would have been made if you had filed on a separate basis for federal tax purposes.

For credits or refunds based upon carryback of a net operating loss (NOL) – To claim a credit or refund resulting from the carryback of an NOL to a prior year, file an amended return for the year to which the carryback is being applied within three years of the date the original return was filed or within two years of the date the tax was paid, whichever is later.

You must attach the following to your amended return:

- a copy of the New York State return previously filed with New York State for the loss year; and
- Form CT-3.4 when carrying back loss incurred in a tax year that began on or after January 1, 2015, to a tax year that began on or after January 1, 2015.

NOLs from tax years that begin on or after January 1, 2015, cannot be carried back to tax years that began before January 1, 2015.

For credits or refunds of corporation tax paid – To claim any refund type that requires an amended return, other than an NOL carryback (see *For credits or refunds based upon carryback of a net operating loss (NOL)*), file an amended New York State return for the year being amended and, if applicable, attach a copy of the claim form filed with the IRS (usually Form 1120X) and proof of federal refund approval, *Statement of Adjustment to Your Account*. You must use the tax return for the year being amended.

If you are a federal S corporation, file an amended New York State return for the year being amended. If applicable, attach a copy of the amended federal Form 1120S.

The amended return must be filed within three years of the date the original return was filed or within two years of the date the tax was paid, whichever is later. If you did not file an original return, you must make the request within two years of the date the tax was paid. However, a claim for credit or refund based on a federal change must be filed within two years from the time the amended return reporting the change or correction was required to be filed (see *For amended returns based on changes to federal taxable income (FTI)).* For additional limitations on credits or refunds, see §1087.

Filing your final return

Mark an ***X*** in the *Final return* box on page 1 of the return if the corporation is a:

- domestic corporation that ceased doing business, employing capital, owning or leasing property, or deriving receipts from activity, in New York State during the tax year and wishes to dissolve; or
- foreign corporation that is no longer subject to the franchise tax in New York State.

Do not mark an ***X*** in the *Final return* box if you are only changing the type of return that you file (for example, from Form CT-3 to CT-3-S).

Do not mark an ***X*** in the *Final return* box in the case of a merger or consolidation.

Include the full profit from any installment sale made in your final tax year on your final return. Also include on your final return any remaining profit not yet received from a prior years' installment sale. Include such amounts in your FTI before NOL and special deductions on Part 3, line 1.

For information on voluntary dissolution and surrender of authority, see *Instructions for voluntary dissolution of a New York business corporation* (TR-125), and *Instructions for surrender of authority by foreign business corporation* (TR-199), on our website (see *Need help?)*.

New York S corporation termination year

When a New York S corporation terminates its federal or New York S election on a day other than the first day of a tax year, the tax year is divided into two tax periods (an S short year and a C short year). The corporation must file Form CT-3-S for the New York S short year and Form CT-3 for the New York C short year.

When an IRC section 338(h)(10) election is made for a target corporation that is a New York S corporation, the target corporation must file two short-period (less than 12 months) returns. When filing the second short-period return, the FTI of the new target is the starting point for computing entire net income (ENI).

The total tax for the S short year and the C short year may not be less than the fixed dollar minimum tax determined as if the corporation were a C corporation for the entire tax year. For more information, see Form CT-3-S-I, *Instructions for Form CT-3-S*.

The due date of the New York S corporation short year return (Form CT-3-S) is the same as the New York C corporation short year, even though they are treated as separate short tax years.

Overview of corporation franchise tax

Tax bases

Corporations subject to tax under Tax Law Article 9-A generally must compute three distinct taxes and pay the tax that results in the largest amount owed. The three taxes include a tax on business income, a tax on capital, and a fixed dollar minimum tax.

New York State innovation hot spot program

A qualified entity of a New York State innovation hot spot that is located solely within a hot spot is subject only to the fixed dollar minimum tax for five tax years beginning with the first tax year the qualified entity becomes a tenant in, or part of, an innovation hot spot. A qualified entity must be certified by a New York State innovation hot spot. A taxpayer who claims this benefit or who enters an amount on Form CT-3, Part 3, line 4, as a subtraction from FTI for the income or gain attributable to the operations at, or as part of, the hot spot is no longer eligible for any other New York State exemption, deduction, credit, or refund under the Tax Law to the extent that such exemption, deduction, credit, or refund is attributable to the business operations of a tenant in, or as part of, the New York State innovation hot spot. Claiming these benefits represents an irrevocable election.

Tax on business income

The tax on the business income base is computed in Part 3. The business income base is determined using a single receipts factor. The factor is computed in Part 6.

Tax on business capital

The tax on the business capital base is computed in Part 4. The business capital base is determined using a single receipts factor. The factor is computed in Part 6.

Fixed dollar minimum tax

The fixed dollar minimum tax is determined by a corporation's New York receipts.

A domestic corporation that is no longer doing business, employing capital, owning or leasing property, or deriving receipts from activity, in New York State is exempt from the fixed dollar minimum tax for years following its final tax year and is no longer required to file a franchise tax return, provided it meets the requirements listed in §209.8.

Computation of tax for corporate partners

A taxpayer that is a partner in a partnership (a corporate partner) computes its tax for its interest in the partnership using either the aggregate method or entity method, whichever applies. For an exception to these methods, see *Election by a foreign corporate limited partner*.

Aggregate method – Under the aggregate method, a corporate partner is viewed as having an undivided interest in the partnership's assets, liabilities, and items of receipts, income, gain, loss, and deduction. The partner is treated as participating in the partnership's transactions and activities.

Entity method – Under the entity method, a partnership is treated as a separate entity and a corporate partner is treated as owning an interest in the partnership entity. The partner's interest is an intangible asset that is classified as business capital. To the extent a corporate partner's ENI includes its distributive share of partnership items of income, gain, loss, or deduction, those items are treated as business income.

Corporate partners required to file under the aggregate method

A corporate partner receiving a complete Form IT-204-CP, *New York Corporate Partner's Schedule K-1,* must file using the aggregate method. In addition, a corporate partner must file using the aggregate method if the corporate partner has access to the information necessary to compute its tax using the aggregate method. A corporate partner is presumed to have access to the information and therefore is required to file using the aggregate method if it meets **one or more** of the following conditions:

- it is conducting a unitary business with the partnership;
- it is a general partner of the partnership or is a managing member of an LLC that is treated as a partnership for federal income tax purposes;
- it has a 5% or more interest in the partnership;

- it has reported information from the partnership for a prior tax year using the aggregate method;
- its partnership interest constitutes more than 50% of its total assets;
- its basis in its interest in the partnership determined under IRC section 705 on the last day of the partnership year that ends within or with the taxpayer's tax year is more than $5 million; or
- any member of its affiliated group has the information necessary to perform such computation.

A corporate partner that does not receive a complete Form IT-204-CP may file using the entity method **only** if it does **not** meet any of the conditions listed above **and** does not have access (and will not have access within the time period allowed for filing a return with regard to all extensions of time to file) to the information necessary to compute its tax using the aggregate method and certifies these facts to the Commissioner of Taxation and Finance.

Computation of tax under the aggregate method – The taxpayer's **distributive share** (IRC section 704) of each partnership item of receipts, income, gain, loss, and deduction, and the taxpayer's **proportionate part** of each partnership asset, liability, and partnership activity are included in the computation of the taxpayer's business income base, capital base, and the fixed dollar minimum. These items have the same source and character in the hands of the partner for Article 9-A purposes that the items have for the partner for federal income tax purposes.

Computation of tax under the entity method – A corporate partner is treated as owning an interest in the partnership entity for purposes of determining the taxes measured by the business income base, capital base, and the fixed dollar minimum. The partner's interest is an intangible asset that is business capital.

Election by a foreign corporate limited partner – A foreign corporation that is a limited partner in, and that is engaged, directly or indirectly, in the participation or in the domination or control of all or any portion of the business activities of, one or more limited partnerships, where such partnership(s) are doing business, employing capital, owning or leasing property, maintaining an office, or deriving receipts from activity, in New York State is subject to tax under Article 9-A. When this is the **sole** reason such foreign corporation is taxable under Article 9-A, and the corporation does not file on a combined basis for Article 9-A purposes, the corporation may elect to compute its tax by taking into account **only** its distributive share of each partnership item of receipts, income, gain, loss, and deduction (including any addition or subtraction modifications to FTI) and its proportionate part of each asset, liability, and partnership activity of the limited partnership (the separate accounting election).

If a partnership is required to file a NYS partnership return, but is **not** doing business, employing capital, owning or leasing property, maintaining an office, or deriving receipts from activity, in NYS (when, for example, the partnership has a NYS partnership return filing requirement only because it has a NYS resident partner that is an individual, estate, or trust), then having an interest in that partnership would not subject a foreign corporate limited partner to tax under Article 9-A, and the separate accounting election would **not** be applicable with respect to that partnership.

This election may not be made if the limited partnership and corporate group are engaged in a unitary business, wherever conducted.

Corporate group means the corporate limited partner itself or, if it is a member of an affiliated group, the corporate limited partner and all other members of such affiliated group.

Affiliated group has the same meaning as such term is defined in IRC section 1504 without regard to the exclusions provided for in section 1504(b). However, the term *common parent corporation* means any person as defined in IRC section 7701(a)(1).

How to make the separate accounting election – The separate accounting election is made by the foreign corporate limited partner at the time of filing Form CT-3, is not revocable, and is binding with respect to that partnership interest for all future tax years. **For its tax years beginning on or after January 1, 2017,** a foreign corporation makes the separate accounting election, with respect to a limited partnership, on Form CT-60, *Affiliated Entity Information Schedule*, in Schedule B, Part 3. Form CT-60 must be signed and filed with Form CT-3.

How to complete Form CT-3 when the separate accounting election is made – If you file Form CT-3, and you have made the separate accounting election for a limited partnership, when computing your tax bases report **only** your **distributive share** or **proportionate part** of receipts, income, gain, loss, deduction, assets, liabilities, and activities of such limited partnership. Thus, when computing the tax on the business income base, your starting point would be federal taxable income as if your **only** activity was your interest in the partnership. The same is true for your starting point in computing the tax on the capital base.

In computing the business income and capital bases, any required modifications and/or adjustments required to be made to the starting points will, again, be made as if your **only** activity was your interest in the partnership. Business income and business capital amounts so computed are then apportioned to New York State using a business apportionment factor that is computed by completing Form CT-3, Part 6, using **only** your **distributive share** of such limited partnership's receipts, net income, net gains, and other items, that must be included in the numerator and denominator of the business apportionment fraction in accordance with Tax Law §210-A and the applicable regulations.

Note: Receipts, net income, net gains, and other items must be **sourced**, and the amounts allowed in the business apportionment factor must be determined, in accordance with **Article 9-A** sourcing rules set forth in Tax Law §210-A. Include in the numerator and denominator of the business apportionment fraction **only** your share of the receipts, net income, net gains (not less than zero), and other applicable items described in Tax Law §210-A that are earned by the partnership in the regular course of business and included in your business income, determined without regard to the amount subtracted on Form CT-3, Part 3, line 6, (subtraction modification for qualified banks), and without regard to any amount from investment capital that is determined to exceed the 8% of ENI limitation on gross investment income (see Form CT-3.1).

For the fixed dollar minimum tax, the amount computed for the numerator of the business apportionment factor, as described above, is the amount of New York receipts used to compute the fixed dollar minimum tax.

When the separate accounting election is in effect, do not take into account any gain or loss that is recognized from the sale of the interest in the limited partnership for which the election was made.

When the separate accounting election is in effect and you do not have access to all of the necessary information to properly complete Form CT-3 – If you have made the separate accounting election with respect to a limited partnership, and

Tax rates schedule

Tax base	Tax rates
Table 1 – Business income base for general business taxpayers	.065
Table 2 – Business income base for qualified small business taxpayers	.065
Table 3 – Business income base for qualified New York manufacturers	.00
Table 4 – Business income base for qualified emerging technology companies (QETCs)	.04875
Table 5 – Capital base	.00075
Table 6 – Capital base for qualified New York manufacturers and QETCs	.00056
Table 7 – Capital base for qualified cooperative housing corporations	.0004
Table 8 – Fixed dollar minimum tax	
For a corporation with New York receipts of:	
Not more than $100,000:	$ 25
More than $100,000 but not over $250,000:	$ 75
More than $250,000 but not over $500,000:	$ 175
More than $500,000 but not over $1,000,000:	$ 500
More than $1,000,000 but not over $5,000,000:	$ 1,500
More than $5,000,000 but not over $25,000,000:	$ 3,500
More than $25,000,000 but not over $50,000,000:	$ 5,000
More than $50,000,000 but not over $100,000,000:	$ 10,000
More than $100,000,000 but not over $250,000,000:	$ 20,000
More than $250,000,000 but not over $500,000,000:	$ 50,000
More than $500,000,000 but not over $1,000,000,000:	$ 100,000
Over $1,000,000,000:	$ 200,000
Table 9 – Fixed dollar minimum tax for qualified New York manufacturers and QETCs	
For a corporation with New York receipts of:	
Not more than $100,000:	$ 19
More than $100,000 but not over $250,000:	$ 56
More than $250,000 but not over $500,000:	$ 131
More than $500,000 but not over $1,000,000:	$ 375
More than $1,000,000 but not over $5,000,000:	$ 1,125
More than $5,000,000 but not over $25,000,000:	$ 2,625
Over $25,000,000:	$ 3,750
Table 10 – Fixed dollar minimum tax for non-captive REITs and non-captive RICs	
For a corporation with New York receipts of:	
Not more than $100,000:	$ 25
More than $100,000 but not over $250,000:	$ 75
More than $250,000 but not over $500,000:	$ 175
Over $500,000:	$ 500

you do not have the information necessary to compute your tax bases and business apportionment factor as discussed above, you must treat your distributive share of such partnership's items of income, gain, loss, and deduction as business income. In this case, you would show the starting point for the computation of the business income base as described above, but would make **no** modifications and/or adjustments to such amounts. The starting point for the computation of business capital would be the partnership interest, with no adjustments being made thereto. These business income and business capital amounts would be apportioned 100% to NYS. Report a business apportionment factor of 100% by reporting, on Form CT-3, Part 6, line 54, a New York State receipts amount (column A) **equal to** your distributive share of such limited partnership's Everywhere receipts (column B).

When the separate accounting election is in effect for multiple limited partnership interests AND you have NO limited partnership interests for which the election has NOT been made – Complete the front page of Form CT-3. Then complete Part 1, making sure to mark an ***X*** in the box for Section C, line 7. Then you must compute the business income base (Part 3) and capital base (Part 4) per the following instructions.

An **individual** pro forma Form CT-3, Part 3, lines 1 through 13, and an **individual** pro forma Form CT-3, Part 4, lines 1 through 11, must be completed for **each** limited partnership for which the election was made. These lines must be completed as if your **only** activity was your interest in each such partnership; this includes any modifications and/or adjustments required in such computations.

Apportion each such pro forma business income base and pro forma capital base to New York State using a business apportionment factor that is computed by using **only** your **distributive share** of the limited partnership's receipts, net income, net gains, and other items, that must be included in the numerator and denominator of the business apportionment fraction in accordance with Tax Law §210-A and the applicable regulations, **for which** you are apportioning the pro forma business income base and pro forma capital base. To do so, complete an individual pro forma Form CT-3, Part 6 for **each** limited partnership for which the election was made.

For **each** limited partnership for which the election was made, multiply that partnership's pro forma business income base, and pro forma capital base, by the pro forma business apportionment factor computed for **that** limited partnership. Each result is the amount to enter on the associated pro forma Form CT-3, Part 3, line 15 (for the business income base), and on the associated pro forma Form CT-3, Part 4, line 13 (for the capital base).

For **each** pro forma business income base, complete the pro forma Form CT-3, Part 3, lines 16 through 19. **Sum all** pro forma Forms CT-3, Part 3, line 19, counting negative amounts as zeros. Enter the result on Part 3, line 19 of the Form CT-3 **that will be filed with New York State**.

Complete Part 3, line 20 of the Form CT-3 that will be filed with New York State, and also enter the line 20 amount on Part 2, line 1a of the Form CT-3 that will be filed with New York State.

For the capital base, on Part 4, line 13, of the Form CT-3 that will be filed with New York State, enter the **sum** of **all** pro forma Forms CT-3, Part 4, line 13. When summing the pro forma line 13s, count any negative amounts as zeros. Then, complete Part 4, line 15 of the Form CT-3 that will be filed with New York State, and also enter the line 15 amount on Part 2, line 1b of the Form CT-3 that will be filed with New York State.

On Part 2, line 1c of the Form CT-3 that will be filed with New York State, enter the **sum** of **all** pro forma Forms CT-3, Part 6, line 54, column A. Then complete the remaining lines of Part 2 of the Form CT-3 that will be filed with New York State.

Make no entries on Part 6 of the Form CT-3 that will be filed with New York State.

Foreign airlines

Foreign airlines that have a foreign air carrier permit pursuant to section 402 of the Federal Aviation Act of 1958 may exclude from ENI all income from international operations effectively connected to the United States, foreign passive income, and income earned from overseas operations, provided the foreign country in which the airline is based has a similar exemption from tax with respect to United States airlines (§208.9(c-1)).

When computing the tax on capital, foreign airlines may also exclude from business capital those assets used to generate the income that was excluded based on the previous paragraph (to the extent the assets were employed in generating that income) (§208.7(b)).

However, if the country in which the foreign airline is based does not provide a similar exemption from tax with respect to United States airlines, the foreign airline is not entitled to the exclusions from income and capital described above.

How to fill out your tax return

Important identifying information

When preparing your corporation tax return, be sure to accurately complete the corporation's identifying information (employer identification number (EIN) and file number) including your current address. Keep a record of your identifying information for future use.

If you use a paid preparer or accounting firm, make sure they use your complete and accurate information when completing all your forms.

All filers must complete the beginning and ending tax year boxes in the upper right corner on page 1 of the form.

Signature

The return must be certified by the president, vice president, treasurer, assistant treasurer, chief accounting officer, or other officer authorized by the taxpayer corporation.

The return of an association, publicly traded partnership, or business conducted by a trustee or trustees must be signed by a person authorized to act for the association, publicly traded partnership, or business.

If an outside individual or firm prepared the return, all applicable entries in the paid preparer section must be completed, including identification numbers (see *Paid preparer identification numbers* in Form CT-1).

Failure to sign the return will delay the processing of any refunds and may result in penalties.

Line instructions

Line A – Make your check or money order payable in United States funds. We will accept a foreign check or foreign money order only if payable through a United States bank or if marked ***Payable in U.S. funds.***

Line B – If during the tax year you do business, employ capital, own or lease property, maintain an office, or derive receipts from activity, in the MCTD, you are subject to the MTA surcharge.

A corporation is deriving receipts from activity in the MCTD if it has receipts within the MCTD of $1 million or more in a tax year. For more information, see Form CT-3-M-I.

The MCTD includes the counties of New York, Bronx, Kings, Queens, Richmond, Dutchess, Nassau, Orange, Putnam, Rockland, Suffolk, and Westchester.

Mark an ***X*** in the appropriate box. If *Yes*, you must file Form CT-3-M.

Line C – Pursuant to Public Law 86-272, a foreign corporation is not subject to the tax imposed by Article 9-A if its activities are limited to those described in that law. If you are disclaiming tax liability in New York State based on Public Law 86-272, but still want to file a New York State franchise tax return, mark an ***X*** in the box. You must also complete Form CT-3 in its entirety **and** enter ***0*** on Part 2, line 4.

Part 1 – General corporate information

Section A – Qualification for preferential tax rates

Failure to mark a box that pertains to you may result in a delay in processing your return or the loss of a claimed tax benefit.

Generally, you will have only one box marked in Section A indicating the preferential tax status you are actually utilizing to realize the tax benefits of that status. However, a qualified New York manufacturer can have the boxes on both lines 2 and 3 marked if it meets the principally engaged test for line 2 and the different principally engaged test for line 3.

Also, a small business taxpayer utilizing the small business tax benefits would mark the box on line 6 as well as the box on line 6b if it was also a QETC, or the box on line 6c if it was also a qualified New York manufacturer.

Line 1 – If you are claiming QETC status for purposes of the lower business income base tax rate, the lower capital base tax rate and cap, and the reduced fixed dollar minimum tax amounts, you must mark an ***X*** in the box. For qualifying criteria, see New York State Public Authorities Law section 3102-e(1)(c), without regard to the $10 million limitation. For more information, see TSB-M-12(9)C, *Clarification of Qualifications for Qualified Emerging Technology Company (QETC) Tax Credits*.

Line 2 – If you are claiming qualified New York manufacturer status based on the principally engaged test (see below) for purposes of the lower business income base tax rate and the reduced fixed dollar minimum tax amounts, you must mark an ***X*** in the box.

A q*ualified New York manufacturer* is a manufacturer (as described below) that has property in New York State that is principally used by the manufacturer in the production of goods by manufacturing, processing, assembling, refining, mining, extracting, farming, agriculture, horticulture, floriculture, viticulture, or commercial fishing, and either:

- the adjusted basis of the property for federal income tax purposes is at least $1 million at the close of the tax year; or
- all of its real and personal property is located in New York State.

A corporation qualifies as a manufacturer if during the tax year the taxpayer is **principally engaged** in the production of goods by manufacturing, processing, assembling, refining, mining, extracting, farming, agriculture, horticulture, floriculture, viticulture, or commercial fishing. A taxpayer is *principally engaged* in the foregoing activities if during the tax year more than 50% of its gross receipts are derived from receipts for the sale of goods produced by these activities.

For purposes of the 0% business income base tax rate and the reduced fixed dollar minimum tax amounts, the generation and distribution of electricity, the distribution of natural gas, and the production of steam associated with the generation of electricity are **not** considered qualifying activities for purposes of the principally engaged test.

For more information, see TSB-M-15(3)C, *Real Property Tax Credit and Reduction of Tax Rates for Qualified New York Manufacturers*, and TSB-M-15(3.1)C, *Revised Information on the Real Property Tax Credit and Reduction of the Capital Base Tax Rate for Qualified New York Manufacturers*.

Line 3 – If you are claiming qualified New York manufacturer status based on the principally engaged test for purposes of the lower capital base tax rate and capital base tax cap, you must mark an ***X*** in the box. The definition of *qualified New York manufacturer* and the principally engaged test, as described in line 2 instructions, apply. For purposes of the lower capital base tax rate and capital base tax cap, the generation and distribution of electricity, the distribution of natural gas, and the production of steam associated with the generation of electricity are **not** considered qualifying activities for purposes of the principally engaged test. For more information, see TSB-M-15(3)C and TSB-M-15(3.1)C.

Line 4 – If you are claiming qualified New York manufacturer status based on the significant employment and property test (see below) for purposes of the lower business income base tax rate, the lower capital base tax rate and cap, and the reduced fixed dollar minimum tax amounts, you must mark an ***X*** in the box.

A taxpayer that does not satisfy the principally engaged test may be a qualified New York manufacturer if the taxpayer employs during the tax year at least 2,500 employees in manufacturing in New York and the taxpayer has property in the state used in manufacturing, the adjusted basis of which for federal income tax purposes at the close of the tax year is at least $100 million.

For purposes of the 0% business income base tax rate, the reduced fixed dollar minimum tax amounts, and the lower capital base tax rate and capital base tax cap, the generation and distribution of electricity, the distribution of natural gas, and the production of steam associated with the generation of electricity are **not** considered qualifying activities for purposes of determining if employees are employed in manufacturing, or if property is used in manufacturing. For more information, see TSB-M-15(3)C and TSB-M-15(3.1)C.

Line 5 – A qualified cooperative housing corporation is entitled to use a reduced tax rate of .0004 when computing its tax using the capital base. To claim this reduced rate, you must mark an ***X*** in the box.

A corporation that has only one class of stock that entitles the shareholder to live in a house or an apartment in a building owned or leased by the corporation may be a cooperative housing corporation. For a complete definition, see IRC section 216(b).

Note: All cooperative housing corporations must file Form TP-588, *Cooperative Housing Corporation Information Return,* twice a year. For more information, see the instructions on Form TP-588.

Line 6 – If you are claiming small business taxpayer status for purposes of the exemption from the capital base tax when you are reporting for either of your first two tax years, you must mark an ***X*** in the box.

A corporation qualifies as a small business taxpayer if:

1) its ENI is not more than **$390,000**;
2) the total amount of money and other property it received for stock, as a contribution to capital and as paid-in surplus, is not more than $1 million as of the last day of its tax year;

3) the average number of individuals (excluding general executive officers) employed full time in New York State during the tax year is 100 or fewer; **and**
4) the corporation is not part of an affiliated group, as defined in IRC section 1504, unless the group itself would have met the above criteria if it had filed a combined return.

For purposes of item 3 above, determine the average number of individuals employed full time in the state by averaging the sum of such individuals employed on March 31, June 30, September 30, and December 31 of the tax year.

An individual *employed full time* means an employee in a job consisting of at least 35 hours per week, or two or more employees who are in jobs that together constitute the equivalent of a job of at least 35 hours per week (full-time equivalent). A full-time equivalent employee in New York State includes any employee regularly connected with or working out of an office or place of business of the taxpayer in New York State.

General executive officers include the chairman, president, vice president, secretary, assistant secretary, treasurer, assistant treasurer, comptroller, and any other officer charged with the general executive affairs of the corporation. An executive officer whose duties are restricted to territory either in or outside New York State is not a general executive officer.

Short periods: A corporation that files Form CT-3 for a tax year of less than 12 months must annualize ENI from Form CT-3, Part 3, line 7, to determine if it qualifies as a small business taxpayer. For a period of less than 12 months, annualize the ENI by multiplying the ENI by 12 and dividing the result by the number of months in the short period.

Line 6a – If you are claiming the small business taxpayer exception to the capital base tax (see line 6 instructions), you must provide the information requested on this line. The amount taken into account with respect to any property other than money is the amount equal to the adjusted basis to the taxpayer of such property for determining gain, reduced by any liability to which the property was subject or was assumed by the taxpayer. Use the worksheet below to determine the total capital contributions to enter on this line.

	No. of shares	Amount
Par value stock......................		
No-par value stock		
Contributions to capital and paid-in surplus		
Total capital contributions; enter on line 6a		

Line 7 – For information as to how to qualify as an entity of a New York State innovation hot spot, see TSB-M-14(1)C, *New York State Business Incubator and Innovation Hot Spot Support Act*.

Part 1 Section B – New York State information

Line 1 – Enter the number of full-time employees at the end of the tax year. For more information, see Section A, line 6 instructions.

Line 2 – Enter the total amount of all wages and compensation of employees (except general executive officers) that work out of an office or location in New York State.

Line 3 – A *business establishment* is a single physical location where business is conducted, or where services or industrial operations are performed.

Line 5 – A taxpayer that is not included in a combined return with a related member must add back royalty payments directly or indirectly paid, accrued, or incurred in connection with one or more direct or indirect transactions with one or more related members during the tax year. These royalty payments must be added back to the extent deductible in calculating FTI. This addback applies unless the taxpayer meets one of the following four exceptions:

1. The addback will not apply to the portion of the royalty payment for which the taxpayer establishes by clear and convincing evidence of the form and type specified by the Commissioner of Taxation and Finance that:
   - the related member was subject to tax in New York or another state or possession of the United States, a foreign nation, or a combination of these on a tax base that included the royalty payment paid, accrued, or incurred by the taxpayer;
   - the related member during the same tax year directly or indirectly paid, accrued, or incurred the portion of the royalty payment to a person that is not a related member; and
   - the transaction giving rise to the royalty payment between the taxpayer and the related member was undertaken for a valid business purpose.
2. The addback will not apply if the taxpayer establishes by clear and convincing evidence of the form and type specified by the commissioner that:
   - the related member was subject to tax on, or measured by, its net income in New York, another state or possession of the United States, or a combination of these;
   - the tax base for the tax included the royalty payment paid, accrued, or incurred by the taxpayer; and
   - the aggregate effective rate of tax applied to the related member in those jurisdictions is not less than 80% of the statutory rate of tax that applied to the taxpayer under §210 for the tax year.
3. The addback will not apply if the taxpayer establishes by clear and convincing evidence of the form and type specified by the commissioner that:
   - the royalty payment was paid, accrued, or incurred to a related member organized under the laws of a country other than the United States;
   - the related member's income from the transaction was subject to a comprehensive income tax treaty between that country and the United States;
   - the related member was subject to tax in a foreign nation on a tax base that included the royalty payment paid, accrued, or incurred by the taxpayer;
   - the related member's income from the transaction was taxed in that country at an effective rate of tax at least equal to that imposed by New York; and
   - the royalty payment was paid, accrued, or incurred pursuant to a transaction that was undertaken for a valid business purpose and using terms that reflect an arm's-length relationship.
4. The addback will not apply if the taxpayer and the commissioner agree in writing to the application or use of alternative adjustments or computations. The commissioner may, in his or her discretion, agree to the application or use of alternative adjustments or computations if he or she concludes that the income of the taxpayer would not be properly reflected in the absence of such an agreement.

If you are claiming one of these exceptions, mark an ***X*** in the box and see the instructions for line 5a.

Line 5a – Enter the number of the applicable exception (see above) and the amount of royalty payments excluded from ENI. Attach a statement to your return explaining how you meet each requirement for the exception.

Line 6 – A corporation is deriving receipts from activity in this state if it has receipts within this state of $1 million or more in the tax year. If you are not protected by Public Law 86-272 and are subject to tax **solely** as a result of deriving receipts in New York, mark an ***X*** in the box (§209.1).

Part 1 Section C – Filing information

To avoid an erroneous assessment or delayed refund, all filers **must** complete the applicable lines in this section.

Line 6 – Federal Public Law (P.L. 110-343) added section 457A to the Internal Revenue Code (IRC) to address the taxation of certain nonqualified deferred compensation.

If you were required to report any nonqualified deferred compensation on your 2018 federal tax return, as required under IRC section 457A, or if any such amounts flowed-through to you from a pass-through entity, mark an ***X*** in the *Yes* box; otherwise mark an ***X*** in the *No* box.

Part 2 – Computation of balance due or overpayment

Line 1b – The tax on the capital base does not apply to certain filers. If you are a:

- REIT as defined in IRC section 856 that is subject to tax under IRC section 857, or
- RIC as defined in IRC section 851 that is subject to tax under IRC section 852,

enter ***0*** here and on Part 4, line 15.

A REIT or RIC filing federal Form 1120-REIT or 1120-RIC **must** mark an ***X*** in the applicable box on Part 1, Section C, line 1, to avoid an erroneous assessment or delayed refund.

A **small business taxpayer** may claim an exemption from the tax on capital base for its first two tax years if it meets certain requirements. However, it must mark the correct box on Part 4, line 14 for the return to process properly, and must complete lines 6 through 6c in Part 1, Section A, as applicable.

Line 1c – The fixed dollar minimum tax is determined by the corporation's New York receipts. Enter your New York receipts in the first box. If you do not have New York receipts, enter ***0***. **To avoid an erroneous assessment or a delay in your refund,** you **must** enter an amount on this line.

New York receipts are the receipts included in the numerator of the apportionment factor as determined in Part 6, *Computation of business apportionment factor*.

For a short period, compute New York receipts by dividing the amount of New York receipts for the tax year by the number of months in the tax year and multiplying the result by 12.

See Table 8, 9, or 10 of the *Tax rates schedule* to determine the applicable fixed dollar minimum tax to enter on line 1c. The fixed dollar minimum tax may be reduced for short periods.

Period	**Reduction**
Not more than six months	50%
More than six months but not more than nine months	25%
More than nine months	None

A homeowners association, as such term is defined in IRC section 528(c), without regard to section 528(c)(1)(E), with no FTI, as the term is defined in section 528(d), is not subject to the fixed dollar minimum tax and must enter ***0*** on line 1c. A homeowners association filing federal Form 1120-H must mark an ***X*** in the applicable box on Part 1, Section C, line 1, to avoid an erroneous assessment or delayed refund.

Qualified New York manufacturers and QETCs must mark an ***X*** in the applicable box on Part 1, Section A, line 1, 2, or 4, and non-captive REITs, and non-captive RICs must mark the 1120-REIT or 1120-RIC box on Part 1, section C, line 1, to avoid an erroneous assessment or delayed refund.

Line 2 – Tax due

Small business taxpayer exception: If you qualify as **both** a small business taxpayer **and** either a qualified New York manufacturer or a QETC, you must use the small business taxpayer rate for purposes of the business income base in order to be exempt from the tax on capital base. You **cannot** claim qualified New York manufacturer or QETC status for those lower business income base tax rates, **and** also claim small business taxpayer status for the exemption from the capital base tax.

To indicate that you are claiming small business taxpayer status, mark an ***X*** in the box on Part 1, Section A, line 6, but do **not** mark an ***X*** in any of the boxes on Part 1, Section A, line 1, 2, 3, or 4.

Qualified entity of a New York State innovation hot spot exception: If located **solely** within a hot spot and electing to be subject only to the fixed dollar minimum tax, enter only the amount from line 1c. To indicate that you are making this election, mark an ***X*** in the box on Part 1, Section A, line 7.

Taxable DISC exception: Enter the larger of line 1b or 1c.

Line 3 – Complete Part 7, and enter the total amount of the tax credits that you are claiming to reduce your tax due. If you are claiming more than one tax credit, see Form CT-600-I, *Instructions for Form CT-600*, for the order of application under Article 9-A. **Attach** copies of all forms and schedules used. If you claim a tax credit without filing the appropriate tax credit claim form, the tax credit will be disallowed.

There are limited instances in which the use of a tax credit can reduce your tax below the fixed dollar minimum tax shown on line 1c. The manufacturer's real property tax credit may reduce your tax to $25. The QEZE tax reduction credit (if you have a 100% zone allocation), the tax-free New York area excise tax on telecommunications credit (if you have a 100% area allocation), and the tax-free New York area tax elimination credit (if you have a 100% area allocation) may reduce your tax to $0.

Line 8 – Form CT-222 is filed by a corporation to inform the Tax Department that the corporation meets one of the exceptions to reduce or eliminate the underpayment of estimated tax penalty pursuant to §1085(d).

Lines 9 and 10 – If you are not filing this return on time, you must pay interest and additional charges. See *Penalties and interest*.

Lines 12a through 12k

If you want to make a contribution to *Return a Gift to Wildlife*, *Breast Cancer Research and Education Fund*, *Prostate and Testicular Cancer Research and Education Fund*, *National September 11 Memorial & Museum at the World Trade Center*, *Volunteer Firefighting and Volunteer Emergency Services Recruitment and Retention Fund*, *Veterans Remembrance and Cemetery Maintenance and Operations Fund*, *Women's Cancers Education and Prevention Fund*, *Veterans' Home Assistance Fund*, *Love Your Library Fund*, *Lupus Education and Prevention Fund*, *Military Family Relief Fund*, or all eleven, enter the whole dollar amount(s) on the appropriate line(s). Your gift will increase your payment due or reduce your overpayment. You cannot change the amount of your gift after you file your return.

Line 12a – Return a Gift to Wildlife – Your contribution will benefit New York's fish, wildlife, and marine resources, and you can receive a free issue of *Conservationist* magazine. Call

1 800 678-6399 for your free sample issue. For more information about New York State's environmental conservation programs, go to *www.dec.ny.gov*. For information about *Conservationist*, go to *www.TheConservationist.org*.

Line 12b – Breast Cancer Research and Education Fund – Your contribution will support ground-breaking research and education in New York State to prevent, treat, and cure breast cancer. Help make breast cancer a disease of the past. For more information, go to *www.wadsworth.org/extramural/breastcancer*. New York State will match your contribution to the Breast Cancer Research and Education Fund, dollar for dollar.

Line 12c – Prostate and Testicular Cancer Research and Education Fund – Your contribution will advance prostate and testicular cancer research, support programs and education projects in New York State. New York State will match contributions to the Prostate and Testicular Cancer Research and Education Fund, dollar for dollar.

Line 12d – National September 11 Memorial & Museum at the World Trade Center *(9/11 Memorial)* – Your contribution will help create and sustain the National September 11 Memorial & Museum which will commemorate and honor the thousands of people who died in the attacks of September 11, 2001, and February 26, 1993. The Memorial and Museum will recognize the endurance of those who survived, the courage of those who risked their lives to save others, and the compassion of all who supported us in our darkest hours. Help New York State, the nation, and the world remember by making a contribution. For more information, go to *www.911memorial.org*.

Line 12e – Volunteer Firefighting and Volunteer Emergency Services Recruitment and Retention Fund – Contributions to this fund will help recruit and retain the men and women who make up our volunteer fire and volunteer emergency medical services units. Volunteer firefighters and volunteer emergency services personnel are crucial to the effective operation of a municipality and for the safety and well-being of the citizens of this state. Volunteer firefighters and volunteer emergency medical services personnel provide invaluable benefits to their local communities. Despite their importance, the number of volunteer firefighters and volunteer emergency services personnel has declined significantly over the past few years. For more information, go to *www.dhses.ny.gov/ofpc* or contact the State Office of Fire Prevention and Control at (518) 474-6746.

Line 12f – Veterans Remembrance and Cemetery Maintenance and Operation Fund *(Veterans Remembrance)* Your contribution will help provide for the perpetual care of state veterans cemeteries. Contributions will be used for the purchase, leasing, and improvement of land for veterans cemeteries, the purchase and leasing of equipment and other materials needed for the maintenance of cemeteries, and other associated costs.

Line 12g – Women's Cancers Education and Prevention Fund – Contributions to this fund will be used for grants for women's cancers education and prevention programs that have been approved by the New York State Department of Health. High risk women's cancers include cervical, endometrial, gestational trophoblastic tumors, ovarian, uterine sarcoma, vaginal, and vulvar cancers. Increased education and early detection can help women become more aware of symptoms and seek timely medical attention. For more information, go to *www.health.ny.gov/diseases/cancer/*.

Line 12h – Veterans' Home Assistance Fund *(Veterans' Homes)* – Contributions to this fund will be used for the care and maintenance of certain veterans' homes in New York. Monies on deposit in the fund will be disbursed equally each fiscal year to the following facilities: The State Home for Veterans and Their Dependents at Oxford; The State Home for Veterans in the City of New York *(St. Albans)*; The State Home for Veterans at Batavia; the State Home for Veterans at Montrose; and The Long Island State Veterans Home at Stony Brook University. Either the Commissioner of Health or the Commissioner of Education shall approve and certify expenditures from the fund.

Line 12i – Love Your Library Fund – Contributions to this fund will be used for the purposes of providing funding for the statewide summer reading program established under the New York State Education Law. The New York State Department of Education will oversee the collection and distribution of amounts in the fund.

Line 12j – Lupus Education and Prevention Fund *(Lupus Fund)* – Contributions to this fund will be used to assist in supporting Lupus education and prevention programs, including grants, which are approved by the Department of Health. Monies on deposit in the fund will be disbursed each fiscal year for programs that support lupus education, prevention, and awareness. The Commissioner of Health will approve and certify expenditures from the fund.

Line 12k – Military Family Relief Fund *(Military Family Fund)* – Contributions to this fund will be used to provide assistance to military families for housing, clothing, food, medical services, utilities, or any other related necessity of daily living. The New York State Director of Veterans' Affairs will establish criteria for determining who is eligible to receive assistance from this fund.

Line 15 – Determine the amount to enter by completing the *Worksheet for Part 2, line 15* below.

Worksheet for Part 2, line 15

From the Form CT-300 used to report the MFI for the tax period for which **this** return is being filed (**Note:** For calendar-year 2018 filers, such Form CT-300 was due March 15, **2018**):

1	Enter the portion of line A *(Payment enclosed)* that represents **New York State** MFI paid: generally, the amount on line 6, column A of such Form CT-300.	1	
2	Enter the portion of line 5, column A **actually** applied toward satisfying the amount on line 2, column A: generally, the lesser of the amount on line 5, column A or the amount on line 2, column A of such Form CT-300. This is your *2017 anticipated overpayment applied*.	2	
3	**Add the amounts on lines 1 and 2, and enter the total here and on Form CT-3, Part 2, line 15.**	3	

Line 20 – Enter the sum of the amounts reported on lines 25 and 30 of the Form CT-3 that you filed for the tax period **immediately prior** to the tax period for which this return is being filed.

Composition of prepayments on Part 2, line 22 – If you need more space, write ***see attached*** in this section, and attach a separate sheet showing all relevant prepayment information. Transfer the total shown on the attached sheet to line 22.

Payment due or overpayment to be credited/refunded

If line 14 is **less than** line 22, skip lines 23a through 23c and proceed to line 24a.

If line 14 is **greater than or equal to** line 22, proceed to line 23a.

Line 23a – Subtract line 22 from line 14 and enter the result here.

Line 23b – If on line 5, column A of the Form CT-300 used to report the MFI for the tax period immediately **following** the tax period for which this return is being filed (the **next** franchise tax period) you did **not** apply an anticipated overpayment amount of New York State **franchise** tax from the tax period for which this return is being filed to your MFI for the **next** franchise tax period, enter ***0*** and proceed to line 23c. **Note:** For calendar-year 2019 filers, such Form CT-300 was due March 15, **2019**.

If on line 5, column A of such Form CT-300 you **did** apply an anticipated overpayment amount of New York State **franchise** tax from the tax period for which this return is being filed to your MFI for the **next** franchise tax period, enter the amount from line 5, column A of such Form CT-300 that you **actually** applied toward satisfying the amount on line 2, column A of such Form CT-300: generally, the lesser of the amount on line 5, column A or the amount on line 2, column A.

Line 23c – Add lines 23a and 23b. Enter the result here, and enter the **payment amount** on page 1, line A. Skip lines 24a through 24c.

Line 24a – Subtract line 14 from line 22 and enter the result here.

Line 24b – If on line 5, column A of the Form CT-300 used to report the MFI for the tax period immediately **following** the tax period for which this return is being filed (the **next** franchise tax period) you did **not** apply an anticipated overpayment amount of New York State **franchise** tax from the tax period for which this return is being filed to your MFI for the **next** franchise tax period, enter ***0*** and proceed to line 24c. **Note:** For calendar-year 2019 filers, such Form CT-300 was due March 15, **2019**.

If on line 5, column A of such Form CT-300 you **did** apply an anticipated overpayment amount of New York State **franchise** tax from the tax period for which this return is being filed to your MFI for the **next** franchise tax period, enter the amount from line 5, column A of such Form CT-300 that you **actually** applied toward satisfying the amount on line 2, column A of such Form CT-300: generally, the lesser of the amount on line 5, column A or the amount on line 2, column A. If line 24b is **less than** or **equal to** line 24a, proceed to line 24c. If line 24b is **greater than** line 24a, subtract line 24a from line 24b and enter the result on line **23c**. This is the amount due. Enter the **payment** amount on Form CT-3, page 1, line A. Skip line 24c.

Line 24c – Subtract line 24b from line 24a. This is your overpayment amount. Proceed to line 25.

Unrequested refunds to be credited forward – If the corporation overpays its tax, it will not automatically receive a refund. Instead, we will credit your overpayment to the following tax year unless you request a refund on line 28. We will notify you that the overpayment has been credited and explain how to request a refund of the credited amount. If you choose to request a refund of such credited amount, you must claim a refund of such overpayment prior to the original due date of the following year's return.

Lines 25 through 28 – You may apply an overpayment to your next state franchise tax period, or to your MTA surcharge for this period, or you may have it refunded. Indicate on these lines the amount of overpayment you want credited or refunded.

Lines 29 and 30 – If you request a refund of unused tax credits, enter the total amount on line 29. If you request tax credits to be credited as an overpayment to next year's return, enter the total amount on line 30. **Do not include** these amounts in the total credits claimed on Part 2, line 3; or Part 7, line 2 or 3. Attach the appropriate tax credit forms.

Part 3 – Computation of tax on business income base

Note: All amounts entered on lines 2, 4, 6, 8, 10, 12, 16, and 18 must be entered as a positive number.

Business income is ENI minus investment income and other exempt income.

ENI is:

- FTI for non-alien corporations; **or**
- income, gain, or loss, effectively connected with the conduct of a trade or business within the United States, as determined under IRC section 882, for an alien corporation that under any provision of the IRC is not treated as a *domestic corporation* as defined in IRC section 7701; **or**
- FTI that would have been reported to the IRS in the case of a corporation which is exempt from federal income tax (other than tax on unrelated business income imposed under IRC section 511), but is taxable under Article 9-A;

plus or minus certain New York State modifications.

The **sum** of investment income and other exempt income must **not** exceed ENI.

Line 1 – Generally, the amount to enter is your FTI, before NOL and special deductions, as required to be reported to the U.S. Treasury Department. However, see below, for instructions specific to different federal Forms 1120.

- If you file federal Form 1120, use the amount from line 28.

  Note: If you were required to include in your calculation of FTI an IRC section 965(a) inclusion amount, the inclusion is already reflected in such line 28 amount. Tax Law §208.9(b)(23) requires that any IRC section 965(c) amount deducted when computing FTI must be added back to FTI. However, as the amount reported on line 1 is **before** the special deductions amount reported on federal Form 1120, no addition modification to FTI for any IRC section 965(c) deduction is required. Also, Tax Law §208.9(b)(24) requires that any IRC section 250(a)(1)(A) amount deducted (as reduced by IRC section 250(a)(2)) when computing FTI must be added back to FTI. However, as the amount reported on line 1 is **before** the special deductions amount reported on federal Form 1120, no addition modification to FTI for any IRC section 250(a)(1)(A) deduction is required. You are allowed the IRC section 250 deduction for the portion of the deduction computed under IRC section 250(a)(1)(B)(i), as reduced by IRC section 250(a)(2). This is done using a subtraction modification on Form CT-225.
- If you file Form 1120-REIT, use REIT taxable income (as defined in IRC section 857(b)(2), but **before** the NOL deduction, total deduction for dividends paid, and the IRC section 857(b)(2)(E) deduction), as modified by IRC section 858.

  Note: If you were required to include in your calculation of REIT taxable income an IRC section 965(a) inclusion amount, such inclusion, as well as the corresponding

IRC section 965(c) amount, is already reflected in the REIT taxable income amount. Tax Law §208.9(b)(23) requires that any IRC section 965(c) amount deducted when computing REIT taxable income must be added back to REIT taxable income. The add back of the IRC section 965(c) deduction amount is reported on Form CT-225. A federal election can be made under IRC section 965(m)(1)(B). When such election is made, New York State conforms to this election.

- If you file Form 1120-RIC, use the sum of:
  - investment company taxable income (as defined in IRC section 852(b)(2), modified for IRC section 855, but **before** the deduction for dividends paid and the deductions for tax imposed under IRC sections 851(d)(2) and 851(i)) **plus**
  - the amount taxable under IRC section 852(b)(3).

  Note: Your FTI reported on line 1 must include the amount of the IRC section 965(a) inclusion regardless of how, or on what lines, on your federal return you reported such amount. Tax Law §208.9(b)(23) requires that any IRC section 965(c) amount deducted when computing FTI must be added back to such FTI. Therefore, if the FTI you report on line 1 includes the deduction under IRC section 965(c), you must add back such deduction when computing ENI. The add back is reported on Form CT-225. No add back is required if the IRC section 965(c) deduction is not reflected in the FTI amount you report on line 1.
- If you file federal Form 1120-H, use the amount from line 19.
- If you file federal Form 1120-POL, use the amount from line 19.

  Note: If you were required to include in your calculation of FTI an IRC section 965(a) inclusion amount, such inclusion, as well as the corresponding IRC section 965(c) amount, is already reflected in the line 1 amount. Tax Law §208.9(b)(23) requires that any IRC section 965(c) amount deducted when computing FTI must be added back to FTI. The add back of the IRC section 965(c) deduction amount is reported on Form CT-225.
- If you file federal Form 1120-C, use the amount from line 25c. **Note:** If you were required to include in your calculation of FTI an IRC section 965(a) inclusion amount, the inclusion is already reflected in such line 25c amount. Tax Law §208.9(b)(23) requires that any IRC section 965(c) amount deducted when computing FTI must be added back to FTI. However, as the amount reported on line 1 is **before** the special deductions amount reported on federal Form 1120-C, no addition modification to FTI for any IRC section 965(c) deduction is required. Also, Tax Law §208.9(b)(24) requires that any IRC section 250(a)(1)(A) amount deducted (as reduced by IRC section 250(a)(2)) when computing FTI must be added back to FTI. However, as the amount reported on line 1 is **before** the special deductions amount reported on federal Form 1120-C, no addition modification to FTI for any IRC section 250(a)(1)(A) deduction is required. You are allowed the IRC section 250 deduction for the portion of the deduction computed under IRC section 250(a)(1)(B)(i), as reduced by IRC section 250(a)(2). This is done using a subtraction modification on Form CT-225.
- If you are a member of a federal affiliated group that files a consolidated return, complete a pro forma 1120 reporting the FTI you would have been required to report on a separate federal tax return, and attach a copy of the federal consolidating workpaper indicating your separate taxable income before any elimination of intercorporate transactions included in the federal consolidated return.
- If you are a federal S corporation filing federal Form 1120S but you have **not** made an election to be treated as a New York S corporation, you must determine the amount you would have had to report as FTI, before NOL and special deductions, were you not a federal S corporation. Attach a separate sheet showing how you determined this amount. In general, the items on Form 1120 affected are:
  - dividends
  - interest
  - gross rents
  - gross royalties
  - capital gain net income
  - charitable contributions
  - IRC section 199 deduction
- If you file Form 1120-F, use the amount from Section II, line 29. Mark an ***X*** in the box on Part 1, Section C, line 5.
- If you are exempt from federal income tax but subject to New York State franchise tax, you must determine the amount you would have had to report as FTI, before NOL and special deductions, were you not exempt. Attach a separate sheet showing how you determined the amount.
- If you have an amount of excess inclusion as a result of having a residual interest in a real estate mortgage investment conduit (REMIC), you must properly reflect this income in FTI.
- If you are a corporate stockholder in a tax-exempt DISC, all transactions between you and each such DISC must be eliminated from your receipts, expenses, assets, and liabilities. Your ENI must not include the amount of the deemed distribution of current income, if any, that was included in your FTI. The tax-exempt DISC itself has no franchise tax filing requirement.

Line 6 – Certain thrifts and community banks are eligible to make **one** of the following modifications to ENI:

- Subtraction modification for qualified residential loan portfolios (§208.9(r))
- Subtraction modification for community banks and small thrifts (§208.9(s))

Enter the amount of subtraction modification (r) or (s) from Form CT-3.2, Schedule A, line 1.

Note: The subtraction modification under §208.9(t) will only be claimed by a thrift or community bank that is filing as part of a combined group on Form CT-3-A.

Line 8 – The amount entered on this line must **not** exceed your ENI (line 7).

Line 12 – An addback to business income is required when the presumptive holding period for qualification as investment capital is not met. See Form CT-3.1.

Line 19 – When this line is reporting a loss, Form CT-3.4 must be filed to report such loss, and to make the irrevocable election to waive the carryback of such loss, if applicable.

Line 20 – If you do not qualify as a QETC (see Part 1, Section A, line 1 instructions), or a qualified New York manufacturer (see Part 1, Section A, lines 2 and 4 instructions), multiply line 19 by 6.5% (.065). Enter the result on this line and on Part 2, line 1a.

QETCs: Multiply line 19 by 4.875% (.04875). Enter the result on this line and on Part 2, line 1a.

Qualified New York manufacturers: Enter ***0*** on this line and on Part 2, line 1a.

Mark an ***X*** in the applicable box in Part 1, Section A, to avoid an erroneous assessment or delayed refund.

Part 4 – Computation of tax on capital base

The tax on the capital base is computed on that portion of the total business capital apportioned to New York State. Total business capital includes the addback of capital previously reported as investment capital that subsequently does not meet the holding period requirement. §208.7(a) defines business capital as all assets, other than investment capital and stock issued by the taxpayer, less liabilities not deducted from investment capital. Business capital includes only those assets the income, loss, or expense of which are properly reflected (or would have been properly reflected if not fully depreciated or expensed, or depreciated or expensed to a nominal amount) in the computation of ENI for the tax year. Business capital includes stock that generates, or could generate, other exempt income. When filing using the aggregate method, corporate partners must include their proportionate part of the partnership's assets and liabilities in their computation.

Lines 1 through 15

To determine the value of your assets for the capital base computations, you must include real property and marketable securities at fair market value (FMV). You must include all other property at the value shown on your books in accordance with generally accepted accounting principles (GAAP). Use lines 2 through 5 to adjust the value of the real property and marketable securities you reported on your federal return. If you are not required to complete the balance sheet on your federal tax return, use the amount that would have been reported on the federal return. If you are an alien corporation, only report the amounts that are effectively connected with your United States trade or business.

On lines 1 through 6, enter the values at the beginning of the year in column A and at the end of the year in column B. Enter the average value in column C. Average value is generally computed **quarterly** if your usual accounting practice permits it. However, you may use a more frequent basis such as monthly, weekly, or daily. If your usual accounting practice does not permit a quarterly or more frequent computation of the average value of assets, you may use a semiannual or annual computation if no distortion of average value results.

Short periods – If a tax return is for a period of less than 12 months, determine the amount of business capital by multiplying the average value by the number of months covered by the return and dividing by 12 (§210.2).

Line 4 – Enter the FMV of real property and marketable securities included on line 2. The *fair market value* of an asset is the price (without deduction of an encumbrance whether or not the taxpayer is personally liable) at which a willing seller will sell and a willing purchaser will buy. You can generally find the FMV of marketable securities from price quotes in financial newspapers. For determination of FMV of real property, see TSB-M-85(18.1)C, *Valuation of Real Property*.

Line 6 – Enter the amount of all liabilities attributable to assets entered on line 1, both long and short term. Use the same method of averaging used to determine average value of assets.

Line 10 – An addback to business capital is required when the presumptive holding period for qualifications of investment capital is not met (§208.5(d)). See Form CT-3.1.

Line 14 – Small business taxpayers (see Part 1, Section A, line 6 instructions)**:** You may claim an exemption from the tax on the capital base for your first two tax years. If you are claiming this exemption, enter ***0*** on line 15 and mark the box indicating the year for which the exemption is taken. You will continue to be liable for the tax computed on Part 2, line 2.

Line 15 – Capital base tax computation – If you do **not** qualify as a cooperative housing corporation, QETC, or qualified New York manufacturer, multiply line 13 by the tax rate of .00075. Do **not** enter more than $5 million.

Cooperative housing corporations: Multiply line 13 by the tax rate of .0004 (see Part 1, Section A, line 5 instructions). Do **not** enter more than $5 million.

Qualified New York manufacturers (see Part 1, Section A, lines 2, 3, and 4 instructions) **and QETCs** (see Part 1, Section A, line 1 instructions)**:** Multiply line 13 by the tax rate of .00056. Do **not** enter more than $350,000.

Part 5 – Computation of investment capital for the current tax year

This part computes the amount of investment capital that is excluded from the tax on the capital base and is reported on Part 4, line 8.

For more information on investment capital, see Form CT-3.1.

Note: You **must** file Form CT-3.1 and identify investment capital items or the subtraction will be disallowed.

Part 6 – Computation of business apportionment factor

Receipts, net income, net gains, and other items are sourced, and the amounts allowed in the apportionment factor are determined, per §210-A. Include only the receipts, net income, net gains, and other items described in §210-A that are earned in the regular course of business and included in your business income, determined without regard to the amount subtracted on Part 3, line 6 *(Subtraction modification for qualified banks)*, and without regard to any amount from investment capital that is determined to exceed the 8% of ENI limitation on gross investment income.

Note: Generally, receipts from services are reported on line 52 *(Receipts from other services/activities not specified)*.

Columns A and B – *New York State* (NYS) (column A) amounts are determined per the specific line instructions. *Everywhere* (EW) (column B) amounts should be 100% of the amount of the item being reported on a line unless otherwise specified. If only one line of Part 6 applies to your business, you must still complete both columns for that line. Skip a line only if **both** the numerator (column A) and the denominator (column B) are zero.

Taxpayers that have no receipts required to be included in the denominator of the apportionment factor must mark the box at the beginning of Form CT-3, Part 6, *Computation of business apportionment factor*. Examples include taxpayers that own property in New York State but have no FTI, ECI, or receipts from the rental, sale or lease of such property amounts, or taxpayers whose only income is dividends and net gains from the sales of stock or sales of partnership interests when the fixed percentage election is **not** made. If you have any other everywhere receipts, this box does not apply. If you mark the box, you must attach a statement explaining why you have no receipts required to be included in the business apportionment factor. Failure to properly complete Part 6 may result in the imposition of a 100% business apportionment factor.

Section 210-A.2 – Sales of tangible personal property, electricity and net gains from real property

Line 1 – Receipts from the sale of tangible personal property are included in the New York State column when shipments are made to points in the state, or the destination of the property is a point in the state. Receipts from sales of tangible personal property and electricity that are traded as commodities, as defined in IRC section 475, are included on line 27, in accordance with §210-A.5(a)(2)(I).

Line 2 – Receipts from the sale of electricity are included in the New York State column when delivered to points in the state. Receipts from sales of tangible personal property and electricity that are traded as commodities, as defined in IRC section 475, are included on line 27, in accordance with §210-A.5(a)(2)(I).

Line 3 – For the New York State column, net the gains from the sales of real property located within the state against the losses from the sales of real property located within the state and enter the result (but not less than zero). For the Everywhere column, net the gains from the sales of real property located everywhere against the losses from the sales of real property located everywhere and enter the result (but not less than zero).

Section 210-A.3 – Rentals of real and tangible personal property, royalties, and rights for certain closed-circuit and cable TV transmissions

Line 4 – Receipts from rentals of real and tangible personal property located within the state are included in the New York State column.

Line 5 – Receipts of royalties from the use of patents, copyrights, trademarks, and similar intangible personal property within the state are included in the New York State column.

Line 6 – Receipts from the sales of rights for closed-circuit and cable television transmissions of an event (other than events occurring on a regularly scheduled basis) taking place within the state as a result of the rendition of services by employees of the corporation, as athletes, entertainers, or performing artists, are entered in the New York column to the extent that those receipts are attributable to such transmissions received or exhibited within the state.

Section 210-A.4 – Receipts from sale of, license to use, or granting of remote access to digital products

Line 7 – For Article 9-A apportionment purposes, the term *digital product* means any property or service, or combination thereof, of whatever nature delivered to the purchaser through the use of wire, cable, fiber-optic, laser, microwave, radio wave, satellite or similar successor media, or any combination of these. Digital product includes, but is not limited to, an audio work, audiovisual work, visual work, book or literary work, graphic work, game, information or entertainment service, and storage of digital products. In addition, it includes computer software by whatever means delivered. The term *delivered* to includes furnished or provided to or accessed by. A digital product does **not** include legal, medical, accounting, architectural, research, analytical, engineering or consulting services.

If the receipt for a digital product is comprised of a combination of digital property and services, it cannot be divided into separate components and is considered to be one receipt, regardless of whether it is separately stated for billing purposes. The entire receipt must be allocated according to a hierarchy (see below).

Receipts from the sale of, license to use, or granting of remote access to digital products within the state, are sourced according to the following hierarchy:

1) The customer's primary use location of the digital product.
2) The location where the digital product is received by the customer or is received by a person designated for receipt by the customer.
3) The apportionment fraction for the preceding tax year for such digital product.
4) The apportionment fraction in the current tax year for those digital products that can be sourced using the methods in items 1 and 2.

Note: Item 3 does not apply to your first tax period that begins on or after January 1, 2015, for which you are subject to Article 9-A.

The taxpayer must exercise due diligence under each method before rejecting it and proceeding to the next method in the hierarchy, and must base its determination on information known to the taxpayer or information that would be known to the taxpayer upon reasonable inquiry.

Section 210-A.5(a)1 – Qualified financial instruments (QFIs), the 8% fixed percentage method

Line 8 – A *qualified financial instrument (QFI)* means a financial instrument of these types that is marked to market in the tax year by the taxpayer under IRC section 475 or 1256: Type A (reported on lines 11 and 12); Type B (reported on lines 13 – 18); Type C (reported on lines 19 – 21): Type D (reported on lines 22 – 24); Type I (reported on line 27); Type(s) H (reported on lines 29 and 30); and Type(s) G (also reported on line 30).

If the taxpayer has in the tax year marked to market a financial instrument within types A, B, C, D, and I, then **any** financial instrument **within that same type** that has **not** been marked to market by the taxpayer under IRC section 475 or 1256 **is also** a QFI in the tax year. When a financial instrument within either types H or G is marked to market, **not** all financial instruments within type H or G, respectively, are QFIs, as explained further below.

When reporting interest from "other" financial instruments on line 29, and net gains and other income from "other" financial instruments on line 30, marking to market one "other" financial instrument does **not** necessarily cause all "other" financial instruments to be QFIs. It is an instrument by instrument determination as to when "other" financial instruments are of the same type. Thus, you may have more than one **type** of "other" financial instruments reported on either of lines 29 and 30, and some types may be QFI while other types may not be QFI.

Line 30 can be used to report financial instruments under clause **G** (dividends and net gains from sales of stock or partnership interests) **or** clause **H** ("other" financial instruments) of §210-A.5(a)(2), or both. Line 30 will be used to report financial instruments under clause (G) **only** when the financial instrument is a QFI **and** the 8% fixed percentage method has been elected. When **any** stock that is business capital has been marked to market, **all** stock that is business capital is a QFI (for exception, see next paragraph immediately following). When **any** partnership interest in a widely held or publicly traded partnership has been marked to market, **all** partnership interests in a widely held or publicly traded partnership are QFIs. However, marking to market stock that is business capital does **not** cause partnership interests in a widely held or publicly traded partnership that are **not** marked to market to be QFIs. The same is true in regard to the marking to market of partnership interests in a widely held or publicly traded partnership in respect to stock that is business capital. When a financial instrument falling under clause (H) has been marked to market, it does **not** necessarily cause all financial instruments under clause (H) to be QFIs. It is an instrument by instrument determination as to when instruments under clause (H) are of the same **type**. Thus, you may have more than one type of "other" financial instruments under clause (H) to report on line 30. Marking to market a financial instrument of the type under clause (G) does **not** cause financial instruments of the type under clause (H) to be QFIs. The same is true in regard to clause (H) in respect to clause (G).

If the **only** loans that are marked to market under IRC section 475 or 1256 are loans secured by real property, then **no** loans are QFIs. Stock that is investment capital shall **not** be a QFI. A stock that generates other exempt income as defined in §208.6-a, and that is not, **itself**, marked to market under IRC section 475 or 1256, is **not** a QFI with respect to such other exempt income only, even if other stocks are marked to market in the tax year.

Taxpayers may elect to use the 8% *fixed percentage method* to apportion business receipts from QFIs. This election is irrevocable, applies to **all** QFIs, and must be made on an annual basis on the original timely filed return (determined with regard to valid extensions of time for filing) by marking an ***X*** in the box on line 8. If you do not mark the box but still apportion QFI receipts by 8%, you will be considered to have made the election and to have marked the box.

Non-captive REITs and non-captive RICs may also elect to use the 8% fixed percentage method to apportion business receipts from QFIs even though they do not mark to market assets under IRC section 475 or 1256.

Regardless of whether or not the 8% fixed percentage method is elected, when **any** financial instrument has been marked to market that is described on:

a) **either** line 11 or 12, then the boxes on **both** lines 11 and 12 must be marked, and all financial instruments reported on such lines are QFIs (Type A financial instruments);
b) **any** of lines 13 through 18, then the box above line 13 must be marked, and all financial instruments reported on such lines are QFIs (Type B financial instruments);
c) **any** of lines 19 through 21, then the box above line 19 must be marked, and all financial instruments reported on such lines are QFIs (Type C financial instruments);
d) **any** of lines 22 through 24, then the box above line 22 must be marked, and all financial instruments reported on such lines are QFIs (Type D financial instruments);
e) line 27, then the box above line 27 must be marked, and all financial instruments reported on line 27 are QFIs (Type I financial instruments);
f) line 28, then the box above line 28 must be marked;
g) line 29, then the box above line 29 must be marked;
h) line 30, due to clause (H), then the section 210-A.5(a)(2)(H) box above line 30 must be marked; and
i) line 30, due to clause (G), then the section 210-A.5(a)(2)(G) box above line 30 must be marked

A marked QFI box does **not** indicate which method of sourcing (8% fixed percentage method or customer-based sourcing rule) is being used to apportion such instruments. Also, because lines 28, 29, and 30 may report more than one **type** of financial instrument, when the QFI box above line 28 is marked, or one of the boxes above lines 29 and 30 is marked: a) in the case of line 28, it does **not** indicate that all financial instruments being reported on line 28 are QFIs, and b) in the case of lines 29 and 30 it does **not** indicate that all financial instruments being reported on lines 29 and 30 are QFIs.

General lines 9 through 52 instructions

For all financial instruments that do **not** meet the definition of a QFI, or for instruments that meet the definition of a QFI but the 8% fixed percentage method election is **not** in effect, use the customer-based sourcing rules as detailed in the specific line instructions for lines 9 through 27, 29, and 30.

Regardless of whether or not the 8% fixed percentage method election is in effect, Worksheets A, B, and C of these instructions compute certain amounts for lines 10, 12, 21, 24, 28, and 30 of Part 6.

For purposes of these apportionment instructions, an individual is deemed to be located in New York State if his or her billing address is in the state. A business entity is deemed to be located in New York State if its commercial domicile is located in the state.

Use the following hierarchy to determine the *commercial domicile* of a business entity, based on known information, or information that would be known upon reasonable inquiry:

1) The seat of management and control of the business entity.
2) The billing address of the business entity in the taxpayer's records.

You must exercise due diligence before rejecting the first method and proceeding to the next method in this hierarchy.

For purposes of these apportionment instructions, *registered securities broker or dealer* means a broker or dealer registered as such by the Securities and Exchange Commission (SEC) or a broker or dealer registered as such by the commodities futures trading commission, and shall include an over-the-counter (OTC) derivatives dealer as defined under regulations of the SEC (17 CFR 240.3b-12).

Section 210-A.5(a)(2)(A) – Loans

A loan is secured by real property if 50% or more of the value of the collateral used to secure the loan (when valued at FMV as of the time the loan was originated) consists of real property.

Line 9 – Include in the New York column, interest from loans secured by real property located within the state.

Include in the Everywhere column interest from loans secured by real property located anywhere.

Line 10 – For the New York column, multiply the amount of **net** gains (not less than zero) from sales of loans secured by real property by a fraction, the numerator of which is the amount of gross proceeds from sales of loans secured by real property located within the state, and the denominator of which is the amount of gross proceeds from sales of such loans everywhere.

In the Everywhere column, include the amount of net gains (not less than zero) from sales of loans secured by real property both within and outside New York State.

Use Worksheet A at the end of these instructions.

Line 11 – When the 8% fixed percentage method **is** elected (the box on Part 6, line 8, is marked), **and** the QFI box on line 11 **is** marked, use such method for **all** financial instruments to be reported on this line.

When the 8% fixed percentage method **is not** elected (the box on Part 6, line 8, is **not** marked), **and** the QFI box on line 11 **is** marked, use the customer-based sourcing rule below for **all** financial instruments to be reported on this line.

When the QFI box on line 11 is **not** marked, use the customer-based sourcing rule below for **all** financial instruments to be reported on this line.

In the New York column, include interest from loans **not** secured by real property if the borrower is located in New York State.

In the Everywhere column, include interest from all loans **not** secured by real property.

Line 12 – For the New York column, multiply net gains (not less than zero) from sales of loans **not** secured by real property by a fraction, the numerator of which is the amount of gross proceeds from sales of loans not secured by real property to purchasers located within the state, and the denominator of which is the amount of gross proceeds from sales of such loans to purchasers located within and outside the state.

In the Everywhere column, include the amount of net gains (not less than zero) from sales of loans **not** secured by real property within and outside the state.

Use Worksheet A at the end of these instructions.

Section 210-A.5(a)(2)(B) – Federal, state, and municipal debt

Lines 13 through 18 – Receipts are **not** included in column A (NYS) **unless** you have made the election to apportion QFI receipts using the 8% fixed percentage method. For lines 13, 15, and 16, in the Everywhere column, enter 100% of the applicable receipts regardless of if the 8% fixed percentage method election was made. For lines 17 and 18, if the 8% fixed percentage method election was made, and the QFI box above line 13 is marked, enter 100% of the receipts constituting interest and net gains from sales of debt instruments issued by other states or their political subdivisions in the Everywhere column. Otherwise, enter 50% for lines 17 and 18 in the Everywhere column.

Line 16 – When netting gains against losses, only net the gains from federal, NYS, and NYS political subdivisions debt against the losses from federal, NYS, and NYS political subdivisions debt. Do not enter less than zero.

Line 18 – When netting gains against losses, only net the gains from other states and their political subdivisions debt against the losses from other states and their political subdivisions debt. Do not enter less than zero.

Section 210-A.5(a)(2)(C) – Asset-backed securities and other government agency debt

Line 19 – In the Everywhere column, enter 100% of the interest income from **all**:

1) Asset-backed securities issued by government agencies;
2) Other securities issued by government agencies, including but not limited to securities issued by the Government National Mortgage Association (GNMA), the Federal National Mortgage Association (FNMA), the Federal Home Loan Mortgage Corporation (FHLMC), or the Small Business Administration (SBA); and
3) Asset-backed securities issued by other entities.

In the New York column, enter 8% of the amount in the Everywhere column.

Line 20 – In the Everywhere column enter the result (but not less than zero) of netting the gains and losses from all:

1) Sales of asset-backed securities or other securities issued by government agencies, including but not limited to securities issued by GNMA, FNMA, FHLMC, or the SBA; and
2) Sales of other asset-backed securities that are sold through a registered securities broker or dealer, or through a licensed exchange.

In the New York column, enter 8% of the amount in the Everywhere column.

Line 21 – For the New York column, multiply net gains (not less than zero) from sales of other asset-backed securities **not** reported on line 20 by a fraction, the numerator of which is the amount of gross proceeds from such sales to purchasers located in the state, and the denominator of which is the amount of gross proceeds from such sales to purchasers located within and outside the state.

In the Everywhere column, enter 100% of the amount of net gains (not less than zero) from sales of other asset-backed securities not reported on line 20.

Use Worksheet A at the end of these instructions.

Section 210-A.5(a)(2)(D) – Corporate bonds

Line 22 – In the New York column, enter interest from corporate bonds when the commercial domicile of the issuing corporation is in the state.

If the 8% fixed percentage method election has been made (the box on line 8 is marked), **and** the QFI box above line 22 is marked, enter 8% of the applicable receipts in the New York column.

Line 23 – In the Everywhere column, enter the result (but not less than zero) of netting the gains and losses from the sales of all corporate bonds sold through a registered securities broker or dealer, or through a licensed exchange.

In the New York column, enter 8% of the amount in the Everywhere column.

Line 24 – For the New York column, multiply net gains (not less than zero) from those sales of corporate bonds **not** reported on line 23 by a fraction, the numerator of which is the amount of gross proceeds from such sales to purchasers located within the state, and the denominator of which is the amount of gross proceeds from such sales to purchasers located within and outside the state.

In the Everywhere column, enter the amount of net gains (not less than zero) from sales of corporate bonds to purchasers within and outside the state.

Use Worksheet A at the end of these instructions.

Section 210-A.5(a)(2)(E) – Interest income from reverse repurchase and securities borrowing agreements

Line 25 – In the New York column, enter 8% of net interest income (not less than zero) from reverse repurchase agreements and securities borrowing agreements. For this calculation, net interest income is determined after the deduction of the amount of interest expense from the taxpayer's repurchase agreements and securities lending transactions, but cannot be less than zero. The amount of such interest expense is the interest expense associated with the sum of the value of the taxpayer's repurchase agreements where the taxpayer is the seller or borrower, **plus** the value of the taxpayer's securities lending agreements where the taxpayer is the securities lender (provided such sum is limited to the sum of the value of the taxpayer's reverse repurchase agreements where the taxpayer is the purchaser or lender, **plus** the value of the taxpayer's securities lending agreements where the taxpayer is the securities borrower).

Section 210-A.5(a)(2)(F) – Interest income from federal funds

Line 26 – In the Everywhere column, enter 100% of the net interest from federal funds. In determining net interest from federal funds, deduct interest expense that is from federal funds. The resulting net interest cannot be less than zero.

In the New York column, enter 8% of the amount in the Everywhere column.

Section 210-A.5(a)(2)(I) – Net income from sales of physical commodities

Line 27 – For the New York column, multiply the net income from sales of physical commodities by a fraction, the numerator of which is the amount of receipts from sales of physical commodities actually delivered to points within the state or, if there is no actual delivery of the physical commodity, the amount sold to purchasers located in the state, and the denominator of which is the amount of receipts from all sales of physical commodities actually delivered to points within and outside the state or, if there is no actual delivery of the physical commodity, the amount sold to purchasers located both within and outside the state.

Net income (not less than zero) from sales of physical commodities is determined after the deduction of the cost to acquire or produce the physical commodities.

In the Everywhere column, enter 100% of the net income (not less than zero) from sales of physical commodities.

Section 210-A.5(a)(2)(J) – Marked to market net gains

Line 28 – All marked to market net gains are reported on this line for **all** financial instruments.

For the purposes of computing marked to market net gains for this line, *marked to market* means that a financial instrument is **treated** by the taxpayer as sold for its FMV on the last business day of the taxpayer's tax year, despite no actual sale having taken place, under IRC section 475 or 1256. The term *marked to market gain or loss* means the gain or loss recognized by the taxpayer under IRC section 475 or 1256 because the financial instrument is **treated** as sold for its FMV on the last business day of the tax year.

All marked to market net gains are reported on this line. When the 8% fixed percentage method **is** elected, use such method to source marked to market net gains for all financial instruments **that are QFIs**.

When the 8% fixed percentage method **is** elected, use the customer-based sourcing rule below to source the marked to market net gains for those financial instruments that are **not** QFIs. Also, use the customer-based sourcing rule below to source **all** marked to market net gains for **all** financial instruments when the 8% fixed percentage method **is not** elected.

The amount of marked to market net gains to be included in the **New York** column of line 28 for financial instruments **described** on any certain line of Form CT-3, Part 6, is determined by multiplying such marked to market net gains by a fraction, the **numerator** of which is the amount included in the numerator of the apportionment fraction for the net gains from **actual** sales of financial instruments reported on that **same** certain line of Form CT-3, Part 6, and the **denominator** of which is the amount included in the denominator of the apportionment fraction for the net gains from **actual** sales of the financial instruments reported on that **same** certain line of Form CT-3, Part 6.

In the **Everywhere** column, enter 100% of the marked to market net gains from financial instruments for which the amount to be included in the New York column is determined under the immediately preceding paragraph.

If financial instruments that are **described** on any certain line of Form CT-3, Part 6, have marked to market net gains, but there are **no actual** sales of financial instruments reported on that **same** certain line of Form CT-3, Part 6, **or** if there **are actual** sales of financial instruments reported on that **same** certain line of Form CT-3, Part 6, but those **actual** sales resulted in a net **loss**, the amount of the marked to market net gains to include in the **New York** column of line 28 for those same financial instruments is determined by multiplying such marked to market net gains by a fraction, the **numerator** of which is the **sum** of the amounts entered in the New York column for Part 6, lines 9 through 30, and the **denominator** of which is the **sum** of the amounts entered in the Everywhere column of Part 6, lines 9 through 30.

In the **Everywhere** column, enter 100% of the marked to market net gains from financial instruments for which the amount to be included in the New York column is determined under the immediately preceding paragraph.

Use Worksheet C at the end of these instructions.

However, when sourcing the marked to market net gain from loans secured by real property, always use customer-based sourcing (even when the 8% fixed percentage method election was made). If using customer-based sourcing to source such marked to market net gains, when 210-A.5(a)(2)(j)(iii) applies, never include any amounts sourced under the 8% fixed percentage method election in computing the NYS aggregate marked to market factor in Part 2 of Worksheet C.

Section 210-A.5(a)(2)(H) – Income from other financial instruments

Line 29 – When the 8% fixed percentage method **is** elected, use such method for all financial instruments to be reported on this line **that are QFIs**. When the 8% fixed percentage method **is** elected, use the customer-based sourcing rule below for those financial instruments to be reported on this line that are **not** QFIs. Also, use the customer-based sourcing rule below for **all** financial instruments to be reported on this line when the 8% fixed percentage method **is not** elected.

Interest income from other financial instruments includes, but is not limited to, interest income on: deposit accounts; money market mutual funds; and debt issued by a country, or political subdivision thereof, other than the United States.

In the New York column, enter interest from other financial instruments when the payor is located in New York State.

Line 30 – More than one type of financial instrument may be reported on this line. Report financial instruments under clause (G) or clause (H) of §210-A.5(a)(2).

Include clause (G) financial instruments **only** when the 8% fixed percentage method **is** elected. The following constitute clause (G) instruments to be included:

- dividends and net gains from stock that is business capital if you have, in the tax year, marked to market any stock under IRC section 475 or 1256; provided that dividends that qualify as other exempt income should **not** be included; and
- net gains from the sale of partnership interests in widely held or publicly traded partnerships if you have, in the tax year, marked to market any partnership interest in a widely held or publicly traded partnership under IRC section 475 or 1256.

Customer-based sourcing rules for clause (H) instruments included on line 30:

- for gains from "other" financial instruments, for the Everywhere column, net the gains from all sales of a type of "other" financial instrument against the losses from all sales of the **same** type of "other" financial instrument. For the New York column, for the **same** type of "other" financial instrument being reported in the Everywhere column, net the gains from all sales of such **same** type of "other" financial instrument, where the purchaser or payor is located in New York State, against the losses from all sales of such **same** type of "other" financial instrument, where the purchaser or payor is located in New

York State. **However**, if the purchaser or payor is a registered securities broker or dealer, or the transaction is made through a licensed exchange, then include 8% of the Everywhere amount in the New York column.

- for “other” income from “other” financial instruments, for the Everywhere column, compute the “other” income (but not less than zero) from a type of “other” financial instrument. For the New York column, for the **same** type of “other” financial instrument being reported in the Everywhere column, compute the “other” income (but not less than zero) from such **same** type of “other” financial instrument, where the purchaser or payor is located in New York State. **However**, if the purchaser or payor is a registered securities broker or dealer, or the transaction is made through a licensed exchange, then include 8% of the Everywhere amount in the New York column.

Use Worksheet B at the end of these instructions.

Section 210-A.5(b) – Other receipts from broker or dealer activities

For the purposes of lines 31 through 37, *securities* has the same meaning as in IRC section 475(c)(2), and *commodities* has the same meaning as in IRC section 475(e)(2). If the taxpayer receives any of the receipts reported on lines 31 through 35 as a result of a securities correspondent relationship that the taxpayer has with another broker or dealer (with the taxpayer acting in this relationship as the clearing firm), those receipts are deemed generated within the state to the extent set forth in §210-A.5(b)(1) through §210-A.5(b)(4). The amount of those receipts excludes the amount the taxpayer is required to pay to the correspondent firm for the correspondent relationship. If the taxpayer receives any of the receipts reported on lines 31 through 35 as a result of a securities correspondent relationship that the taxpayer has with another broker or dealer (with the taxpayer acting in this relationship as the introducing firm), these receipts are deemed generated within the state to the extent set forth in §210-A.5(b)(1) through §210-A.5(b)(4). If the taxpayer is unable to determine the mailing address of the customer from its records, include 8% of the receipts in the numerator of the apportionment fraction.

Line 31 – In the New York column, enter brokerage commissions derived from the execution of securities or commodities purchase or sales orders for the accounts of customers if in the records of the taxpayer, the mailing address of the customer responsible for paying the commissions is in the state.

Line 32 – In the New York column, enter margin interest earned on behalf of brokerage accounts if in the records of the taxpayer, the mailing address of the customer responsible for paying such margin interest is in the state.

Line 33 – In the New York column, enter the amount of fees for advisory services to a customer in connection with the underwriting of securities for the entity that is contemplating issuing or is issuing securities, or fees for managing an underwriting, if in the records of the taxpayer, the mailing address of the customer responsible for paying such fees is in the state.

Line 34 – In the New York column, enter the receipts constituting the primary spread of selling concession from underwritten securities if the customer is located in the state. The term *primary spread* means the difference between the price paid by the taxpayer to the issuer of the securities being marketed and the price received from the subsequent sale of the underwritten securities at the initial public offering price, less any selling concession and any fees paid to the taxpayer for advisory services or any manager’s fees, if those fees are not paid by the customer to the taxpayer separately. The term *public offering price* means the price agreed upon by the taxpayer and the issuer at which the securities are to be offered to the public. The term *selling concession* means the amount paid to the taxpayer for participating in the underwriting of a security where the taxpayer is not the lead underwriter.

Line 35 – In the New York column, enter account maintenance fees if in the records of the taxpayer, the mailing address of the customer responsible for paying such account maintenance fees is in the state.

Line 36 – In the New York column, enter fees for management or advisory services, including fees for advisory services in relation to merger or acquisition activities, if in the records of the taxpayer, the mailing address of the customer responsible for paying such fees is in the state. Exclude fees paid for services reported on line 43.

Line 37 – Interest earned on loans and advances made by the taxpayer to a corporation affiliated with the taxpayer, but with which the taxpayer is not included in a combined return under Article 9-A is deemed to arise from services performed at the principal place of business of the affiliated corporation. If such principal place of business is in New York State, include the interest in the New York column.

Section 210-A.5(c) – Receipts from credit card and similar activities

Lines 38 through 42 – These lines are used by corporations that **issue or process** credit cards and **not** by businesses that accept credit cards as payment for goods or services.

Line 38 – In the New York column, enter interest, fees, and penalties in the nature of interest from bank, credit, travel, and entertainment card receivables if in the records of the taxpayer, the mailing address of the card holder is in the state.

Line 39 – In the New York column, enter service charges and fees from such cards, if in the records of the taxpayer, the mailing address of the card holder is in the state.

Line 40 – In the New York column, enter receipts from merchant discounts when the merchant is located within the state. If the merchant has locations both within and outside of New York State, **only** receipts from merchant discounts attributable to sales made from locations within New York State are entered in the New York column. The location of the merchant is presumed to be the address of the merchant shown on the invoice submitted to the taxpayer by the merchant.

Line 41 – In the New York column, enter receipts from credit card authorization processing, and clearing and settlement processing, received by credit card processors if the location where the customer of the credit card processor accesses the credit card processor’s network is located within the state.

Line 42 – For the New York column, multiply the total amount of all other receipts received by credit card processors not reported on lines 1 through 41, lines 43 through 51, or line 53 by the average of 8% and the percent of its New York access points. The *percent of New York access points* is the number of locations within the state from which the credit card processor’s customers access the credit card processor’s network, divided by the total number of locations in the United States where the credit card processor’s customers access the credit card processor’s network.

Section 210-A.5(d) – Receipts from certain services to investment companies

Line 43 – For the New York column, multiply the receipts received from an investment company arising from the sale of management, administration, or distribution services to such investment company by a fraction, the numerator of which is the sum of the monthly percentages determined for each month of the investment company's federal tax year that ends within the tax year of the taxpayer (but excluding any month during which the investment company had no outstanding shares), and the denominator of which is the number of those monthly percentages.

To determine the monthly percentage for each month, divide the number of shares in the investment company that are owned on the last day of the month by shareholders that are located in New York State by the total number of shares in the investment company outstanding on that date.

In the Everywhere column, enter 100% of the receipts received from an investment company arising from the sale of management, administration, or distribution services to the investment company.

For purposes of these receipts, the following apply:

- An individual, estate or trust is deemed located in the state if his, her, or its mailing address in the records of the investment company is in the state. A business entity is deemed located in the state if its commercial domicile is located in the state.
- *Investment company* means a regulated investment company, as defined in IRC section 851, and a partnership to which IRC section 7704(a) applies (by virtue of section 7704(c)(3)) and that meets the requirements of IRC section 851(b). This is applied to the tax year, for federal income tax purposes, of the business entity that is asserted to constitute an investment company that ends within the tax year of the taxpayer.
- *Receipts from an investment company* includes amounts received directly from an investment company as well as amounts received from the shareholders in the investment company, in their capacity as such.
- *Management services* means the rendering of investment advice to an investment company, making determinations as to when sales and purchases of securities are to be made on behalf of an investment company, or the selling or purchasing of securities constituting assets of an investment company, and related activities, but only where such activity or activities are performed pursuant to a contract with the investment company entered into according to the federal Investment Company Act of 1940, section 15(a), as amended.
- *Distribution services* means the services of advertising, servicing investor accounts (including redemptions), marketing shares or selling shares of an investment company; but in the case of advertising, servicing investor accounts (including redemptions) or marketing shares, **only** where such service is performed by a person who is (or was, in the case of a closed end company) also engaged in the service of selling such shares. In the case of an open-end company, the service of selling shares must be performed pursuant to a contract entered into pursuant to the federal Investment Company Act of 1940, section 15(b), as amended.
- *Administration services* includes clerical, accounting, bookkeeping, data processing, internal auditing, legal, and tax services performed for an investment company, but only if the provider of such service or services during the tax year in which such service or services are sold also sells management or distribution services (as defined above), to such investment company.

Section 210-A.6 – Receipts from railroad and trucking businesses

Line 44 – For the New York column, multiply receipts from the conduct of a railroad business or a trucking business (including surface railroad, whether or not operated by steam, subway railroad, elevated railroad, palace car or sleeping car business) by a fraction, the numerator of which is the revenue miles in such business within the state during the period covered by this return, and the denominator of which is the revenue miles in such business both within and outside the state during such period.

Section 210-A.6-a – Receipts from operation of vessels

Line 45 – For the New York column, multiply receipts from the operation of vessels by a fraction, the numerator of which is the aggregate number of working days of the vessels owned or leased by the taxpayer in territorial waters of the state during the period covered by this return, and the denominator of which is the aggregate number of working days of all vessels owned or leased by the taxpayer during such period.

Section 210-A.7 – Receipts from aviation services

Line 46 Air freight forwarding – In the New York column, enter the receipts from the activity of air freight forwarding acting as principal and like indirect air carrier receipts arising from that activity as follows:

- 100% of such receipts if both the pickup and delivery associated with those receipts are made in the state; and
- 50% of such receipts if either the pickup or delivery associated with those receipts is made in this state.

In the Everywhere column, enter the amount of receipts from all such activity.

Line 47 Other aviation services – For the New York and Everywhere columns, determine the portion of receipts from aviation services, other than services described in line 46 (but including the receipts of a qualified air freight forwarder, as described below) to enter by completing *Worksheet for Part 6, line 47*.

Aircraft arrivals and departures means the number of landings and takeoffs in the tax year, **plus** the number of air pickups and deliveries by such aircraft. Do **not** include arrivals and departures solely for maintenance, repair, or refueling (where no debarkation or embarkation of traffic occurs). Arrivals and departures of ferry and personnel training flights, or in the event of emergency situations, are also not included. Arrivals and departures of flights transporting officers and employees receiving air transportation are included (but see *Note:* below for exceptions) without regard to remuneration.

Note: The Commissioner of Taxation and Finance may exempt from the calculation arrivals and departures of all non-revenue flights including flights involving the transportation of officers and employees receiving air transportation to perform maintenance or repair services, or where such officers or employees are transported in conjunction with an emergency situation or the investigation of an air disaster (other than on a scheduled flight).

Revenue tons handled by the taxpayer at airports means the weight, in tons, of revenue passengers (at 200 pounds per passenger) and revenue cargo first received, either as originating or connecting traffic or finally discharged at an airport.

Originating revenue means revenue to the taxpayer from the transportation of revenue passengers and revenue property first received by the taxpayer as originating or connecting traffic at airports.

A corporation is a *qualified air freight forwarder* with respect to another corporation if:

- it owns or controls, either directly or indirectly, all of the capital stock of such other corporation; or if all of its capital stock is owned or controlled, either directly or indirectly, by such other corporation; or if all of the capital stock of both corporations is owned or controlled, either directly or indirectly, by the same interests;

- it is principally engaged in the business of air freight forwarding; and
- its air freight forwarding business is carried on principally with the airline or airlines operated by such other corporation.

Section 210-A.8 – Advertising: newspapers/periodicals, TV/radio, and other means

Line 48 – For the New York column, multiply receipts from sales of advertising in newspapers or periodicals by a fraction, the numerator of which is the number of newspapers and periodicals delivered to points within the state, and the denominator of which is the number of newspapers and periodicals delivered to points both within and outside the state.

Line 49 – For the New York column, multiply receipts from sales of advertising on television or radio by a fraction, the numerator of which is the number of viewers or listeners within the state, and the denominator of which is the number of viewers or listeners both within and outside the state.

Line 50 – For the New York column, multiply receipts from sales of advertising **not** reported on either line 48 or 49 that is furnished, provided, or delivered to or accessed by the viewer or listener through the use of wire, cable, fiber-optic, laser, microwave, radio wave, satellite or similar successor media, or any combination of these by a fraction, the numerator of which is the number of viewers or listeners within the state, and the denominator of which is the number of viewers or listeners both within and outside the state.

Section 210-A.9 – Receipts from the transportation or transmission of gas through pipes

Line 51 – For the New York column, multiply receipts from the transportation or transmission of gas through pipes by a fraction, the numerator of which is the taxpayer's transportation units within the state, and the denominator of which is the taxpayer's transportation units both within and outside the state. A *transportation unit* is the transportation of one cubic foot of gas over a distance of one mile.

Section 210-A.10 – Receipts from other services/activities not specified

Line 52 – In the New York column, enter receipts from services and other business receipts not reported on lines 1 through 51 or line 53, if the location of the customer is within the state. The determination of the amount of receipts included in the New York column is made according to the *Hierarchy of methods* below. The taxpayer must exercise due diligence under each method described before rejecting it and proceeding to the next method in the hierarchy, and must base its determination on information known to the taxpayer, or information that would be known to the taxpayer upon reasonable inquiry.

Hierarchy of methods

1) The benefit is received in this state.
2) Delivery destination.
3) The apportionment fraction for such receipts within the state determined according to §210-A.10 for the preceding tax year.
4) The apportionment fraction for the current tax year determined according to §210-A.10 for those receipts that can be sourced using the hierarchy of sourcing method in item 1 or 2.

Note: Item 3 does not apply to your first tax period that begins on or after January 1, 2015, for which you are subject to Article 9-A.

Line 53 – Section 210-A.11 – Discretionary adjustments

GILTI – Global intangible low-taxed income (GILTI) under IRC section 951A must be included on line 53; include 100% of such income, less the IRC section 250(a)(1)(B)(i) amount (if applicable), on line 53 in the *Everywhere* column. Such income is **not** included in the *New York* column. You must attach to your return a statement that indicates the amount of GILTI included in the *Everywhere* column.

Discretionary adjustments – If it appears that the apportionment fraction determined according to §210-A does not result in a proper reflection of the taxpayer's business income or capital within the state, the Commissioner of Taxation and Finance is authorized in his or her discretion to adjust it, or the taxpayer may request that the commissioner adjust it. This is done by:

- excluding one or more items in such determination,

Worksheet for Part 6, line 47

		A Within NYS	B Column A X 60% (.60)	C Everywhere	D NYS percentage *(round to three decimal places)*
1 **Aircraft arrivals and departures** during the period of this return	1				
2 Divide line 1, column B, by line 1, column C	2				
3 **Revenue tons handled at airports** during the period of this return	3				
4 Divide line 3, column B, by line 3, column C	4				
5 **Originating revenue** during the period of this return	5				
6 Divide line 5, column B, by line 5, column C	6				
7 Add all percentage amounts in column D, lines 2, 4, and 6; then divide by 3	7				
8 Enter 100% of receipts from other aviation services; also enter on line 47, in column B	8				
9 Multiply line 7 by line 8; also enter on line 47, in column A	9				

- including one or more other items in such determination, or
- any other similar or different method calculated to effect a fair and proper apportionment of the business income and capital reasonably attributed to the state.

The party seeking the adjustment bears the burden of proof to demonstrate that the apportionment fraction determined according to §210-A does not result in a proper reflection of the taxpayer's business income or capital within the state and that the proposed adjustment is appropriate.

Where you have received approval from the commissioner to make such adjustment, use line 53 to report it. Do **not** use line 53 to report an adjustment **unless** you have received the approval of the commissioner. If you have received the approval of the commissioner, you must attach a copy of such approval to your return. If you have not received the approval of the commissioner before filing this return, you must file using the statutory rules for apportionment. You may file an amended return after you have received approval.

Calculation of business apportionment factor

Line 55 – The business apportionment factor (BAF) should be shown as a decimal, not a percent. When computing the BAF, round to 6 decimal places. For example, 5,000/7,500 = 0.6666666 = 0.666667. **Note:** If all your receipts are New York State receipts, enter decimal as 1.000000.

Worksheet A – Gross proceeds factors and net gains for lines 10, 12, 21, and 24				
Line 10	§210-A.5(a)(2)(A)(iii) – **Gross proceeds** from sales of loans secured by real property *(see instructions)*			
	10a	NYS		
	10b	EW		
	10c	NYS gross proceeds factor		
	§210-A.5(a)(2)(A)(iii) – **Net gains** from sales of loans secured by real property *(see instructions)*			
	10d	EW		
	10e	NYS		
Line 12	§210-A.5(a)(2)(A)(iv) – **Gross proceeds** from sales of loans not secured by real property *(see instructions)*			
	12a	NYS		
	12b	EW		
	12c	NYS gross proceeds factor		
	§210-A.5(a)(2)(A)(iv) – **Net gains** from sales of loans not secured by real property *(see instructions)*			
	12d	EW		
	12e	NYS		
Line 21	§210-A.5(a)(2)(C) – **Gross proceeds** from all other asset backed securities not reported on line 20 *(see instructions)*			
	21a	NYS		
	21b	EW		
	21c	NYS gross proceeds factor		
	§210-A.5(a)(2)(C) – **Net gains** from all other asset backed securities not reported on line 20 *(see instructions)*			
	21d	EW		
	21e	NYS		
Line 24	§210-A.5(a)(2)(D) – **Gross proceeds** from other sales of corporate bonds not reported on line 23 *(see instructions)*			
	24a	NYS		
	24b	EW		
	24c	NYS gross proceeds factor		
	§210-A.5(a)(2)(D) – **Net gains** from other sales of corporate bonds not reported on line 23 *(see instructions)*			
	24d	EW		
	24e	NYS		

Worksheet A – Gross proceeds factors and net gains – Form CT-3, Part 6, lines 10, 12, 21, and 24.

General information

This worksheet computes the amounts for Form CT-3, Part 6, lines 10, 12, 21, and 24. See the corresponding Form CT-3-I, Part 6 line instructions and also the specific instructions below. In the instructions below, ***all lines*** refers to lines 10, 12, 21, and 24, and specific rows (a, b, c, d, or e) are indicated to clarify which rows of these lines the specific instruction applies to.

Line instructions for Worksheet A

Use the instructions for Condition 1 or Condition 2 below, whichever applies; however:

- for **line 10**, use the specific instructions under Condition 1 below and skip Condition 2.
- for **lines 12, 21, and 24,** when the receipts for a certain line are **not** from QFIs (the QFI box pertaining to that specific line is **not** marked), use the specific instructions under Condition 1 below.

Condition 1 – If the fixed percentage method for QFIs is **not** in effect (use when Form CT-3, Part 6, line 8 box is **not** marked)

1.1. For all lines, rows a and b respectively, enter the total NYS and EW gross proceeds amount for that line's category of receipts; do not enter an amount less than zero. In determining such total gross amounts for each line, deduct any cost incurred to acquire the securities. When this results in a negative proceed amount for an individual security reported on a line, such negative amount is not limited to zero, and is netted against any positive proceed amounts for securities also reported on the **same** line.

1.2. For all lines, row c, divide the amount in row a by the amount in row b, and enter the result rounded to four decimal places; however, if either the amount in row a or the amount in row b is equal to zero, enter ***0***. This is the NYS gross proceeds factor for each respective line. It is used to compute the row e *(NYS)* amount for all lines.

1.3. For all lines, row d, enter the *EW* receipts for that line's category of receipts, but if the result is less than zero, enter ***0***.

1.4. For all lines, row e, multiply the factor in that line's row c (the NYS gross proceeds factor) by the amount in that line's row d, and enter the result. If the result is zero, enter ***0***.

Condition 2 – If the fixed percentage method for QFIs **is** in effect (use for a specific line when Form CT-3, Part 6, line 8 box is marked **and** the QFI box pertaining to **that** specific line is also marked)

2.1. Leave rows a through c blank, for such specific line(s).

2.2. For such specific lines, row d, enter the *EW* receipts for that line's category of receipts, but if the result is less than zero, enter ***0***.

2.3. In **row e**, for such specific line(s), multiply row d by 8% (.08) and enter the result; however, if the result is an amount equal to zero, enter ***0*** in row e.

Where are the amounts calculated on Worksheet A entered?

The amounts entered or calculated in rows a, b, and c, for all lines, are only used for Worksheet A calculations and do not get transferred to any other form or worksheet. The amounts entered or calculated in rows d and e need to be entered on Form CT-3, as follows:

Amount from Worksheet A	Amount is entered on
Line 10d (EW)	CT-3, Part 6, line 10 EW (column B)
Line 10e (NYS)	CT-3, Part 6, line 10 NYS (column A)
Line 12d (EW)	CT-3, Part 6, line 12 EW (column B)
Line 12e (NYS)	CT-3, Part 6, line 12 NYS (column A)
Line 21d (EW)	CT-3, Part 6, line 21 EW (column B)
Line 21e (NYS)	CT-3, Part 6, line 21 NYS (column A)
Line 24d (EW)	CT-3, Part 6, line 24 EW (column B)
Line 24e (NYS)	CT-3, Part 6, line 24 NYS (column A)

Worksheet B – Net gains and "other" income for line 30			
Part 1			
§210-A.5(a)(2)(H) – **Net gains** from all "other" financial instruments of one type *(see instructions)*			
30.1a	EW		
30.1b	NYS		
§210-A.5(a)(2)(H) – **Net gains** from all "other" financial instruments of a second type *(see instructions)*			
30.1a	EW		
30.1b	NYS		
§210-A.5(a)(2)(H) – **Net gains** from all "other" financial instruments of a third type *(see instructions)*			
30.1a	EW		
30.1b	NYS		
§210-A.5(a)(2)(H) – **Other income** from all "other" financial instruments of one type *(see instructions)*			
30.2a	EW		
30.2b	NYS		
§210-A.5(a)(2)(H) – **Other income** from all "other" financial instruments of a second type *(see instructions)*			
30.2a	EW		
30.2b	NYS		
§210-A.5(a)(2)(H) – **Other income** from all "other" financial instruments of a third type *(see instructions)*			
30.2a	EW		
30.2b	NYS		
Part 2 *(see instructions)*			
§210-A.5(a)(2)(G) – **Dividends** from stock that is business capital *(see instructions)*			
30.3a	EW		
30.3b	NYS		
§210-A.5(a)(2)(G) – **Net gains** from sales of stock that is business capital *(see instructions)*			
30.4a	EW		
30.4b	NYS		
§210-A.5(a)(2)(G) – **Net gains** from sales of partnership interests *(see instructions)*			
30.5a	EW		
30.5b	NYS		
Totals of Parts 1 and 2			
§210-A.5(a)(2)(H) and (G) – Net gains and "other" income from "other" financial instruments *(see instructions)*			
30a	Total EW		
30b	Total NYS		

Worksheet B – Net gains and "other" income – Form CT-3, Part 6, line 30

General information

This worksheet computes certain amounts for Form CT-3, Part 6, line 30. See the line 30 instructions in Form CT-3-I, Part 6 and also the specific instructions below. In the instructions below, ***all lines*** refers to all lines 30.1 and 30.2, and lines 30.3, 30.4, 30.5, and 30, and specific rows (a or b) are indicated to clarify which rows of these lines the specific instruction applies to. **Note:** Lines 30.1 through 30.5 are specific to this worksheet only. Since Form CT-3, Part 6, line 30 is comprised of different types of receipts that have to be netted separately, these receipts amounts are shown separately on lines 30.1 through 30.5.

Line instructions for Worksheet B

Part 1

Only clause (H) receipts are reported in Part 1.

Step 1 – Lines 30.1 and 30.2, row a – Regardless of whether or not the fixed percentage method is in effect for **lines 30.1 and 30.2,** for **row a** (EW), follow the applicable Form CT-3-I, Part 6, line 30 instructions to determine the amount of everywhere receipts, except that if the amount is less than zero, enter ***0***. When you have **net gains** from sales of more than one type of "other" financial instruments, use separate lines 30.1 to report sales of all "other" financial instruments of each such type. The same is true for lines 30.2 when reporting **other income** from "other" financial instruments.

If you have receipts reportable on lines 30.1 or 30.2 from **more** than three separate types of "other" financial instruments, use an additional line 30.1 or line 30.2 for **each** additional separate type of "other" financial instrument for which you have net gains (line 30.1) or other income (line 30.2); include the amounts from these additional lines in the same manner as you would for the three lines 30.1 and 30.2 provided on the worksheet, as you complete the steps below, as applicable.

Step 2 – Complete **lines 30.1 and 30.2, row b** (NYS)**,** using the instructions for Condition 1 or Condition 2, or both, as applicable.

Condition 1 – If the fixed percentage method for QFIs is **not** in effect (Form CT-3, Part 6, line 8 box is **not** marked); **or** if the receipts from line 30.1 or 30.2 do **not** represent receipts from QFIs (see instructions for Form CT-3, Part 6, line 8):

1.1. For such **lines 30.1 and 30.2, row b,** follow the applicable line 30 instructions to determine the amount of NYS receipts, except that if the amount is less than zero, enter ***0***. Use a separate line 30.1 for **net gains** from sales of all "other" financial instruments of each certain type, and use a separate line 30.2 for **other income** from all "other" financial instruments of each certain type.

Condition 2 – If the fixed percentage method for QFIs **is** in effect (Form CT-3, Part 6, line 8 box is marked) **and**:

2.1. the clause (H) QFI box is **not** marked on Form CT-3, Part 6, above line 29, then lines 30.1 and 30.2, row **b**, are completed in the same manner as if the fixed percentage method is **not** in effect (see above instructions).

2.2. the clause (H) QFI box **is** marked on Form CT-3, Part 6, above line 29, **and** the receipts to be reported on a line 30.1 or 30.2 represent receipts from QFIs (see instructions for CT-3, Part 6, line 8), then for such lines 30.1 or 30.2, **row b,** multiply row **a**, for each respective line, by 8% (.08) and enter the result; however, if the result is an amount equal to zero, enter ***0*** in row **b**. Use a separate line 30.1 for **net gains** from sales of all "other" financial instruments of **each** certain type, and use a separate line 30.2 for **other income** from all "other" financial instruments of **each** certain type.

Part 2

Only clause (G) receipts are reported in Part 2.

Part 2 of Worksheet B must **only** be completed **if** the fixed percentage method for QFIs **is** in effect. If Form CT-3, Part 6, line 8 box is **not** marked, leave lines 30.3, 30.4, and 30.5 blank and continue with *Totals of Parts 1 and 2* instructions below; otherwise continue with Step 1 below.

Step 1 – Lines 30.3 and 30.4, rows a (EW) and b (NYS) – If the fixed percentage method for QFIs **is** in effect and you have marked to market **any** stock that is business capital under

IRC section 475 or 1256 in the tax year, complete substep 1.1 below; otherwise leave lines 30.3 and 30.4 blank and continue with Step 2 below.

1.1. Enter on **line 30.3**, **row a,** 100% of dividends from stock that is business capital, provided that dividends that qualify as other exempt income should **not** be included. Enter on **line 30.4**, **row a**, 100% of net gains from sales of stock that is business capital; if the amount is less than zero, enter ***0***.

   1.1.1. For **lines 30.3 and 30.4**, **row b**, multiply row **a**, for each respective line, by 8% (.08) and enter the result; however, if the result is an amount equal to zero, enter ***0*** in row b.

Step 2 – Line 30.5, rows a (EW) and b (NYS) – If the fixed percentage method for QFIs **is** in effect, and you have marked to market **any** partnership interest in a widely held or publicly traded partnership under IRC section 475 or 1256 in the tax year, complete substep 2.1, below; otherwise leave line 30.5 blank and continue with *Totals of Parts 1 and 2* below.

2.1. Enter on **line 30.5**, **row a**, 100% of net gains from sales of partnership interests in widely held or publicly traded partnerships; if the amount is less than zero, enter ***0***.

   2.1.1. In **line 30.5**, **row b**, multiply row **a**, for each respective line, by 8% (.08) and enter the result; however, if the result is an amount equal to zero, enter ***0*** in row b.

Totals of Parts 1 and 2

Step 1 – Line 30, rows a and b

2.1. For line 30, row **a**, enter the sum of the amounts in row a, lines 30.1 through 30.5.

2.2. For line 30, row **b**, enter the sum of the amounts in row b, lines 30.1 through 30.5.

Where are the amounts calculated on Worksheet B entered?

The amounts entered or calculated on lines 30.1 through 30.5 are used to compute the line 30 totals and do not get transferred to any other form or worksheet; the line 30 totals need to be entered on Form CT-3 as follows:

Amount from Worksheet B	Amount is entered on
Line 30b (Total NYS)	Form CT-3, Part 6, line 30 NYS (column A)
Line 30a (Total EW)	Form CT-3, Part 6, line 30 EW (column B)

Worksheet C – Marked to market (MTM) net gains for line 28

Part 1 – MTM net gains under §§210-A.5(a)(1) and 210-A.5(a)(2)(J) *(see instructions)*

Line 10	MTM net gains from loans secured by real property				
	10a	EW			
	10b	NYS		J(ii)	J(iii)
Line 12	MTM net gains from loans **not** secured by real property				
	12a	EW			
	12b	NYS	8%	J(ii)	J(iii)
Line 14					
Line 16	MTM net gains from federal, NYS, and NYS political subdivisions debt				
	16a	EW			
	16b	NYS	8%	J(ii)	J(iii)
Line 18	MTM net gains from other states and their political subdivisions debt				
	18a	EW			
	18b	NYS	8%	J(ii)	J(iii)
Line 20	MTM net gains from government agency debt or asset-backed securities sold through an exchange				
	20a	EW			
	20b	NYS	8%	J(ii)	J(iii)
Line 21	MTM net gains from all other asset-backed securities				
	21a	EW			
	21b	NYS	8%	J(ii)	J(iii)
Line 23	MTM net gains from corporate bonds sold through broker/dealer or licensed exchange				
	23a	EW			
	23b	NYS	8%	J(ii)	J(iii)
Line 24	MTM net gains from other corporate bonds				
	24a	EW			
	24b	NYS	8%	J(ii)	J(iii)
Line 27	MTM net gains from physical commodities				
	27a	EW			
	27b	NYS	8%	J(ii)	J(iii)
Line 30	MTM net gains from all "other" financial instruments of one type				
	30a	EW			
	30b	NYS	8%	J(ii)	J(iii)
Line 30	MTM net gains from all "other" financial instruments of a second type				
	30a	EW			
	30b	NYS	8%	J(ii)	J(iii)
Line 30	MTM net gains from all "other" financial instruments of a third type				
	30a	EW			
	30b	NYS	8%	J(ii)	J(iii)
Line 30-Stk	MTM net gains from stock that is business capital				
	30a Stk	EW			
	30b Stk	NYS	8%		
Line 30-Pship	MTM net gains from partnership interests				
	30a Pship	EW			
	30b Pship	NYS	8%		

Worksheet C continued on next page

Worksheet C *(continued)*			
J(ii) Totals *(see instructions)*			
J(ii) Total EW			
J(ii) Total NYS			
Line 28	Total MTM net gains under §210-A.5(a)(2)(J)		
	28a	EW	
	28b	NYS	
Part 2 – NYS aggregate MTM factor, based on net gains from actual sales, plus J(ii) MTM net gains *(see instr.)*			
A	NYS		
B	EW		
C	NYS aggregate MTM factor		

Worksheet C – Marked to market (MTM) net gains – Form CT-3, Part 6, line 28

General information

Note: You must first complete Worksheets A and B, and lines 9 through 27, 29, and 30 of Form CT-3, Part 6; then, follow the steps below, in order, to complete Worksheet C.

This worksheet computes the amounts for Form CT-3, Part 6, line 28. See the Form CT-3, Part 6, line 28 instructions and also the specific instructions below. For purposes of Worksheet C, §210-A.5(a)(2)(J)(ii) is referred to as J(ii), and §210-A.5(a)(2)(J)(iii) as J(iii). J(ii) sources MTM net gains based on the sourcing of net gains from **actual** sales of financial instruments of the **same** type. J(iii) is used when there are **no** actual sales of a type, or the actual sales of a type resulted in a net **loss** for that type.

Part 1 of the worksheet computes MTM net gains for those financial instruments that are **described on** Form CT-3, Part 6, lines 10, 12, 16, 18, 20, 21, 23, 24, 27, and 30, **and that have been MTM**. Row b is broken out into subcolumns for lines 10, 12, 16, 18, 20, 21, 23, 24, 27, and all lines 30. For each such line, only **one** of the subcolumns will apply for that line, depending on the sourcing rule that applies for that line; the subcolumns that do **not** apply should be left **blank**.

Part 2 of the worksheet is generally only applicable if the 8% fixed percentage method for QFIs is **not** in effect. Provided however, that if the fixed percentage method for QFIs **is** in effect, and you have MTM net gains reportable on line 10 of the worksheet, you **may** have to complete Part 2 of the worksheet, as instructed further below. Part 2 computes the NYS aggregate MTM factor. This factor is used to determine NYS MTM net gains under J(iii) in Part 1, as per the specific line instructions under *Customer-based sourcing* below.

Line instructions for Worksheet C

If the fixed percentage method for QFIs **is** in effect (Form CT-3, Part 6, line 8 box **is** marked), you **must** complete the steps under the *8% fixed percentage method elected* instructions below to complete Worksheet C. Do **not** complete the steps under the *Customer-based sourcing* instructions, **unless** specifically instructed to do so for a certain line.

If the fixed percentage method for QFIs is **not** in effect (Form CT-3, Part 6, line 8 box is **not** marked), you **must** complete the steps under the *Customer-based sourcing* instructions below to complete Worksheet C. Do **not** complete the steps under the *8% fixed percentage method elected* instructions.

Regardless of whether or not the fixed percentage method for QFIs is in effect, use a **separate** line 30 for MTM net gains from all "other" financial instruments of one **same** certain type. If you need more than three lines 30, use an additional line 30 for each separate type of "other" financial instrument for which you have MTM net gains; include the amounts from these additional lines in the same manner as you would for the three lines 30 provided on the worksheet, as you complete the steps below, as applicable.

8% fixed percentage method elected

When the 8% fixed percentage method for QFIs **is** in effect, follow the instructions for Condition 1 or Condition 2 below, whichever applies. When Condition 1 applies, only Part 1 of Worksheet C needs to be completed, and the **Part 1, J(ii) Totals** section should be left blank. When Condition 2 applies, you may need to complete Part 2 of the worksheet and the **Part 1, J(ii) Totals** section.

Condition 1 – If you do **not** have MTM net gains reportable on line 10 of this worksheet, complete **steps 1** and **2** below (under these *8% fixed percentage method elected* instructions) and do **not** complete any of the steps under the *Customer-based sourcing* instructions.

Condition 2 – If you have MTM net gains reportable on line 10 of this worksheet, you must determine the amounts to enter on line 10 by completing the applicable steps under *Customer-based sourcing* **for line 10 only**. When Condition 2 applies:

- First, **for line 10 only**, complete **steps 1.1** through **4.1.2** under *Customer-based sourcing*, (do **not** complete step 5).
- Next, complete **all of steps 1 and 2 below** (under these *8% fixed percentage method elected* instructions) for all remaining lines (including lines 30-STK and 30-Pship, if applicable).

Step 1 – Part 1, rows a and b

1.1. In **row a** (EW), lines 12, 16, 18, 20, 21, 23, 24, 27, all lines 30, 30-Stk, and 30-Pship, enter **100%** of your MTM net gains for those financial instruments **described** on each such line (and described further in the lines corresponding line instructions in Form CT-3, Part 6), except that if the net amount is less than or equal to zero, enter ***0***.

Note: Use **line 30** for MTM net gains from "other" financial instruments (§210-A.5(a)(2)(H)). If in the tax year you have MTM **any** stock under IRC section 475 or 1256, use **line 30-Stk** for MTM net gains from sales of stock that is business capital (§210-A.5(a)(2)(G)); otherwise leave line 30-Stk blank. If in the tax year you have MTM **any** partnership interest in a widely held or publicly traded partnership under IRC section 475 or 1256, use **line 30-Pship** for MTM net gains from sales of partnership interests in widely held or publicly traded partnerships (§210-A.5(a)(2)(G)); otherwise, leave line 30-Pship blank.

1.2. In **row b** (NYS), **subcolumn 8%**, lines 12, 16, 18, 20, 21, 23, 24, 27, all lines 30, 30-Stk, and 30-Pship, multiply row **a**, for each respective line, by 8% (.08) and enter the result; if the result is equal to zero, enter ***0***. You must leave **row b**, **subcolumn J(ii)** and **row b**, **subcolumn J(iii)** blank for all such lines as they are **not** applicable when the 8% fixed percentage method sourcing **is** in effect for QFIs.

Step 2 – Part 1, line 28, rows a and b

2.1. For worksheet line 28, **row a**, enter the **sum** of the amounts from row a for lines 10, 12, 16, 18, 20, 21, 23, 24, 27, all lines 30, 30-Stk, and 30-Pship.

2.2. For worksheet line 28, **row b**, enter the **sum** of all amounts from all applicable subcolumns in row b for lines 10, 12, 16, 18, 20, 21, 23, 24, 27, all lines 30, 30-Stk, and 30-Pship.

Customer-based sourcing

Parts 1 and 2 of Worksheet C need to be completed when the 8% fixed percentage method for QFIs is **not** in effect. To complete Worksheet C in this instance, follow Steps 1 through 5 below, in that order.

Note: Lines 30-Stk and 30-Pship should **not** be completed as these lines are not applicable when customer-based sourcing is used (§210-A.5(a)(2)(G)).

If the fixed percentage method for QFIs **is** in effect **and** you have MTM net gains reportable on worksheet line 10, then you must use customer-based sourcing for the MTM net gains **for line 10 only**. In this instance follow the instructions for **Condition 2** under the *8% fixed percentage method elected* instructions, above.

Step 1 – Part 1, row a, and row b, subcolumn J(ii)

1.1. In **row a**, lines 10, 12, 16, 18, 20, 21, 23, 24, 27, and all lines 30, enter **100%** of your **MTM** net gains for those financial instruments **described** on each such line (and described further in the corresponding line instructions in Form CT-3, Part 6), except that if the net amount is less than or equal to zero, enter ***0***.

1.2. **Row b, subcolumn J(ii)** - Subcolumn J(ii), lines 10, 12, 16, 18, 20, 21, 23, 24, 27, and all lines 30, is used to compute **NYS MTM** net gains, for those financial instruments **described** on each such line, under the sourcing rules of J(ii). Follow the steps below to compute the subcolumn J(ii) amounts. Complete substeps 1.2.1 through 1.2.4 for each line (10, 12, 16, 18, 20, 21, 23, 24, 27, and all lines 30):

1.2.1. If the step 1.1 amount is equal to zero, for any line, enter ***0*** in row b, subcolumns J(ii) and J(iii), for **that** line.

1.2.2. For **each** line for which row **a** is **not** equal to zero, determine if you have **actual** everywhere sales that generated a **net gain** during the tax year, for **that** type of financial instrument. You had **actual** everywhere sales that generated a **net gain** during the tax year for a specific type of financial instrument if there is an amount greater than zero reported on **that** type of financial instrument's corresponding line of Form CT-3, Part 6, column **B** (EW). However, for line 30, you had **actual** everywhere sales that generated a **net gain** during the tax year for a type of financial instrument described in §210-A.5(a)(2)(H) if there is an amount greater than zero reported on Worksheet **B**, on line 30.1 (used to report the **same** specific type of financial instruments), row **a**.

1.2.3. For **each** line for which Worksheet C, row **a**, is **not** equal to zero, if you **did** have **actual** everywhere sales that generated a **net gain** for the **same** specific type of financial instrument described on such line (as determined in substep 1.2.2 above), enter in row b, subcolumn J(ii), for such line, the **product** of: the amount in row **a** for such line, and a fraction, the numerator and the denominator of which are determined as follows:

- For all such lines (except line 30): the **numerator** of the fraction for such line (except line 30) is the amount from Form CT-3, Part 6, column A (NYS) of the corresponding line; and the **denominator** of the fraction for such line (except line 30) is the amount from Form CT-3, Part 6, column B (EW) of the corresponding line. However, if the numerator so determined is equal to zero, enter ***0***. For line 30, see the specific line 30 instruction below.
- **Line 30 –** The **numerator** of the fraction for any **specific** line 30 is the amount from Worksheet B, line 30.1 (used to report the **same** specific type of financial instrument), row b (NYS). The **denominator** of the fraction for any **specific** line 30 is the amount from Worksheet B, line 30.1 (used to report the **same** specific type of financial instrument), row a (EW). However, if the numerator so determined is zero, enter ***0***.

1.2.4. For **each** line for which row **a** is **not** equal to zero, if you did **not** have **actual** everywhere sales that generated a **net gain** for the **same** specific type of financial instrument described in **that** line (as determined in substep 1.2.2 above), leave row b, subcolumn J(ii) **blank** for **that** line.

Step 2 – Part 1, J(ii) Total EW, and J(ii) Total NYS

When you have completed Part 1, row a, and row b subcolumn J(ii), for lines 10, 12, 16, 18, 20, 21, 23, 24, 27, and all lines 30, you must next complete the **J(ii) Total** lines for EW and NYS, which are below line 30-Pship. The J(ii) totals are needed to calculate the NYS aggregate MTM factor in Part 2 of this worksheet, when applicable.

2.1. Enter in the **J(ii) Total EW** line, the **sum** of the row **a** amounts for all lines that have an amount entered in row **b**, subcolumn J(ii) even if the amount entered is zero.

2.2. Enter in the **J(ii) Total NYS** line, the **sum** of the row b, subcolumn J(ii) amounts for all lines that have an amount entered in row b, subcolumn J(ii).

Step 3 – Part 2

Part 2 of the worksheet computes your NYS aggregate MTM factor which you will need in order to complete Part 1, row b, subcolumn J(iii), when applicable.

Never include any amounts sourced under the 8% fixed percentage method election when determining the amounts to include in the sums described in these step 3 instructions.

3.1. **Line A** – Enter the **sum** of: the **J(ii) Total NYS** amount from Part 1 of this worksheet plus the amounts from Form CT-3, Part 6, column A (NYS), lines 9 through 27, 29, and 30.

3.2. **Line B** – Enter the **sum** of: the **J(ii) Total EW** amount from Part 1 of this worksheet plus the amounts from Form CT-3, Part 6, column B (EW), lines 9 through 27, 29, and 30.

3.3. **Line C** – Divide the line A amount by the line B amount and enter the result, rounded to four decimal places.

Step 4 – Part 1, row b, subcolumn J(iii)

4.1. **Row b, subcolumn J(iii)** - Subcolumn J(iii), lines 10, 12, 16, 18, 20, 21, 23, 24, 27, and all lines 30, is used to compute **NYS MTM** net gains, for those financial instruments **described** on each such line, under the sourcing rules of J(iii). Follow the steps below to compute the subcolumn J(iii) amounts. Complete substeps 4.1.1 and 4.1.2 for each line (10, 12, 16, 18, 20, 21, 23, 24, 27, and all lines 30):

4.1.1. For **each** line, if there is an amount greater than or equal to zero entered in row b, subcolumn J(ii), then leave row b, subcolumn J(iii) **blank** for **that** line. **Note**: When you had **actual** everywhere sales that generated a **net gain** for **that type** of financial instrument during the tax year, subcolumn J(ii) should have an amount entered, and subcolumn J(iii) should be left **blank**.

4.1.2. For **each** line, if you did **not** have **actual** everywhere sales that generated a **net gain** for **the specific type** of financial instrument **described** on **that** line (**row b, subcolumn J(ii)** was left blank per substep 1.2.4), enter in row b, subcolumn J(iii), for **that** line, the **product** of: the amount in row a (EW) for **that** line, and the factor in Part 2, line C.

Step 5 – Part 1, line 28, rows a and b

5.1. For line 28, **row a** (EW), enter the **sum** of the amounts from row **a** (EW) for lines 10, 12, 16, 18, 20, 21, 23, 24, 27, and all lines 30.

5.2. For line 28, **row b** (NYS), enter the **sum** of all amounts from row **b** (NYS), subcolumns J(ii) **and** J(iii) for lines 10, 12, 16, 18, 20, 21, 23, 24, 27, and all lines 30.

Where are the amounts calculated on Worksheet C entered?

The amounts entered or calculated on Part 1, lines 10, 12, 16, 18, 20, 21, 23, 24, 27, 30, 30-Stk, and 30-Pship and Part 2, lines A, B, and C are only used to compute the **line 28** MTM totals in Part 1 and do not get transferred to any other form or worksheet; the **line 28 totals** from Part 1 need to be entered on Form CT-3 as follows:

Amount from Worksheet C	Amount is entered on
Line 28b (NYS)	Form CT-3, Part 6, line 28 NYS (column A)
Line 28a (EW)	Form CT-3, Part 6, line 28 EW (column B)

Part 7 – Summary of tax credits claimed

Enter in the appropriate box the amount of each tax credit that is being used to reduce the Part 2, line 2 tax due amount. Attach the corresponding properly completed credit form to the return.

Line 2 – Enter the total amount of any tax credits that you are claiming against your current year's franchise tax here and on Part 2, line 3. For other credits not specified, enter the amount of credits being claimed in the *Other credits* box and include this amount in the total. Generally, the *Other credits* box will be used only when a credit claim form for a newly-enacted tax credit was not developed in time to appear on Form CT-3. Do not include any amount of tax credit requested as a refund on Part 2, line 29, or requested as a tax credit to be credited as an overpayment to next year's return on Part 2, line 30. If you are required to recapture a tax credit that was allowed in a previous reporting period and the result is a negative credit amount on your credit claim form, enter this negative amount using a minus sign (-) in the applicable box.

Line 3 – Enter the amount of those tax credits being claimed on Part 2, line 3, against your current year's franchise tax that are refund **eligible**. Do **not** include any amount of credits actually requested as a refund on Part 2, line 29, or requested as an overpayment credited to next year's tax on Part 2, line 30. Refer to the individual credit forms and Form CT-600-I for refund eligibility.

STATE OF CONNECTICUT
DEPARTMENT OF REVENUE SERVICES

SN 2018(7)

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Hartford CT 06103-1837

SPECIAL NOTICE

Treatment of Global Intangible Low-Taxed Income for Connecticut Corporation Business Tax Purposes

Effective Dates: This guidance applies to income years commencing on or after January 1, 2018.

Purpose: As a result of changes made by the federal Tax Cuts and Jobs Act, certain US taxpayers are subject to tax on their global intangible low-taxed income (GILTI) for income years beginning on or after January 1, 2018. This publication explains how GILTI will be treated for Connecticut Corporation Business Tax purposes.

Federal Treatment: For federal purposes, GILTI is included in a corporation's gross income and is generally treated in a manner similar to Subpart F income. I.R.C. §§ 951A(a) and 951A(f).[1] A corporation with GILTI is allowed to claim a deduction against a portion of such income on its federal return. I.R.C. § 250. The amount of a corporation's GILTI and corresponding deduction are determined under federal law. In addition, a corporation may exclude from its federal gross income any income that has previously been taxed as GILTI. I.R.C. § 959.

Connecticut Treatment

Dividends Received Deduction for GILTI. Connecticut treats Subpart F income as a dividend. Because GILTI is treated in a manner similar to Subpart F income for federal tax purposes, Connecticut will treat such income as dividend income.

Connecticut provides a dividend received deduction (DRD) that fully offsets the dividend income that a corporation receives from foreign corporations to the extent such income is not otherwise deducted. Accordingly, even though a corporation must include its GILTI on its Connecticut return, it is then entitled to claim a deduction to fully offset such income.

After a corporation claims the DRD, a corporation must add back its expenses that relate to its dividend income on its Connecticut return. Pursuant to Conn. Gen. Stat. § 12-217(a)(2), which was recently amended by 2018 Conn. Pub. Acts 49, § 13, this addback is equal to 5% of the dividend income. The addback should equal 5% of the gross amount of GILTI prior to any corresponding federal deduction.

The combined effect of the 100% DRD and the 5% addback is a net 95% DRD for GILTI.

Previously Taxed GILTI Excluded. Connecticut conforms to the federal definition of "gross income" unless there is a modification specifically provided by Connecticut law. No Connecticut modification exists with respect to the previously taxed GILTI exclusion. Therefore, because income previously taxed as GILTI is excluded from gross income for federal purposes, it is similarly excluded for Connecticut Corporation Business Tax purposes.

GILTI Excluded from Apportionment Factor Calculation. For Corporation Business Tax purposes, Connecticut does not include dividend income in the apportionment factor calculation. Accordingly, GILTI must be excluded from the apportionment factor calculation.

How to Report GILTI on a Connecticut Corporation Business Tax Return. As of the date of this publication, the Internal Revenue Service has not issued forms that show how GILTI, the corresponding deduction, and the previously taxed income exclusion will be reported for federal tax purposes. After the Internal Revenue Service issues such forms, the Department of Revenue Services (DRS) will issue specific guidance on how such

[1] All references to the Internal Revenue Code are to the Internal Revenue Code as amended by the Tax Cuts and Jobs Act.

items will need to be reported on a Connecticut Corporation Business Tax return.

Effect on Other Documents: None.

Effect of This Document: A Special Notice announces a new policy or practice in response to changes in state or federal laws or regulations or to judicial decisions. A Special Notice indicates an informal interpretation of Connecticut tax law by DRS.

For Further Information: Call DRS during business hours, Monday through Friday:

- **1-800-382-9463** (Connecticut calls outside the Greater Hartford calling area only); **or**
- **860-297-5962** (from anywhere).

TTY, TDD, and Text Telephone users only may transmit inquiries anytime by calling 860-297-4911.

Forms and Publications: Visit the DRS website at **www.ct.gov/DRS** to download and print Connecticut tax forms and publications.

Paperless Filing/Payment Methods (fast, easy, free, and confidential): Business and individual taxpayers can use the **Taxpayer Service Center *(TSC)*** at **www.ct.gov/TSC** to file a variety of tax returns, update account information, and make payments online.

File Electronically: You can choose first-time filer information and filing assistance or log directly into the ***TSC*** to file returns and pay taxes.

Pay Electronically: You can pay taxes for tax returns that cannot be filed through the ***TSC***. Log in and select the *Make Payment Only* option. Choose a payment date up to the due date of the tax and mail a paper return to complete the filing process.

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SN 2018(7)
Corporation business tax
Issued: 7/20/2018

FLORIDA DEPARTMENT OF REVENUE

STATUS REPORT

Examination of the Impact of the Tax Cuts and Jobs Act of 2017

August 3, 2018

Status Report on the
Examination of the Impact of the Tax Cuts and Jobs Act of 2017
August 3, 2018

I. Overview

During the 2018 legislative session, the Florida Legislature recognized that federal tax law changes made by the Tax Cuts and Jobs Act of 2017 (Public Law 115-97) would have significant effects on Florida corporate income tax and taxpayers when it is fully implemented. To better understand these effects, the Department of Revenue was directed to examine how the Tax Cuts and Jobs Act of 2017 will affect the state corporate income tax as a result of the state's adoption of the 2018 Internal Revenue Code. Chapter 2018-119, Laws of Florida, provides guidance on how the examination is to be conducted and requires a final report to be submitted to the Governor, President of the Senate, Speaker of the House of Representatives, and the chairs of the appropriate legislative committees by February 1, 2019. The chapter law also requires the Department to provide status reports on August 3, 2018, and November 16, 2018, to the chairs of the appropriate legislative committees. The status reports are to include a brief description of the Department's activities as well as any relevant guidance issued by the Internal Revenue Service (IRS). The information provided below details the Department's activities thus far in examining the Tax Cuts and Jobs Act of 2017 and describes the processes that the Department has established to solicit and receive public input.

II. Process for Receiving Public Input

In accordance with the law, the Department has established a process to receive input from the public about the Tax Cuts and Jobs Act of 2017. The Department created a dedicated webpage that went live in April, floridarevenue.com/citreview. The webpage provides the public with multiple methods by which to provide comments, including a dedicated email address. The webpage also provides links to the law requiring the examination, Chapter 2018-119, Laws of Florida; the Tax Cuts and Jobs Act of 2017, Public Law No. 115-97; Florida's corporate income tax code, Chapter 220, Florida Statutes; and information from the IRS. The Department sent notices seeking public comment to the Florida Institute of Certified Public Accountants, the Tax Section of the Florida Bar, as well as through the Department's general tax information electronic notification lists. A notice was also published in the Florida Administrative Register on May 2, 2018. Various postings on the Department's website alert taxpayers to the project. The Department posts all public comments received on the webpage weekly. As of July 31, 2018, the Department has received five public comments.

III. Process for Developing the Final Report

The Department has established a 14-member team, from various sections within the agency, to work on this project. The team includes attorneys from the General Counsel's Office, staff and managers from the General Tax Administration Program, Office of Technical Assistance and Dispute Resolution, Office of Tax Research, Office of Legislative and Cabinet Services, and the Executive Office. Currently, the Department has identified 13 topics that have the potential to have significant impacts on Florida. The topics were identified based on information that was obtained during and after the legislative session. The Department's Office of Tax Research used the federal Joint Committee on Taxation's spreadsheet, which identified the estimated budget effects of the Tax Cuts and Jobs Act of 2017, as a starting point. The Department also reviewed a report published by the Council on State Taxation and the final House of Representatives legislative bill analysis on House Bill 7093 to determine possible topics with substantial impact to Florida. One topic was also included after an inquiry from a member of the public. The Department is also monitoring and reviewing IRS guidance and other information as it is released. As IRS guidance is issued and additional information is received about potential impacts from the public or other sources, the list of topics may change.

IV. Topics Under Review and Relevant IRS Guidance

Listed below are the 13 topics that the Department has identified as having the potential to have significant impacts on Florida. For each topic, relevant IRS guidance that has been issued as of July 31, 2018, has been identified. The Department is currently analyzing these topics and guidance to determine the potential effects of the Tax Cuts and Jobs Act of 2017 on the state corporate income tax structure and state revenues. The Department is also reviewing options for changes the Legislature could make to state tax law, which may be needed to integrate state law with federal law.

A. Treatment of Deferred Foreign Income Upon Transition to a Participation Exemption System of Taxation

The Tax Cuts and Jobs Act of 2017 amends Internal Revenue Code (IRC) section 965 to impose a one-time corporate income tax transition tax on deferred (untaxed) foreign income as if such income had been repatriated to the United States in the business's last tax year beginning before January 1, 2018.

Public Law 115-97 References: Section 14103

Internal Revenue Code References: Section 965

IRS Guidance:

- Publication 5292, How to Calculate Section 965 Amounts and Elections Available to Taxpayers, https://www.irs.gov/pub/irs-pdf/p5292.pdf
- Questions and Answers about Reporting Related to Section 965 on 2017 Tax Returns, https://www.irs.gov/newsroom/questions-and-answers-about-reporting-related-to-section-965-on-2017-tax-returns
- Notice 2018-07, Guidance under Section 965, https://www.irs.gov/pub/irs-drop/n-18-07.pdf
- Notice 2018-13, Additional Guidance Under Section 965 and Guidance Under Sections 863 and 6038 in Connection with the Repeal of Section 958(b)(4), https://www.irs.gov/pub/irs-drop/n-18-13.pdf
- Notice 2018-26, Additional Guidance Under Section 965, Guidance Under Sections 62, 962, and 6081 in Connection with Section 965; and Penalty Relief Under Section 6654 and 6655 in Connection with Section 965 and Repeal of Section 958(b)(4), https://www.irs.gov/pub/irs-drop/n-18-26.pdf
- Revenue Procedure 2018-17, https://www.irs.gov/pub/irs-drop/rp-18-17.pdf

Florida Tax Information Publication: 18C01-01

B. Repeal of Alternative Minimum Tax

The Tax Cuts and Jobs Act of 2017 repeals the federal corporate alternative minimum tax (AMT) for taxable years beginning after December 31, 2017. The Act also accelerates the use of previously earned federal AMT credits by not only allowing those credits to offset the regular federal corporate income tax liability, but also by allowing the credit to be refunded.

Public Law 115-97 References: Sections 12001, 12002

Internal Revenue Code References: Sections 53, 55, 56

IRS Guidance:

- Effect of Sequestration on the Alternative Minimum Tax Credit for Corporations, March 28, 2018, https://www.irs.gov/businesses/effect-of-sequestration-on-the-alternative-minimum-tax-credit-for-corporations

C. Increases in the Section 179 Expense Amount

Taxpayers may elect to immediately expense certain business assets rather than depreciating them over time. The Tax Cuts and Jobs Act of 2017 amends IRC section 179, to increase the deduction from $500,000 to $1 million and the deduction phase-out from $2 million to $2.5 million.

Public Law 115-97 References: Sections 11002, 13101

Internal Revenue Code References: Section 179

IRS Guidance:

- Fact Sheet FS-2018-9, April 2018, https://www.irs.gov/newsroom/new-rules-and-limitations-for-depreciation-and-expensing-under-the-tax-cuts-and-jobs-act

- IRS Tax Reform Tax Tip 2018-68, May 3, 2018, https://www.irs.gov/newsroom/tax-reform-changes-to-depreciation-affect-businesses-now

D. Changes to the Net Operating Loss Deduction

The Tax Cuts and Jobs Act of 2017 amends IRC section 172 to eliminate the two-year net operating loss carryback for most taxpayers, extend the carryforward period indefinitely, and limit the amount of net operating loss deduction that may be claimed in each year to 80% of income.

Public Law 115-97 References: Section 13302

Internal Revenue Code References: Section 172

IRS Guidance: None available as of July 31, 2018

E. Bonus Depreciation

The Tax Cuts and Jobs Act of 2017 extends and modifies the additional first-year bonus depreciation deduction through 2026 for most property acquired and placed in service after September 27, 2017. The 50% allowance is increased to 100% for property placed in service before January 1, 2023. After December 31, 2022, the 100% allowance is reduced by 20% per calendar year and eliminated in 2027.

Public Law 115-97 References: Section 13201

Internal Revenue Code References: Section 168(k)

IRS Guidance:

- Fact Sheet FS-2018-9, April 2018, https://www.irs.gov/newsroom/new-rules-and-limitations-for-depreciation-and-expensing-under-the-tax-cuts-and-jobs-act

- IRS Tax Reform Tax Tip 2018-68, May 3, 2018, https://www.irs.gov/newsroom/tax-reform-changes-to-depreciation-affect-businesses-now

- Publication 946 (*How To Depreciate Property*), February 28, 2018, https://www.irs.gov/pub/irs-pdf/p946.pdf

F. Repeal of the Deduction for Domestic Production Activities

Internal Revenue Code section 199 provided a reduced tax rate for income from certain domestic production activities. The Tax Cuts and Jobs Act of 2017 repeals the domestic production activities deduction for taxable years beginning after December 31, 2017.

Public Law 115-97 References: Section 13305

Internal Revenue Code References: Section 199

IRS Guidance: None available as of July 31, 2018

G. BEAT – Base Erosion Anti-Abuse Tax

The Tax Cuts and Jobs Act of 2017 creates a new base erosion and anti-abuse tax (BEAT) in IRC section 59A, which is a new minimum tax on large corporations with significant base erosion payments to related foreign parties. The BEAT tax is in addition to the regular federal income tax and is calculated on payments made to related entities.

Public Law 115-97 References: Section 14401

Internal Revenue Code References: Section 59A

IRS Guidance: None available as of July 31, 2018

H. Amortization of Research and Experimental Expenditures

The Tax Cuts and Jobs Act of 2017 eliminates the current deduction for IRC section 174 expenditures, and requires all domestic research expenditures to be amortized over a minimum of five years and for all foreign research expenditures to be amortized over a minimum of fifteen years. The Research and Development Credit is not affected by the Act.

Public Law 115-97 References: Section 13206

Internal Revenue Code References: Section 174

IRS Guidance: None available as of July 31, 2018

I. Deduction for Dividends Received from Foreign Corporations

The Tax Cuts and Jobs Act of 2017 provides in IRC section 245A that a U.S. corporation that is a 10% or more owner of certain foreign corporations may claim a 100% dividends-received deduction for the foreign source portion of dividends received from that foreign corporation. The foreign dividends-received deduction is limited to domestic corporations (not REITs or RICs) and may not be included in the computation of the foreign tax credit.

Public Law 115-97 References: Section 14101

Internal Revenue Code References: Section 245A

IRS Guidance: None available as of July 31, 2018

J. Global Intangible Low-Taxed Income

The Tax Cuts and Jobs Act of 2017 creates IRC section 951A, which imposes a tax on the global intangible low-taxed income (GILTI) of certain U.S. taxpayers and their affiliates for tax years beginning on or after January 1, 2018. GILTI is included in a company's gross income and generally treated in a manner similar to Subpart F income, with certain deductions and exemptions.

Public Law 115-97 References: Section 14201

Internal Revenue Code References: Section 951A

IRS Guidance: None available as of July 31, 2018

K. Deduction for Foreign Derived Intangible Income

The Tax Cuts and Jobs Act of 2017 creates a new provision in IRC section 250 that gives domestic corporations reduced rates of U.S. tax on their foreign-derived intangible income. It provides a lower effective tax rate on high-returns related to foreign sales. The calculation is similar to GILTI in that returns in excess of 10% of fixed assets form the basis of the calculation.

This is achieved by providing domestic corporations a deduction against foreign-derived intangible income (subject to certain limitations) of 37.5% initially, reduced to 21.875% for tax years beginning after 2025. At a 21% corporate tax rate, the deduction results in effective rates of 13.125% and 16.40625% respectively. IRC section 250 also provides a subtraction for 50% of GILTI and for 50% of IRC section 78 dividends.

Public Law 115-97 References: Section 14202

Internal Revenue Code References: Section 250

IRS Guidance: None available as of July 31, 2018

L. Net Interest Deduction

The deduction for interest expenses is limited to 30% of "adjusted taxable income" (ATI) plus business interest income, with special elections available for real property trades and businesses. For the first four years after the enactment of the Tax Cuts and Jobs Act of 2017, ATI is computed without subtracting depreciation, amortization, or depletion in addition to interest and taxes. Beginning in 2022, ATI would be decreased by depreciation, amortization, or depletion, thus making the computation 30% of net interest expense exceeding earnings before interest and taxes.

Public Law 115-97 References: Section 13301

Internal Revenue Code References: Section 163(j)

IRS Guidance:

- Notice 2018-28, Initial Guidance Under Section 163(j) as Applicable to Taxable Years Beginning After December 31, 2017, April 2, 2018, https://www.irs.gov/pub/irs-drop/n-18-28.pdf

M. Changes to the Treatment of Capital Contributions

The Tax Cuts and Jobs Act of 2017 amends IRC section 118 to provide that certain federal, state, and local incentives used to attract companies are treated as current taxable income to those businesses rather than deferred capital contributions.

Public Law 115-97 References: Section 13312

Internal Revenue Code References: Section 118

IRS Guidance: None available as of July 31, 2018

V. Consultation with the Revenue Estimating Conference

On July 13, 2018, the Department had an initial consultation with members of the Revenue Estimating Conference to discuss the development of the required reports.

VI. Public Workshops

In accordance with the law, the Department will be holding at least two public workshops to gather input and comments from the public. The first public workshop will be held in Tallahassee at 9:00 a.m. on August 22, 2018. A webinar also will be provided so those unable to attend in person will be able to participate from remote locations. The Department will encourage the public to bring to our attention information and topics related to the law changes that they believe are relevant and possible options to be considered. A second workshop is tentatively scheduled for October 24, 2018**.**

Maryland Income Tax
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04-19

Maryland Guidance on the Reporting and Taxation of IRC § 951A Global Intangible Low Taxed Income

Questions have arisen as to how Maryland treats Global Intangible Low Taxed Income (GILTI), the new category of income created by the Tax Cuts and Jobs Act (TCJA). GILTI is included in federal adjusted gross income. GILTI is not a dividend or deemed dividend, so it is not eligible for Maryland's dividend subtraction; therefore, GILTI is taxed as income in Maryland. GILTI's corresponding federal § 250 deduction for corporations is also captured on the Maryland return.

TCJA broadened the scope of foreign earnings subject to tax when it created GILTI. The new federal provisions impose a tax on shareholders of controlled foreign corporations (CFCs) when the return on specific tangible assets of the CFC exceeds 10%. These specific assets are referred to as qualified business asset investment (QBAI). Taxation of GILTI is based on the assumption that if a company invests in tangible assets, it can reasonably expect a return of 10% on those assets. Any profit in excess of 10% of QBAI is supernormal, and it is inferred that supernormal profits are attributable to intangible assets that have been parked in foreign, low tax rate jurisdictions to avoid tax. GILTI rules presume that some of this income is more appropriately sourced to the United States, and is subject to tax, though at a lower rate. Because of how GILTI is calculated, the tax on GILTI will affect any business whose income is high relative to the fixed asset base. The GILTI rules apply to US persons that own, directly or indirectly, 10% or more of the value or vote of the CFC.

The lower tax rate (the "LT" in GILTI) is achieved, at the federal level, through a deduction, as well as a credit. IRC § 250 entitles C corporations to a 50% deduction on GILTI. This deduction is only available to C corporations, not to partnerships or S corporations, who ultimately pass the income to their respective partners and shareholders. Individual partners and shareholders must include their pro-rata share of GILTI on their individual returns. C corporations reporting GILTI are also entitled to a federal tax credit up to 80% of foreign taxes paid, or an amount equal to its US tax liability times the ratio of foreign profits to worldwide profits, whichever is lower.

This Tax Alert will address how, mechanically, GILTI income is captured by Maryland on the income tax returns for corporations, pass-through entities, and individuals.

GILTI on Maryland Forms for Corporations, Pass-Through Entities, and Individuals

Form 500, Corporations

GILTI and the corresponding § 250 deduction are included in Maryland taxable income for corporations. There is no mechanism under Maryland law that provides a foreign tax credit for this income.

GILTI amounts are included in federal adjusted gross income. Federal adjusted gross income at line 28 of federal Form 1120, or line 25a of federal Form 1120-C, is the starting point for Maryland Form 500. The § 250 deduction is a special deduction, reported on line 29b of federal Form 1120 and line 26b of 1120-C. Special deductions are subtracted from federal taxable income on line 1c of Maryland Form 500.

To compute the Maryland apportionment factor, the total amount of GILTI is included in the denominator. Because GILTI is income attributable to intangibles, it is included in the numerator based on the average of the property and payroll factors. If the resulting apportionment formula does not fairly represent the extent of a corporation's activity in this State, the Comptroller may alter the formula or its components. Manufacturing corporations using the single sales factor do not include GILTI in the apportionment formula.

Form 510, S-Corporations, Partnerships, Limited Liability Companies, Business Trusts

The entire amount of GILTI is included in Maryland taxable income for pass-through entities. Pass-through entities are not eligible for the § 250 deduction, and no foreign tax credit is available. GILTI is passed to the individual shareholders, partners, or members through the income reported on the K-1.

The Maryland pass-through entity return begins with the total distributive or pro rata share of income on federal form 1065, 1065-B or 1120S. Since GILTI is included in income at the federal level, it flows through to the Maryland return.

Whether the pass-through entity uses the apportionment formula or separate accounting to determine its allocation of income, GILTI must be included in Maryland income. Pass-through entities using the apportionment formula must include GILTI in the denominator. GILTI is included in the numerator based upon the average of the property and payroll factors. If the resulting apportionment formula does not fairly represent the extent of a corporation's activity in this State, the Comptroller may alter the formula or its components. For entities eligible to apportion income using a separate accounting, the Comptroller may accept a reasonable method of allocating a portion of GILTI to Maryland.

Form 502, Individual Shareholders; Form 504, Fiduciaries

The entire amount of GILTI is included in individuals' and fiduciaries' Maryland taxable income. GILTI is included federal adjusted gross income, which is the starting point for Maryland Forms 502 and 504. No deductions or credits apply, and the entire GILTI amount is subject to Maryland tax.

Nonresident beneficiaries of resident fiduciaries are not taxed on income derived from intangible personal property. To the extent GILTI is held in trust for the benefit of a nonresident beneficiary, it is eligible for the nonresident beneficiary subtraction.

Form 505, Nonresident Individuals

The entire amount of GILTI is included in federal adjusted gross income as other income. However, nonresidents are not subject to Maryland tax on income attributable to intangibles; therefore, GILTI may be excluded from Maryland income on Maryland Form 505.

Note on Apportionment

If the taxpayer asserts the apportionment formula does not fairly reflect the income attributable to Maryland, it may request an alternative apportionment method. Requests for alternative apportionment must be in writing, propose the alternative apportionment calculation, and must include a copy of the Maryland income tax return. The request for alternative apportionment should be submitted at the time the return is filed. If the return has already been filed, taxpayers may still submit the request for alternative apportionment for review. Requests for alternative apportionment should be mailed to: Comptroller of Maryland, Attn: Legal Section, PO Box 1829, Annapolis, MD 21404-1829.

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Waiver of Interest and Penalty on Underpayment of Estimated Tax

Due to the timing of the publication of this Tax Alert, taxpayers affected by IRC § 951A may have underestimated their 2018 final or extension tax payment or 2019 quarterly estimated income tax payments for Maryland purposes. The Comptroller has the authority to waive interest and penalty for reasonable cause. If a taxpayer owes interest or penalty for underpayment of estimated taxes due to underreporting GILTI, and the return has already been filed, they may submit a request for abatement in writing, along with adjusted payment, to Taxpayer Accounting at the following address:

Comptroller of Maryland
110 Carroll Street
Attn: Taxpayer Accounting
Annapolis, Maryland 21401

If the original 2018 return is being filed, the request should be a statement included with the return. The written request must also include support demonstrating that the underpayment was due to the tax on GILTI. The return should be sent to the address in the instructions.

Multistate Tax | April 26, 2019

State Tax Matters

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Income/Franchise:

New Jersey DOR Provides Combined Reporting-Related Guidance on Exclusion of Double Inclusion of GILTI and Treatment of Intercompany Expense Addbacks

TB-88 Combined Groups: Exclusion of Double Inclusion of GILTI and Treatment of Related Party Addbacks, N.J. Div. of Tax. (4/23/19). The New Jersey Division of Taxation (Division) recently issued administrative guidance addressing New Jersey's related party expense "addback" provisions and global intangible low taxed income (GILTI) in light of the federal Tax Cut and Jobs Act's (*i.e.*, P.L. 115-97) provisions related to Internal Revenue Code (IRC) Secs. 951A and 250, and within the context of New Jersey tax reforms enacted in 2018 [A.4202 2018); see previously issued Multistate Tax Alert for more details on these 2018 law changes; A.4495 (2018); see previously issued Multistate Tax Alert for more details on these 2018 law changes] that collectively mandate combined reporting for New Jersey corporation business tax (CBT) purposes and allow for a worldwide election for tax years ending on and after July 31, 2019 (or, beginning on and after August 1, 2018, if the defined "managerial member" has a twelve-month tax year that ends July 31, 2019) – specifically, how members of a combined group included on the same New Jersey combined return should comply with various relevant state statutory provisions.

The Division states that although there are certain income exclusions for New Jersey CBT purposes, there is not a provision under CBT law that specifically excludes the "non-effectively connected income of a member of a combined group that is a corporation incorporated under the laws of a foreign nation." Under state law, the income of a controlled foreign corporation is included in the combined group income if the controlled foreign corporation is a member included on the same New Jersey combined return. Therefore, the Division explains, the inclusion of GILTI generated by the controlled foreign corporation in the entire net income of other members of a combined group "would improperly result in a double inclusion (and double taxation) of the same income." The Division states that it has determined that such double inclusion of the same income is improper and that a schedule is being created for taxpayers to use, "which will eliminate the double taxation of GILTI." The guidance clarifies that only GILTI amounts that are directly attributable to the controlled foreign corporation combined group members that are included in the same New Jersey combined return may be excluded – "GILTI that is not attributable to any of the members of the same New Jersey combined return cannot be excluded." The guidance also notes that the deduction available under N.J.S.A. 54:10A-4.15 (relating to IRC Sec. 250) remains available to

In this issue

the extent it was taken for federal income tax purposes if the GILTI is excluded by the Division to prevent double taxation.

Regarding New Jersey's intercompany expense "addback" provisions, the guidance explains that such addbacks generally do not apply to members of the combined group included on the same New Jersey combined return. However, if there are related parties not included on the same New Jersey combined return, "the related party deduction/expense addbacks will apply unless some other exception applies." With respect to GILTI, the Division states that it will allow the members of a New Jersey combined group to claim New Jersey's "unreasonable exception" to its related party addback provisions for expenses attributable to the related party controlled foreign corporation if:

1. There is a related party not included in the same New Jersey combined return;
2. The members of the combined group have GILTI from the related party; and
3. The members of the combined group can demonstrate that the related party was the entity that generated the GILTI included in the member's entire net income.

The guidance also explains that New Jersey CBT taxpayers filing on a separate return basis that have GILTI from a related party included in their entire net income may also be able to claim an unreasonable exception to the related party addback provisions of N.J.S.A. 54:10A-4(k)(2)(I) and N.J.S.A. 54:10A-4.4. The guidance additionally notes that the amounts deducted pursuant to N.J.S.A. 54:10A-4.15 (relating to IRC Sec. 250) are *not* subject to the related party addback provisions of N.J.S.A. 54:10A-4(k)(2)(I) or N.J.S.A. 54:10A-4.4.

Lastly, the Division announces that it is in the process of drafting regulations addressing the topics covered in this guidance. Please contact us with any questions.

— Norm Lobins (Parsippany)
Managing Director
Deloitte Tax LLP

Mike Bryan (Philadelphia)
Managing Director
Deloitte Tax LLP

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Combined Groups: Exclusion of Double Inclusion of GILTI and Treatment of Related Party Addbacks

TB-88 - Issued April 23, 2019

Tax: Corporation Business Tax

P.L. 2018, c. 48 and P.L. 2018, c. 131 collectively mandate combined reporting for tax years ending on and after July 31, 2019 (beginning on and after August 1, 2018, if a full 12-month tax year of the managerial member begins August 1, 2018, and ends July 31, 2019). The chapter laws also provided several other amendments. This Technical Bulletin addresses I.R.C. § 951A, I.R.C. § 250, N.J.S.A. 54:10A-4(k)(2)(I), and N.J.S.A. 54:10A-4.4 (in the context of New Jersey combined returns only), and the relevant portions of N.J.S.A. 54:10A-4.6.

Both N.J.S.A. 54:10A-4(k)(2)(I) and N.J.S.A. 54:10A-4.4.e contain an exception to the related party addbacks for transactions between members of a combined group reported on a New Jersey combined return.

The relevant portions of N.J.S.A. 54:10A-4.6 state that:

> A taxable member of a combined group shall determine its entire net income from the unitary business as its share of the entire net income of the combined group in accordance with a combined unitary tax return made pursuant to this section and sections 19, 20, and 23 of P.L.2018, c.48 (C.54:18A-4.7, C.54:18A-4.8, and C.54:10A-4.11). The entire net income from the unitary business of a combined group is the sum of the entire net incomes of each taxable member and each nontaxable member of the combined group derived from the unitary business, which shall be determined as follows:
>
> a. For a member incorporated in the United States, the income included in income of the combined group shall be the member's entire net income otherwise determined pursuant to the Corporation Business Tax Act (1945), P.L.1945, c.162 (C.54:10A-1 et seq.).
>
> b. For a member not incorporated in the United States, the income to be included in the entire net income of the combined group shall be determined from a profit and loss statement that shall be prepared for each foreign branch or corporation in the currency in which the books of account of the branch or corporation are regularly maintained, adjusted to conform it to the accounting principles generally accepted in the United States for the presentation of those statements and further adjusted to take into account any book-tax differences required by federal or State law. The profit and loss statement of each foreign member of the combined group and the allocation factors related thereto, whether United States or foreign, shall be translated into or from the currency in which the parent company maintains its books and records on any reasonable basis consistently applied on a year-to-year or entity-by-entity basis. Income shall be expressed in United States dollars. In lieu of these procedures and subject to the determination of the director that the income to be reported reasonably approximates income as determined under the Corporation Business Tax Act (1945), P.L.1945, c.162 (C.54:10A-1 et seq.), income may be determined on any reasonable basis consistently applied on a year-to-year or entity-by-entity basis.

N.J.S.A. 54:10A-4.11 also mandates a water's-edge default filing method with an option of the managerial member to choose either a world-wide election or affiliated group election.

This publication provides information on how members of a combined group included on the same New Jersey combined return will comply with various statutory provisions.

GILTI and the I.R.C. § 250(a) Deduction

For New Jersey Corporation Business Tax purposes, a combined group can include the controlled foreign corporations that generate Global Intangible Low Tax Income (GILTI) included in other members' entire net income. Members of a combined group that are incorporated under the laws of a foreign nation must include all world-wide income regardless of whether it is included as income for federal purposes.

Although there are certain income exclusions for New Jersey Corporation Business Tax (CBT) purposes, there is not a provision in the CBT that specifically excludes the non-effectively connected income of a member of a combined group that is a corporation incorporated under the laws of a foreign nation. The income of a controlled foreign corporation is included in the combined group income if the controlled foreign corporation is a member included on the same New Jersey combined return. Therefore, the inclusion of GILTI generated by the controlled foreign corporation in the entire net income of other members of a combined group would improperly result in a double inclusion (and double taxation) of the same income. The Division of Taxation has determined that such double inclusion of the same income is improper. A schedule is being created for taxpayer's to use, which will eliminate the double taxation of GILTI. The schedule will require the following information:

1. The amount of GILTI (in part or in whole) reported for federal tax purposes by the members of the combined group that are included in the New Jersey combined return;
2. The identity of other members of the combined group that are included in the same New Jersey combined return, which are the controlled foreign corporations that generated GILTI;
3. The amount of the controlled foreign corporation members' income that generated GILTI, which is already included in the combined group's entire net income; and
4. The identity of any other controlled foreign corporations that were not included in the same New Jersey combined return but that also generated GILTI.

Note: Only GILTI amounts that are directly attributable to the controlled foreign corporation combined group members that are included in the same New Jersey combined return can be excluded. GILTI that is not attributable to any of the members of the same New Jersey combined return cannot be excluded.

The deduction available in N.J.S.A. 54:10A-4.15 (relating to IRC § 250) remains available to the extent it was taken for federal purposes if the GILTI is excluded by the Director to prevent double taxation.

Related Parties NOT Included on the Same New Jersey Combined Return and the Related Party Addbacks

The related party expense addbacks do not apply to members of the combined group included on the same New Jersey combined return. If there are related parties not included on the same New Jersey combined return, the related party deduction/expense addbacks will apply unless some other exception applies.

> **The Unreasonable Exception.** Generally, the Director will allow the members of the combined group to claim an unreasonable exception for the expenses attributable to the related party for purposes of the addback required under N.J.S.A. 54:10A-4(k)(2)(I) and N.J.S.A. 54:10A-4.4, consistent with the circumstances outlined in TAM-2011-13R.
>
> **GILTI and the Unreasonable Exception**. There are circumstances where the GILTI inclusion in entire net income of a member of the combined group is generated by a related party controlled foreign corporation that is not included as a member of the same New Jersey combined group. The expenses represented by the payments made by combined group members to the related party controlled foreign corporation are generally required to be added back pursuant to N.J.S.A. 54:10A-4(k)(2)(I) and N.J.S.A. 54:10A-4.4. If no exception applies, it could lead to double taxation.

Therefore, the Director will allow the members of the combined group to claim an unreasonable exception for the expenses attributable to the related party controlled foreign corporation if:

1. There is a related party not included in the same New Jersey combined return; and
2. The members of the combined group have GILTI from the related party; and
3. The members of the combined group can demonstrate that the related party was the entity that generated the GILTI included in the member's entire net income.

Note: Taxpayers filing on a separate return basis that have GILTI from a related party included in their entire net income may also be able to claim an unreasonable exception to the related party addback provisions of N.J.S.A. 54:10A-4(k)(2)(I) and N.J.S.A. 54:10A-4.4.

The amounts deducted pursuant to N.J.S.A. 54:10A-4.15 (relating to IRC § 250) are not subject to the related party addback provisions of N.J.S.A. 54:10A-4(k)(2)(I) or N.J.S.A. 54:10A-4.4.

The Division of Taxation is in the process of drafting regulations addressing the topics covered by this Technical Bulletin.

Note: A Technical Bulletin is an informational document that provides guidance on a topic of interest to taxpayers and may describe recent changes to the relevant laws, regulations, and/or Division policies. It is accurate as of the date issued. However, taxpayers should be aware that subsequent changes to the applicable laws, regulations, and/or the Division's interpretation thereof may affect the accuracy of a Technical Bulletin. The information provided in this document does not cover every situation and is not intended to replace the law or change its meaning.

Technical Memorandum
TSB-M-19(1)C
Corporation Tax
February 8, 2019

New York State Tax Treatment of Repatriation, Foreign-Derived Intangible Income Deduction, and Global Intangible Low-Taxed Income for Businesses

The federal Tax Cuts and Jobs Act[1] (the TCJA) created new provisions in the Internal Revenue Code (IRC) addressing income earned from overseas operations, including mandatory deemed repatriation income, foreign-derived intangible income (FDII), and global intangible low-taxed income (GILTI).

This memorandum generally explains the impact of these federal changes, as well as related changes enacted in the 2018-19 New York State budget,[2] on businesses.

Mandatory deemed repatriation income

The TCJA required taxpayers to recognize mandatory deemed repatriation income as Subpart F income. This is generally accomplished for U.S. shareholders by recognizing post-1986 accumulated earnings and profits and deficits of certain specified foreign corporations under IRC § 965(a) and (b) (together referred to as the *IRC § 965(a) inclusion amount*). These taxpayers are then allowed to deduct a portion of the inclusion amount under IRC § 965(c), resulting in a net IRC § 965 amount. The amounts recognized under IRC § 965 include amounts earned directly by the U.S. shareholders, as well as distributive shares of IRC § 965 amounts from flow-through entities. New York's tax treatment of these amounts varies by type of entity as explained below.

Unlike federal law, which allows certain taxpayers to elect to defer payment of a portion of their federal tax liability related to their mandatory deemed repatriation income, New York taxpayers, including combined groups, cannot defer payment of any portion of their New York State tax associated with mandatory deemed repatriation income.

Exempt organizations

Any net IRC § 965 amount required to be included in federal unrelated business taxable income is included in New York unrelated business taxable income under Article 13. There is no New York exemption or deduction for this income for exempt organizations and no related income modifications.

Insurance corporations[3]

For tax years beginning on or after January 1, 2017, the IRC § 965(a) inclusion amount received from foreign corporations that are not included in a combined report with the taxpayer must be subtracted when computing entire net income (ENI) under Article 33. Taxpayers must deduct this amount from ENI and add back to federal taxable income (FTI) interest and

[1] See Public Law 115-97.
[2] See Part KK of Chapter 59 of the Laws of 2018.
[3] This information does not apply to captive insurers and insurance companies filing a CT-33-NL.

noninterest deductions directly or indirectly attributable to the IRC § 965(a) inclusion amount. Since the IRC § 965(a) inclusion amount is not included in entire net income, the federal deduction under IRC § 965(c) is not allowed.

Insurance corporations that have an underpayment of estimated tax penalty related to the addback of interest deductions directly and indirectly attributable to their IRC § 965(a) inclusion amount on their New York 2017 tax year return may request a penalty waiver if they receive a bill for that penalty. There is no penalty relief for tax years after 2017.

New York C corporations

For tax years beginning on or after January 1, 2017, the IRC § 965(a) inclusion amount received from both unitary and non-unitary corporations not included in a combined return with the taxpayer is considered gross exempt controlled foreign corporation (CFC) income under Article 9-A. It is never considered gross investment income.

The IRC § 965(a) inclusion amount, less any interest deductions directly or indirectly attributable to the income (or less 40% of the IRC § 965(a) inclusion amount if the safe harbor election is made), is considered exempt CFC income and deducted from entire net income (ENI) when computing business income. Since the IRC § 965(a) inclusion amount is considered gross exempt CFC income, the federal deduction under IRC § 965(c) is not allowed.

The IRC § 965(a) inclusion amount is not included in the numerator or denominator of the business apportionment factor (BAF).

The IRC § 965(a) inclusion amount is disregarded for purposes of the “principally engaged” test used to determine a taxpayer’s, or combined group’s, eligibility for preferential rates and amounts available to manufacturers.

New York C corporations that have an underpayment of estimated tax penalty related to the direct and indirect attribution of interest deductions to their IRC § 965(a) inclusion amount (or the 40% safe harbor election attributable to their IRC § 965(a) inclusion amount) on their New York 2017 tax year return may request a penalty waiver if they receive a bill for that penalty. There is no penalty relief for tax years after 2017.

New York S corporations

For purposes of the business apportionment factor (BAF), the net IRC § 965 amount is treated as dividends from stock. When the 8% fixed percentage method election is in effect and the stock that generated the net IRC § 965 amount is a qualified financial instrument, the net IRC § 965 amount is included in the denominator of the BAF and 8% of such amount is included in the numerator of the BAF. In all other instances, the net IRC § 965 amount is **not** included in the numerator or denominator of the New York S corporation’s BAF.

[IRC § 965; Tax Law §§ 208(6-a)(b), 208(9)(b)(23), 1085(c)(1), 1503(b)(1)(A), 1503(b)(1)(B), 1503(b)(1)(S), 1503(b)(2)(B), 1503(b)(2)(H), 1503(b)(2)(W)]

Foreign-derived intangible income (FDII) deduction

For federal tax purposes, a U.S. domestic corporation taxed as a C corporation[4] can deduct a portion of its income derived from serving foreign markets. For purposes of Article 9-A and Article 33, the federal FDII deduction is not allowed for tax years beginning on or after January 1, 2017.

[IRC § 250(a)(1)(A); Tax Law §§ 208(9)(b)(24), 1503(b)(2)(X)]

Global intangible low-taxed income (GILTI)

For federal tax purposes, a U.S. shareholder of any CFC is required to include in gross income its GILTI, which is the excess of a U.S. shareholder's net CFC tested income for the tax year over the U.S. shareholder's net deemed tangible income return for the tax year.[5] A U.S. domestic corporation taxed as a C corporation[6] is allowed a deduction for a portion of its GILTI.[7] GILTI includes amounts earned directly by the U.S. shareholder, as well as distributive shares of GILTI from flow-through entities.

Exempt organizations

Any GILTI amount required to be included in federal unrelated business taxable income is included in New York unrelated business taxable income under Article 13. There is no New York exemption or deduction for this income for exempt organizations and no related income modifications.

Insurance corporations

If the stock of a foreign corporation that generates GILTI is subsidiary capital, the GILTI under IRC § 951A and any GILTI-related IRC § 78 dividends are considered income from subsidiary capital and are exempt from tax. The corresponding deductions allowed under IRC § 250 for GILTI and IRC § 78 dividends attributable to GILTI are disallowed.

In all other instances, the GILTI under IRC § 951A, as well as any GILTI related IRC § 78 dividends, remain in entire net income and are subject to tax. The corresponding deductions allowed under IRC § 250 for GILTI and IRC § 78 dividends attributable to GILTI are allowed in computing ENI.

New York C corporations[8]

Net GILTI income, which is the GILTI recognized under IRC § 951A less the allowable IRC § 250(a)(1)(B)(i) deduction, is included in ENI under Article 9-A. IRC § 78 dividends attributable to GILTI are not included in ENI.

[4] Real estate investment trusts (REITs) and regulated investment companies (RICs) are not eligible for the deduction allowed under IRC § 250 related to FDII.
[5] See IRC § 951A.
[6] REITs and RICs are not eligible for the deduction allowed under IRC § 250 related to GILTI.
[7] See IRC § 250(a)(1)(B).
[8] As REITs and RICs are not allowed the IRC § 250 deduction related to GILTI, these entities must use GILTI, as opposed to the net GILTI income, when following the instructions in this section.

If the stock of a foreign corporation that generates GILTI is business capital, net GILTI income needs factor representation in the BAF in order to properly reflect the taxpayer's business income and capital in the State. The Commissioner has determined that such net GILTI income must be included in the denominator but not the numerator of the BAF. Taxpayers must report this amount in the *Everywhere* column of the discretionary adjustment line of Part 6 of Form CT-3 or Form CT-3-A and attach a statement to the return indicating the GILTI amounts included on this line.

If the stock of a foreign corporation that generates GILTI is investment capital, only the net GILTI income may be deducted as investment income in the computation of business income. Such net GILTI amount, like all other income from investment capital, is not included in the numerator or denominator of the BAF.

The net GILTI amount is disregarded for purposes of the "principally engaged" test used to determine a taxpayer's, or combined group's, eligibility for preferential rates and amounts available to manufacturers.

New York S corporations

GILTI income reported on the federal return and, consequently, the New York return, needs factor representation in the BAF in order to properly reflect the S corporation's business income and capital in the State. Therefore, the Commissioner has determined that such GILTI income must be included in the denominator but not the numerator of the New York S corporation's BAF. Taxpayers must report this amount in the *Everywhere* column of the discretionary adjustment line of Part 3 of the Form CT-3-S and attach a statement to the return indicating the GILTI amounts included on this line.

[IRC §§ 250(a)(1)(B) and 951A; Tax Law §§ 208(9)(b)(2), 208(9)(a)(6), 1503(b)(1)(A)]

Note: A TSB-M is an informational statement of existing department policies or of changes to the law, regulations, or department policies. It is accurate on the date issued. Subsequent changes in the law or regulations, judicial decisions, Tax Appeals Tribunal decisions, or changes in department policies could affect the validity of the information presented in a TSB-M.

INTERNATIONAL COMITY AFTER THE TAX CUTS AND JOBS ACT OF 2017 (PART TWO)

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Prelude

"Comity" defined

- "A state of civility or courtesy between people, organizations, and nations.
  - It's a hoped-for mutual respect and friendliness, although too infrequently the case in politics and business."
- "A harmonious state of things in general and of their properties (as of colors and sounds); congruity of parts with one another and with the whole."
- "State or atmosphere of harmony or mutual civility and respect."
- *Comity of nations*: "courteous respect by one nation for the laws and institutions of another."
- *"Comity* is one of those rare words that has retained its original meaning through the ages. The Latin adjective *cōmis*, "courteous, friendly," developed into the noun *cōmitātem*, meaning "courtesy or friendliness" and ultimately into English *comity* in the 16th century."
- "The phrase *comity of nations*, coined in 1862, refers to the mutual respect for each other's laws and institutions that encourages a friendly back-and-forth between nations."

What does international tax comity mean?

- All countries have the *exact same rules*?
  - Examples: EU's tax directives; OECD BEPS recommendations.
- Having rules that *fit together*? Fit together *how*?
  - To avoid double-taxation? Examples: OECD Model Treaty, UN Model Treaty.
- Avoiding rules that impose undue burdens on foreign persons.
    - In-bound equity and debt investments
    - Engaging in a U.S. trade or business (directly or thru U.S. subsidiary)
    - When counterparties in transactions with US persons
  - Burdens include complexity, compliance costs, tax costs, risks arising from uncertainty.
- Not engaging in tax competition
  - Sweet-heart deals and rulings for US persons
  - Tax breaks to strengthen U.S. economy (to detriment of other countries' economies)
- Not reneging on our treaty obligations (politely referred to as "treaty overrides").

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Comity in Three Acts

- **Act I**: In Which All the Players *Appear* to Sing the Same Song
  - Rules limiting interest expense deductions.
- **Act II**: In Which Our Leading Man Takes a Novel Approach to His Treaty Obligations
  - Overriding Treaty's PE Business Profits Computations?
- **Act III**: In Which All the Players Get Into a Bar Room Brawl
  - Digital tax.

5

Act I: Singing the Same Song

- Rules Limiting the Deduction of Business Interest
  - Is there an international consensus?

- Developments
  - OECD BEPS Reports – Oct. 2015 (update Dec. 2016).
  - EU ATAD I and ATAD II – July 2016 and May 2017.
  - US TCJA 163(j) - Dec. 2017.
    - Impact of US TCJA 59A (BEAT).

6

OECD BEPS Project Action 4: Limiting Base Erosion Involving Interest Deductions

- "BEPS risks in this area may arise in three basic scenarios:
  - Groups placing higher levels of third party debt in high tax countries.
  - Groups using intragroup loans to generate interest deductions in excess of the group's actual third party interest expense.
  - Groups using third party or intragroup financing to fund the generation of tax exempt income."

- Final Report October 2015.
- Updated Final Report December 2016.
  - adds special recommendations for banking/insurance sector.

7

OECD BEPS Reports Recommended Rules

- **1. *De minimis* monetary threshold to remove low risk entities.**
  - Optional: based on net interest expense of local group.
- **2. Fixed ratio rule:** entity may deduct net interest expense up to a *benchmark net interest/EBITDA ratio*
  - Relevant factors set out to help a country set its benchmark ratio within a corridor of 10%-30%.
- **3. Optional group ratio rule:** entity may deduct net interest expense up to *its group's net interest/EBITDA ratio (*where this is higher than the benchmarked ratio).
- **4. Optional carry forward of disallowed interest/unused interest capacity and/or carry back of disallowed interest.**
- **5. Targeted rules to support the general rules and address specific risks.**
- **6. Specific rules to address banking and insurance sectors.**

8

EU Anti-Tax Avoidance Directives ATAD I (July 2016) and ATAD II (May 2017)

- "EU directives should be … **the preferred vehicle for implementing OECD BEPS conclusions** at the EU level."
- "It is essential … that, **as a minimum, Member States implement their commitments under BEPS** and more broadly, take action to discourage tax avoidance practices and ensure fair and effective taxation in the Union in a sufficiently coherent and coordinated fashion."
- "There is a need for common strategic approaches and coordinated action."
- "Only a common framework could prevent a fragmentation of the market and put an end to currently existing mismatches and market distortions."
- "It is necessary to lay down rules…. As these rules would have to fit in 28 separate corporate tax systems, they should be limited to general provisions and leave the implementation to Member States … in a way that fits best their corporate tax systems."

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So far, 5 ATAD Directives

- *Interest Limitation Rule* (ATAD Article 4).
  - We will focus on this one.

- Hybrid Mismatches (ATAD Articles 9, 9(a) and 9(b)); *see* BEPS Action 2
- CFC Rule (ATAD Articles 7 & 8); *see* BEPS Action 3
- General Anti-Abuse Rule (ATAD Article 6); *see* BEPS Action 6
- Exit Taxation (ATAD Article 5).

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ATAD: Interest Limitation Basic Rule

- Implementation required by January 1, 2019
  - unless Member State has equally effective existing rules, in which case later of January 1, 2024 and first tax year following publication of OECD minimum standards.
- Basic rule: deduction for "exceeding borrowing costs" ("EBC") limited to 30% (or less) of taxpayer's tax-adjusted EBITDA for the relevant tax period.
  - EBC = net interest expense
    - taxable interest and other economically equivalent revenues *minus* deductible borrowing costs.
  - EBITDA: computed without tax-exempt income.
- Basic rule applies to all interest expense
  - both related-party and third-party debt.
  - creditor's country of tax residence not relevant.
  - no arms-length exception.

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ATAD: Interest Limitation
Optional Variations Available to Member States

- *De minimis* rule (EBC up to €3m fully deductible, computed at the group level).
- EBC fully deductible for a "stand-alone company" (*i.e.*, not part of a consolidated group for financial accounting purposes and has no associated enterprise or permanent establishment).
- Carry-forward/carry-back of (i) non-deductible EBC or (ii) excess EBC capacity.
- A taxpayer belonging to a group may fully deduct its EBC if it can demonstrate that its equity/total assets is equal to (≥ 98%) or higher than the equity/total assets of the group.
- A taxpayer belonging to a group may deduct based on its EBC Group Ratio times its EBITDA (rather than 30% times its EBITDA).
  - *EBC Group Ratio* = EBC of the group vis-à-vis third-parties over EBITDA of the group.
- Exclusions for pre-June 2016 loans, and certain public infrastructure financings and other financial undertakings.

12

US TCJA: New Section 163(j)

- Deduction for business interest expense may not exceed the sum of:
  - business interest income for a taxable year; and
  - 30 percent of "adjusted taxable income" ("ATI") for such taxable year.
- Effectively caps net interest expense deduction to
  - 30% of EBITDA through end of 2021, and then at 30% of EBIT.
- Disallowed business interest carried forward indefinitely; and treated as business interest paid/accrued in the succeeding taxable year subject to 163(j) limitation.
- Unlike Old Section 163(j) no carry forward of "excess" deduction capacity.
- Unlike Old Section 163(j), applies to interest paid to unrelated parties, and applies irrespective of arms-length terms, leverage ratios or other conditions.
- No "out" based on group external leverage ratios.
- Narrow exception for very small taxpayers and certain real estate businesses.
- **Legislative history says *zero* about BEPS Action 4 reports (and ATAD), even though the new 163(j) is fairly consistent with BEPS Action 4 reports.**

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New 163(j) Proposed Regulations (Nov. 2018)

- "Interest"
  - Defined broadly to include certain items related to debt instruments, like substitute interest payments under a securities loan, gains and losses from hedges of debt instruments, commitment fees and debt issuance costs.
  - Anti-avoidance rule: any deductible expense or loss "predominantly incurred in consideration of the time value of money" also treated as interest.
- Complex rules for partnerships.
  - First, apply 163(j) limitation at partnership level based on income and expenses of partnership; and
  - Second, any resulting disallowed interest expense then allocated to partners as interest expense subject to 163(j) again at partner level.
- CFCs subject to 163(j) limitation for purposes of computing subpart F income, GILTI tested income or loss, and ECI.
- Complex rules for consolidated groups.

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163(j) Prop Regs: How to compute "ATI" Start with "taxable income", then…..

Some Key Additions:

- business interest expense;
- NOL deduction;
- 199A deduction;
- deduction for capital loss carryback or carryover;
- for years beginning before January 1, 2022:*
  - depreciation under sections 167 or 168;
  - amortization of intangibles under sections 167 or 197;
  - certain other amortized expenditures
  - certain depletion.

* But not if capitalized into inventory

Some Key Subtractions:

- business interest income;
- lesser of: (1) any gain recognized on the sale or other disposition of property; and (2) depreciation, amortization, or depletion for taxable years after December 31, 2017 and before January 1, 2022, with respect to such property;
- certain consolidated return investment adjustments attributable to depreciation, amortization, and depletion on disposition of shares of member of a consolidated group;
- distributive share of certain depreciation, amortization, and depletion allowable under section 704(d) upon the sale or other disposition of a partnership interest.

This is a general summary;
there are many additional special rules.

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163(j) Prop Regs Rules for CFCs

- Single entity (CFC by CFC approach) as general rule.
- Irrevocable "group election" (subject to carve out for financial business sub-groups).
  - Avoids interest paid to another CFC but picked up as income by same shareholder as Subpart F or GILTI being limited.
  - No comparable relief for interest by CFC to U.S. shareholder directly.
- ATI generally excludes related party dividend income but may elect to roll-up lower-tier CFC ATI in excess of interest deduction.

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US TCJA: New 59A Base Erosion Anti-Abuse Tax "BEAT"Overview

- Minimum tax (10% rate 2019- 2025) on large U.S. corporations to curb outbound base eroding payments made to related foreign parties ("RFPs").
  - BEAT minimum rate applies to modified taxable income
  - Meaning, taxable income adding back deductible base eroding payments to RFPs.
- Base eroding payments generally include:
  - Interest, royalties, certain service and reinsurance payments, and some COGS and deductions attributable to depreciable or amortizable assets acquired from RFPs;
  - No "out" even if on demonstrably arms-length terms.
- BEAT applies only to corporations with average receipts of US$500M over 3 years and a "base erosion percentage" of 3% or more.
- No foreign tax credits.
- Anti-abuse rules.

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BEAT – Applicable Taxpayer and Aggregation

- To determine "applicable taxpayer" status, aggregate group concept applies:
  - All corporations that are treated as single employer under section 52(a) are aggregated.
  - Generally means members of "same controlled group of corporations" (defined in section 1563(a) substituting "more than 50%" for "at least 80%").
  - Payments within group generally not included in gross receipts or numerator/denominator of "base erosion percentage" calculation.
  - Foreign corporations taken into account only to extent of their ECI (or treaty business profits).

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Base Erosion Percentage Test

- BEAT generally applies if base erosion percentage equals or exceeds 3%
- Lower 2% threshold if affiliated group includes domestic bank or registered securities dealer
- Base erosion percentage = $\dfrac{\text{aggregate amount of “base erosion tax benefits”}}{\text{aggregate amount of deductions + certain other base erosion tax benefits}}$
- Base erosion tax benefits generally are deductions or reduction in gross income resulting from "base erosion payments".
- Percentage is calculated as of end of taxpayer's taxable year-- group members with different taxable years can have different base erosion percentages (i.e. fiscal and calendar year taxpayers that are members of the same aggregate group highly likely to have different base erosion percentages).

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Base Erosion Payments Defined

- Payment or accrual by taxpayer to RFP:
  - if deductible (e.g., royalties, interest, payments for services);
  - if connected to acquisition of depreciable/amortizable property;
  - if reinsurance premiums or other consideration for reinsurance;
  - if involves certain surrogate foreign corporations or related foreign persons, then payments that reduce cost of goods sold
- RFP includes
  - 25% owner of taxpayer (by vote or value);
  - Persons related to taxpayer or 25% owner (within the meaning of section 267(b) or 707(b)(1)); and
  - Controlled taxpayer within the meaning of section 1.482-1(i)(5) together with, or with respect to, the taxpayer.
- Not a Base Erosion Payment if recipient subject to U.S. net income tax (as ECI or PE business profits)

20

Base Erosion Tax Benefits Defined

- Generally, amount of deduction (or reduction of gross income) relating to base erosion payment allowed under Code for taxable year.
- If withholding tax imposed, no base erosion benefit if full 30% withheld.
  - If lower treaty rate applicable, exclusion is reduced proportionately to withholding tax exemption.
- If section 163(j) applies, all disallowed business interest treated first as interest paid/accrued to unrelated party then to related party.
- Allowed portion of business interest expenses paid/accrued to both unrelated and related party is allocated pro rata between domestic and foreign related parties, then to unrelated parties.

21

Modified Taxable Income Defined

- Modified Taxable Income: taxable income computed under chapter 1 without regard to base erosion tax benefits and base erosion percentage of any NOL deduction for the taxable year.
- Determined on taxpayer-by-taxpayer basis.
- Uses add-back approach:
  - Start with taxable income/loss and add back gross amount of base erosion tax benefits and base erosion percentage of NOL deduction.
  - Simplification, avoids parallel attribute system of old AMT.
- Base erosion percentage of NOL deduction fixed on vintage year base (i.e. base erosion percentage in year in which NOL arose).
- For NOLs arising before 2018, base erosion percentage is zero.

22

Act II: Treaty Obligations

- TCJA Proposed Regulations that appear to override US Treaty's PE "business profits"
  - The relevant treaty provision: computation of taxable profits of a PE (using AOA).
  - 2 TCJA overrides: via Proposed Regulations under 59A and 267A.

23

AOA for computing business profits of a PE under a treaty

- In 2008, OECD issued a report on "Attribution of Profits to Permanent Establishments".
- The OECD approach has become known as the AOA (Authorized OECD Approach ("AOA") to computing business profits of a PE branch.
  - Treats PE as if it were a separate entity from the home office (a related separate entity) and applies standard transfer pricing rules.
  - Determines the profits the PE "might be expected to make, in particular in its dealings with other parts of the enterprise, if it were a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions, taking into account the functions performed, assets used and risks assumed by the enterprise through the PE and through the other parts of the enterprise."

24

US Model Treaty Feb 2016: Article 7 "Business Profits"

- 1. Profits of an enterprise of a Contracting State shall be taxable only in that Contracting State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits that are attributable to the permanent establishment in accordance with the provisions of paragraph 2 of this Article may be taxed in that other Contracting State.
- 2. For the purposes of this Article, the profits that are attributable in each Contracting State to the permanent establishment referred to in paragraph 1 of this Article are the profits it might be expected to make, in particular in its dealings with other parts of the enterprise, if it were a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions, taking into account the functions performed, assets used and risks assumed by the enterprise through the permanent establishment and through the other parts of the enterprise.
- 3. Where, in accordance with paragraph 2 of this Article, a Contracting State adjusts the profits that are attributable to a permanent establishment of an enterprise of one of the Contracting States and taxes accordingly profits of the enterprise that have been charged to tax in the other Contracting State, the other Contracting State shall, to the extent necessary to eliminate double taxation, make an appropriate adjustment if it agrees with the adjustment made by the first-mentioned Contracting State; if the other Contracting State does not so agree, the Contracting States shall eliminate any double taxation resulting therefrom by mutual agreement.

25

Prog. Regs. 1.59A-3(b)(4)(v)(B): "internal dealings" rule: applies 59A to a PE's AOA deductions

- "If, pursuant to the terms of an applicable income tax treaty, a foreign corporation determines the profits attributable to a PE based on the assets used, risks assumed, and functions performed by the permanent establishment, then any deduction attributable to any amount paid or accrued (or treated as paid or accrued) by the PE to the foreign corporation's home office or to another branch of the foreign corporation (an 'internal dealing') is a base erosion payment to the extent such payment or accrual is" a 'base erosion payment' described under in Prop. Regs. 1.59A-3(b)(1)."
- "Base erosion payments" include: "any amount paid or accrued by the taxpayer to a foreign related party of the taxpayer and with respect to which a deduction is allowable".

26

Prop. Reg. 1.267A-2(c)(2): "deemed branch payments" rule

- Applies a super-charged 267A to a PE's AOA interest and royalty deductions.
- "deemed branch payment" =
  - AOA fictional deduction for interest or royalty *as if* the PE were paying interest/royalty to the foreign corporation home office, and
  - no inclusion to foreign corporation under its foreign country tax rules.
- Deemed branch payment rule = the interest/royalty deduction is disallowed in computing the PE's business profits (i.e., *overrides* treaty).
- Theory of the rule:
  - if branch were a separate entity subsidiary that made an actual payment that was not included by the foreign corporation, then 267A disallowance would apply; and
  - rules should treat branches the same as separate entity subsidiaries.
- *NB:* the normal 267A rule would disallow the deduction ***only*** if the non-inclusion was the result of the payment being interest or royalty (i.e., if payment were something else, it would be included) ***but*** the deemed branch payment rule disallows the deduction solely because there is a non-inclusion.

27

Commentary

- Treat overrides are permitted under US law **<u>but</u>**
- Reactions to Prop 59A "internal dealings" rule and Prop 267A "deemed branch payments" rule was very negative
  - 59A: a lot of commentators weighed;
  - 267A: two commentators weighed in.
  - *"Inconsistent with treaty obligations and with theory of AOA" which is supposed to determine the appropriate amount of profits of PE for US to tax.*
  - *How can US increase that amount without violating its commitment under the treaty?*
- How bad is it? Is it not even bad at all?

28

Consider this from OECD's report on AOA

- "The AOA does not dictate the specifics or mechanics of domestic law, but only sets a limit on the amount of attributable profit that may be taxed in the host country of the PE. … In addition, the AOA is not designed to prevent the application of any domestic legislation aimed at preventing abuse of tax losses or tax credits by shifting the location of assets or risks. Finally, where their domestic law does not recognise loss transactions in certain circumstances between associated enterprises, countries may consider that the AOA would not require the recognition of a loss on an analogous dealing in determining the profits of a PE."

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FWIW also consider this *from the Feb 2016 US Model Treaty Preamble*

- "The 2016 Model has not adopted the other BEPS recommendations regarding the permanent establishment threshold, notably the revised rules related to dependent and independent agents and the exemption for preparatory and auxiliary activities.
- "It is important to ensure that the implications from any modifications to these treaty provisions are commonly understood and consistently administered by treaty partners.
- "Accordingly, the Treasury Department is working with OECD and G20 member countries to create a common global understanding regarding profit attribution that will address the concerns raised by these BEPS permanent establishment recommendations."

30

Act III: Bar Room Brawl Over Digital Tax

- Our Players in this Act include
  - OECD: trying to develop global consensus proposal; due 2020.
  - EU: Directive on Common System of Digital Services Taxes (2018).
  - UK: Proposed Digital Services Tax (2018).
  - France: Proposed Digital Services Tax (2019).
  - Italy: Tax on Digital Services (2018).
  - US: FDII and GILTI (2018).
  - Various others without title credits.

31

OECD Activities on Digital

- OECD (2015), *Addressing the Tax Challenges of the Digital Economy*, Action 1 - 2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project.
- OECD (2018), *Tax Challenges Arising from Digitalisation – Interim Report 2018*, Inclusive Framework on BEPS.
  - Response: over 200 comment letters.
- OECD (Feb. 2019), *Addressing the Tax Challenges of the Digitalisation of the Economy,* Public Consultation Document

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OECD: Feb 2019 Consultation Document

- "One of the important conclusions of [the 2018 Report] is that members agreed to review the impact of digitalisation on nexus and profit allocation rules and committed to continue working together towards a final report in 2020 aimed at providing a consensus-based long-term solution, with an update in 2019."
- "Since the delivery of the Interim Report, the Inclusive Framework further intensified its work and several proposals emerged that could form part of a long-term solution to the broader challenges arising from the digitalisation of the economy and the remaining BEPS issues. … In this context, the Inclusive Framework agreed to hold a public consultation on possible solutions to the tax challenges arising from the digitalisation of the economy on 13 and 14 March 2019 at the OECD Conference Centre in Paris, France."
- "The objective is to provide external stakeholders an opportunity to provide input early in the process and to benefit from that input. As part of this public consultation, this consultation document describes the proposals discussed by the Inclusive Framework at a high level and seeks comments from the public on a number of policy issues and technical aspects. The comments provided will assist members of the Inclusive Framework in the development of a solution for its final report to the G20 in 2020."

33

OECD Officials Prior to Public Consultation

- "OECD head of tax policy Pascal Saint-Amans said there was a change of tone judging from more than 200 comments the Paris-based policy forum received in a first call for input from businesses, accounting firms, tax justice NGOs and academics."
- "'We have a significant group of business people saying it's probably time to do something,' Saint-Amans told Reuters."
- "While opposed to unilateral national taxes, Washington is a relatively recent convert in favor of a wide-ranging international overhaul, although it wants a solution with a broader focus than just digital companies."
- "'Bargain will have to be made and ... the more extreme proposals will not attract consensus,' the U.S. Treasury's top international tax official, Chip Harter, told journalists."
- "He added that the aim was to have the broad outlines of an agreement from the OECD in June, so that G20 finance ministers could give a mandate to thrash out the numerous technical details before a formal deal is signed in 2020."
  - Reuters, March 12, 2019 by Leigh Thomas.

34

U.S. Reaction to French and UK Digital Tax Developments (May 20, 2019)

- "Treasury officials have been engaged in 'vigorous diplomacy' to dissuade governments from enacting unilateral measures — especially digital services taxes — while countries are in the middle of negotiations on a global consensus-based solution."
- "According to Lafayette G. "Chip" Harter III, Treasury deputy assistant secretary for international tax affairs, unilateral measures proposed or adopted in Europe and elsewhere threaten to undermine negotiations among members of the OECD's base erosion and profit-shifting project's inclusive framework. Speaking May 10 in Washington at the American Bar Association Section of Taxation meeting, Harter said DSTs — which apply to gross turnover for a narrow range of digital transactions — are especially problematic".
- '"**Of greatest concern at the moment are the proposed digital services taxes, one working its way through the French legislative process and the U.K. proposed digital services tax, which would start next year. We've been arguing very strongly that any such taxes should be deferred until after 2020 to give the OECD a chance to agree on an alternative,' Harter said. 'We will keep making the point that digital services taxes are just a very bad idea from a policy standpoint.'"**
- "Harter criticized DSTs for taxing gross revenue instead of economic profit, targeting an innovative sector of the economy, and having design features that ensure they disproportionately target U.S. companies. **He added that the common practice of referring to DSTs as 'GAFA taxes' — referring to Google, Amazon, Facebook, and Apple— clearly shows that U.S. companies are the intended target."**
  - **Tax Notes by Ryan Finley**

35

More US Reaction to French Proposal (March 13, 2019)

- "The proposed 3 percent tax on digital activities appears to be 'highly discriminatory' to U.S. firms, Lafayette G. "Chip" Harter, deputy assistant secretary for international tax affairs at the Treasury Department's Office of Tax Policy, said March 12 at an event in Paris. He said Treasury, the U.S. Trade Representative's office, and lawmakers are 'studying whether the discriminatory impact would give us rights under trade agreements, WTO, treaties.'"
- "But if the French tax does go into effect, it could lead to a tax treaty dispute, a World Trade Organization challenge, retaliatory tariffs, or the U.S. invoking a never-used section of the tax code to raise taxes on French companies' U.S. subsidiaries."
- **"'You're seeing an appropriate American response to something that is clearly designed to be discriminatory against U.S. companies,' said Jake Colvin, vice president for global trade issues at the National Foreign Trade Council."**
- **"'I think a WTO case in inevitable,'** if France does pass the law and the U.S. responds, said William Alan Reinsch, senior adviser and Scholl Chair in International Business at the Center for Strategic and International Studies. '**You always do that, even if it's not the only thing you do.'"**

36

French Response (April 8, 2019)

- "A French lawmaker involved in drafting the country's digital tax bill **dismissed concerns that the proposal could lead to a trade war with the U.S."**
- **"Our response is two-fold. First, France is a sovereign country that conducts its own tax policy. Second, I don't see how a trade war could be started by a tax that raises 400 million euros," assembly member Joel Giraud said April 8 as the country's National Assembly began debate on the measure."**
- "Secretary of State Mike Pompeo has urged France not to move forward with the proposal, which is aimed at U.S. tech giants like Alphabet Inc.'s Google, Facebook Inc., and Apple Inc."
- "Giraud compared the proposal to **recent European Commission fines on companies like Google** that totaled billions of euros. "**That didn't trigger the apocalypse," he said."**
- "The measure is necessary because France doesn't collect tax on the value U.S. tech multinationals create from French consumer data, said French Finance Minister Bruno Le Maire, also speaking at the National Assembly. **"It is unacceptable that this tax situation leads to the emergence of digital giants that buy, one by one, all our startups and kill innovation in our country," Le Maire said."**
- "France's planned tax has elicited recent responses from other U.S. officials. A group of House Republicans wrote a letter to President Donald Trump urging him to take action in response, and the U.S. Trade Representative's office included digital tax measures like France's on a list of "key barriers to digital trade" in 2019."

37

EU Officials Respond (May 20, 2019)

- "EU Tax Commissioner Pierre Moscovici underscored the importance of updating corporate tax rules for the 21st century so that they are based not only on physical presence, but also on digital presence."
- "'But we need now to work on it at the global level,' Moscovici said, pointing to the EU's participation in discussions at the OECD and at the G-20 to find consensus by 2020 on a long term approach to taxing the digital economy."
- "EU Research, Science, and Innovation Commissioner Carlos Moedas agreed on the need for a global solution to avoid unilateral action."
- "However, Moscovici defended EU-wide efforts to introduce a digital services tax, saying that he did not want the proposal to appear protectionist. '**The problem is global and the best level to address it is global, but we also can have a regional answer,' he said**."
  - Tax Notes by Stephanie Soong Johnston

38

TCJA's Contribution to the Brawl "The US Counterpunch to the OECD BEPS Project"

- "A prominent agenda item of the OECD BEPS project is the taxation of digital companies. Many countries in the European Union have expressed frustration with the fact that tech companies, such as Apple, Google ,Facebook and Amazon, are able to operate and sell within their jurisdictions, but pay little or no corporate income tax. The US tax reform effort has put in place a provision that would provide US multinationals a lower tax rate on 'intangible income' – in reality, high profits not tied to tangible forms of capital – earned from foreign sources [(FDII)]."
- "If this works effectively, digital companies should find it in their interest to move, not just their profits to the US, but their intellectual property as well. In addition, the TCJA now imposes a minimum tax on excess foreign earnings of US multinationals. **Hence, if the aim of the BEPS project was to capture more of this intangible income in the European Union, the new US tax law will likely interfere with their efforts**."
  - By Aparna Mathur, Resident Scholar in Economic Policy Studies, American Enterprise Institute (2018)

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*Meanwhile, back in DC (*May 22, 2019)

VAN HOLLEN, KLOBUCHAR, DUCKWORTH INTRODUCE LEGISLATION TO KEEP JOBS IN THE UNITED STATES

- "Instituting a "per-country" minimum tax instead of a blended or "global rate" under current law and eliminating companies' ability to deduct 10 percent of their return on tangible assets before the tax rate on foreign income applies. **These changes would remove the incentive for companies to shift U.S. jobs and physical operations overseas (to countries with tax rates similar to the U.S.)** in order to preserve the value of using tax havens."

I

(Legislative acts)

DIRECTIVES

COUNCIL DIRECTIVE (EU) 2017/952

of 29 May 2017

amending Directive (EU) 2016/1164 as regards hybrid mismatches with third countries

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty on the Functioning of the European Union, and in particular Article 115 thereof,

Having regard to the proposal from the European Commission,

After transmission of the draft legislative act to the national parliaments,

Having regard to the opinion of the European Parliament ([1]),

Having regard to the opinion of the European Economic and Social Committee ([2]),

Acting in accordance with a special legislative procedure,

Whereas:

(1) It is imperative to restore trust in the fairness of tax systems and allow governments to effectively exercise their tax sovereignty. Therefore, the Organisation for Economic Cooperation and Development (OECD) has issued concrete action recommendations in the context of the initiative against Base Erosion and Profit Shifting (BEPS).

(2) The final reports on the 15 OECD Action Items against BEPS were released to the public on 5 October 2015. This output was welcomed by the Council in its conclusions of 8 December 2015. The Council conclusions stressed the need to find common, yet flexible, solutions at Union level consistent with OECD BEPS conclusions.

(3) In response to the need for fairer taxation and, in particular, to follow up on the OECD BEPS conclusions, the Commission presented its Anti-Tax Avoidance Package on 28 January 2016. Council Directive (EU) 2016/1164 ([3]), concerning rules against tax avoidance, was adopted in the framework of that package.

(4) Directive (EU) 2016/1164 provides for a framework to tackle hybrid mismatches.

(5) It is necessary to establish rules that neutralise hybrid mismatches in as comprehensive a manner as possible. Considering that Directive (EU) 2016/1164 only covers hybrid mismatches that arise in the interaction between

([1]) Opinion of 27 April 2017 (not yet published in the Official Journal).
([2]) Opinion of 14 December 2016 (not yet published in the Official Journal).
([3]) Council Directive (EU) 2016/1164 of 12 July 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market (OJ L 193, 19.7.2016, p. 1).

the corporate tax systems of Member States, the ECOFIN Council issued a statement on 12 July 2016 requesting the Commission to put forward by October 2016 a proposal on hybrid mismatches involving third countries in order to provide for rules consistent with and no less effective than the rules recommended by the OECD report on Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2 — 2015 Final Report ('OECD BEPS report on Action 2'), with a view to reaching an agreement by the end of 2016.

(6) Directive (EU) 2016/1164 recognises, inter alia, that it is critical for further work to be undertaken on other hybrid mismatches such as those involving permanent establishments. In view of that, it is essential that hybrid permanent establishment mismatches be addressed in that Directive as well.

(7) In order to provide for a framework that is consistent with and no less effective than the OECD BEPS report on Action 2, it is essential that Directive (EU) 2016/1164 also include rules on hybrid transfers, imported mismatches and address the full range of double deduction outcomes, in order to prevent taxpayers from exploiting remaining loopholes.

(8) Directive (EU) 2016/1164 includes rules on hybrid mismatches between Member States and should thus also include rules on hybrid mismatches with third countries where at least one of the parties involved is a corporate taxpayer or, in the case of reverse hybrids, an entity in a Member State, as well as rules on imported mismatches. Consequently, the rules on hybrid mismatches and tax residency mismatches should apply to all taxpayers that are subject to corporate tax in a Member State including to permanent establishments, or to arrangements treated as permanent establishments, of entities resident in third countries. Rules on reverse hybrid mismatches should apply to all entities that are treated as transparent for tax purposes by a Member State.

(9) Rules on hybrid mismatches should address mismatch situations which result from double deductions, from conflict in the characterisation of financial instruments, payments and entities, or from the allocation of payments. Since hybrid mismatches could lead to a double deduction or to a deduction without inclusion, it is necessary to lay down rules whereby the Member State concerned either denies the deduction of a payment, expenses or losses or requires the taxpayer to include the payment in its taxable income, as appropriate. However, those rules apply only to deductible payments and should not affect the general features of a tax system, whether it is a classical or an imputation system.

(10) Hybrid permanent establishment mismatches occur where differences between the rules in the jurisdictions of permanent establishment and of residence for allocating income and expenditure between different parts of the same entity give rise to a mismatch in tax outcomes and include those cases where a mismatch outcome arises due to the fact that a permanent establishment is disregarded under the laws of the branch jurisdiction. Those mismatch outcomes may lead to a double deduction or a deduction without inclusion, and should therefore be eliminated. In the case of disregarded permanent establishments, the Member State in which the taxpayer is a resident should include the income that would otherwise be attributed to the permanent establishment.

(11) Any adjustments that are required to be made under this Directive should in principle not affect the allocation of taxing rights between jurisdictions laid down under a double taxation treaty.

(12) In order to ensure proportionality, it is necessary to address only the cases where there is a substantial risk of avoiding taxation through the use of hybrid mismatches. It is therefore appropriate to cover hybrid mismatches that arise between the head office and permanent establishment or between two or more permanent establishments of the same entity, hybrid mismatches that arise between the taxpayer and its associated enterprises or between associated enterprises, and those resulting from a structured arrangement involving a taxpayer.

(13) Mismatches that, in particular, result from the hybrid nature of entities should be addressed only where one of the associated enterprises has, at a minimum, effective control over the other associated enterprises. Consequently, in those cases, it should be required that an associated enterprise be held by, or hold, the taxpayer or another associated enterprise through a participation in terms of voting rights, capital ownership or entitlement to received profits of 50 per cent or more. The ownership, or rights of persons who are acting together, should be aggregated for the purposes of applying this requirement.

(14) In order to provide for a sufficiently comprehensive definition of 'associated enterprise' for the purposes of the rules on hybrid mismatches, that definition should also comprise an entity that is part of the same consolidated group for accounting purposes, an enterprise in which the taxpayer has a significant influence in the management and, conversely, an enterprise that has a significant influence in the management of the taxpayer.

(15) It is necessary to address four categories of hybrid mismatches: first, hybrid mismatches that result from payments under a financial instrument; second, hybrid mismatches that are the consequence of differences in the allocation of payments made to a hybrid entity or permanent establishment, including as a result of payments to a disregarded permanent establishment; third, hybrid mismatches that result from payments made by a hybrid entity to its owner, or deemed payments between the head office and permanent establishment or between two or more permanent establishments; lastly, double deduction outcomes resulting from payments made by a hybrid entity or permanent establishment.

(16) In respect of payments under a financial instrument, a hybrid mismatch could arise where the deduction without inclusion outcome is attributable to the differences in the characterisation of the instrument or the payments made under it. If the character of the payment qualifies it for double tax relief under the laws of the payee jurisdiction, such as an exemption from tax, a reduction in the rate of tax or any credit or refund of tax, the payment should be treated as giving rise to a hybrid mismatch to the extent of the resulting undertaxed amount. A payment under a financial instrument should not, however, be treated as giving rise to a hybrid mismatch where the tax relief granted in the payee jurisdiction is solely due to the tax status of the payee or the fact that the instrument is held subject to the terms of a special regime.

(17) In order to avoid unintended outcomes in the interaction between the hybrid financial instrument rule and the loss-absorbing capacity requirements imposed on banks, and without prejudice to State aid rules, Member States should be able to exclude from the scope of this Directive intra-group instruments that have been issued with the sole purpose of meeting the issuer's loss-absorbing capacity requirements and not for the purposes of avoiding tax.

(18) In respect of payments made to a hybrid entity or permanent establishment, a hybrid mismatch could arise where the deduction without inclusion outcome results from differences in the rules governing the allocation of that payment between the hybrid entity and its owner in the case of a payment that is made to a hybrid entity, between the head office and permanent establishment, or between two or more permanent establishments in the case of a deemed payment to a permanent establishment. The definition of hybrid mismatch should only apply where the mismatch outcome is a result of differences in the rules governing the allocation of payments under the laws of the two jurisdictions and a payment should not give rise to a hybrid mismatch that would have arisen in any event due to the tax exempt status of the payee under the laws of any payee jurisdiction.

(19) The definition of hybrid mismatch should also capture deduction without inclusion outcomes that are the result of payments made to a disregarded permanent establishment. A disregarded permanent establishment is any arrangement that is treated as giving rise to a permanent establishment under the laws of the head office jurisdiction but which is not treated as a permanent establishment under the laws of the other jurisdiction. The hybrid mismatch rule should not apply, however, where the mismatch would have arisen in any event due to the tax exempt status of the payee under the laws of any payee jurisdiction.

(20) In respect of payments made by a hybrid entity to its owner, or deemed payments made between the head office and permanent establishment or between two or more permanent establishments, a hybrid mismatch could arise where the deduction without inclusion outcome results from the payment or deemed payment not being recognised in the payee jurisdiction. In that case, where the mismatch outcome is a consequence of the non-allocation of the payment or deemed payment, the payee jurisdiction is the jurisdiction where the payment or deemed payment is treated as being received under the laws of the payer jurisdiction. As with other hybrid entities and branch mismatches that give rise to deduction without inclusion outcomes, no hybrid mismatch should arise where the payee is exempt from tax under the laws of the payee jurisdiction. In respect of this

category of hybrid mismatches, however, a mismatch outcome would only arise to the extent that the payer jurisdiction allows the deduction in respect of the payment or deemed payment to be set off against an amount that is not dual-inclusion income. If the payer jurisdiction allows the deduction to be carried forward to a subsequent tax period, then the requirement to make any adjustment under this Directive could be deferred until such time as the deduction is actually set off against non-dual-inclusion income in the payer jurisdiction.

(21) The hybrid mismatch definition should also capture double deduction outcomes regardless of whether they arise as a result of payments, expenses that are not treated as payments under domestic law or as a result of amortisation or depreciation losses. As with deemed payments and payments made by a hybrid entity that are disregarded by the payee, a hybrid mismatch should only arise, however, to the extent that the payer jurisdiction allows the deduction to be set off against an amount that is not dual-inclusion income. This means that if the payer jurisdiction allows the deduction to be carried forward to a subsequent tax period, the requirement to make an adjustment under this Directive could be deferred until such time as the deduction is actually set off against non-dual-inclusion income in the payer jurisdiction.

(22) Differences in tax outcomes that are solely attributable to differences in the value ascribed to a payment, including through the application of transfer pricing, should not fall within the scope of a hybrid mismatch. Furthermore, as jurisdictions use different tax periods and have different rules for recognising when items of income or expenditure have been derived or incurred, those timing differences should not generally be treated as giving rise to mismatches in tax outcomes. However, a deductible payment under a financial instrument that cannot reasonably be expected to be included in income within a reasonable period of time should be treated as giving rise to a hybrid mismatch if that deduction without inclusion outcome is attributable to differences in the characterisation of the financial instrument or payments made under it. It should be understood that a mismatch outcome could arise if a payment made under a financial instrument is not included in income within a reasonable period of time. Such a payment should be treated as included in income within a reasonable period of time, if included by the payee within 12 months of the end of the payer's tax period or as determined under the arm's length principle. Member States could require that a payment be included within a fixed period of time in order to avoid giving rise to a mismatch outcome and secure tax control.

(23) Hybrid transfers could give rise to a difference in tax treatment if, as a result of an arrangement to transfer a financial instrument, the underlying return on that instrument was treated as derived by more than one of the parties to the arrangement. In those cases, the payment under the hybrid transfer could give rise to a deduction for the payer while being treated as a return on the underlying instrument by the payee. This difference in tax treatment could lead to a deduction without inclusion outcome or to the generation of a surplus tax credit for the tax withheld at source on the underlying instrument. Such mismatches should therefore be eliminated. In the case of a deduction without inclusion, the same rules should apply as for neutralising mismatches from payments under a hybrid financial instrument. In the case of hybrid transfers that have been structured to produce surplus tax credits, the Member State concerned should prevent the payer from using the surplus credit to obtain a tax advantage including through the application of a general anti-abuse rule consistent with Article 6 of Directive (EU) 2016/1164.

(24) It is necessary to provide for a rule that allows Member States to tackle discrepancies in the transposition and implementation of this Directive resulting in a hybrid mismatch despite the fact that Member States act in compliance with this Directive. Where such a situation arises and the primary rule provided for in this Directive does not apply, a secondary rule should apply. Nevertheless, the application of both the primary and secondary rules only apply to hybrid mismatches as defined by this Directive and should not affect the general features of the tax system of a Member State.

(25) Imported mismatches shift the effect of a hybrid mismatch between parties in third countries into the jurisdiction of a Member State through the use of a non-hybrid instrument thereby undermining the effectiveness of the rules that neutralise hybrid mismatches. A deductible payment in a Member State can be used to fund expenditure involving a hybrid mismatch. To counter such imported mismatches, it is necessary to include rules that disallow the deduction of a payment if the corresponding income from that payment is set off, directly or indirectly, against a deduction that arises under a hybrid mismatch giving rise to a double deduction or a deduction without inclusion between third countries.

I

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(1) Opinion of 27 April 2017 (not yet published in the Official Journal).
(2) Opinion of 14 December 2016 (not yet published in the Official Journal).
(3) Council Directive (EU) 2016/1164 of 12 July 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market (OJ L 193, 19.7.2016, p. 1).

the corporate tax systems of Member States, the ECOFIN Council issued a statement on 12 July 2016 requesting the Commission to put forward by October 2016 a proposal on hybrid mismatches involving third countries in order to provide for rules consistent with and no less effective than the rules recommended by the OECD report on Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2 — 2015 Final Report ('OECD BEPS report on Action 2'), with a view to reaching an agreement by the end of 2016.

(6) Directive (EU) 2016/1164 recognises, inter alia, that it is critical for further work to be undertaken on other hybrid mismatches such as those involving permanent establishments. In view of that, it is essential that hybrid permanent establishment mismatches be addressed in that Directive as well.

(7) In order to provide for a framework that is consistent with and no less effective than the OECD BEPS report on Action 2, it is essential that Directive (EU) 2016/1164 also include rules on hybrid transfers, imported mismatches and address the full range of double deduction outcomes, in order to prevent taxpayers from exploiting remaining loopholes.

(8) Directive (EU) 2016/1164 includes rules on hybrid mismatches between Member States and should thus also include rules on hybrid mismatches with third countries where at least one of the parties involved is a corporate taxpayer or, in the case of reverse hybrids, an entity in a Member State, as well as rules on imported mismatches. Consequently, the rules on hybrid mismatches and tax residency mismatches should apply to all taxpayers that are subject to corporate tax in a Member State including to permanent establishments, or to arrangements treated as permanent establishments, of entities resident in third countries. Rules on reverse hybrid mismatches should apply to all entities that are treated as transparent for tax purposes by a Member State.

(9) Rules on hybrid mismatches should address mismatch situations which result from double deductions, from conflict in the characterisation of financial instruments, payments and entities, or from the allocation of payments. Since hybrid mismatches could lead to a double deduction or to a deduction without inclusion, it is necessary to lay down rules whereby the Member State concerned either denies the deduction of a payment, expenses or losses or requires the taxpayer to include the payment in its taxable income, as appropriate. However, those rules apply only to deductible payments and should not affect the general features of a tax system, whether it is a classical or an imputation system.

(10) Hybrid permanent establishment mismatches occur where differences between the rules in the jurisdictions of permanent establishment and of residence for allocating income and expenditure between different parts of the same entity give rise to a mismatch in tax outcomes and include those cases where a mismatch outcome arises due to the fact that a permanent establishment is disregarded under the laws of the branch jurisdiction. Those mismatch outcomes may lead to a double deduction or a deduction without inclusion, and should therefore be eliminated. In the case of disregarded permanent establishments, the Member State in which the taxpayer is a resident should include the income that would otherwise be attributed to the permanent establishment.

(11) Any adjustments that are required to be made under this Directive should in principle not affect the allocation of taxing rights between jurisdictions laid down under a double taxation treaty.

(12) In order to ensure proportionality, it is necessary to address only the cases where there is a substantial risk of avoiding taxation through the use of hybrid mismatches. It is therefore appropriate to cover hybrid mismatches that arise between the head office and permanent establishment or between two or more permanent establishments of the same entity, hybrid mismatches that arise between the taxpayer and its associated enterprises or between associated enterprises, and those resulting from a structured arrangement involving a taxpayer.

(13) Mismatches that, in particular, result from the hybrid nature of entities should be addressed only where one of the associated enterprises has, at a minimum, effective control over the other associated enterprises. Consequently, in those cases, it should be required that an associated enterprise be held by, or hold, the taxpayer or another associated enterprise through a participation in terms of voting rights, capital ownership or entitlement to received profits of 50 per cent or more. The ownership, or rights of persons who are acting together, should be aggregated for the purposes of applying this requirement.

(14) In order to provide for a sufficiently comprehensive definition of 'associated enterprise' for the purposes of the rules on hybrid mismatches, that definition should also comprise an entity that is part of the same consolidated group for accounting purposes, an enterprise in which the taxpayer has a significant influence in the management and, conversely, an enterprise that has a significant influence in the management of the taxpayer.

(15) It is necessary to address four categories of hybrid mismatches: first, hybrid mismatches that result from payments under a financial instrument; second, hybrid mismatches that are the consequence of differences in the allocation of payments made to a hybrid entity or permanent establishment, including as a result of payments to a disregarded permanent establishment; third, hybrid mismatches that result from payments made by a hybrid entity to its owner, or deemed payments between the head office and permanent establishment or between two or more permanent establishments; lastly, double deduction outcomes resulting from payments made by a hybrid entity or permanent establishment.

(16) In respect of payments under a financial instrument, a hybrid mismatch could arise where the deduction without inclusion outcome is attributable to the differences in the characterisation of the instrument or the payments made under it. If the character of the payment qualifies it for double tax relief under the laws of the payee jurisdiction, such as an exemption from tax, a reduction in the rate of tax or any credit or refund of tax, the payment should be treated as giving rise to a hybrid mismatch to the extent of the resulting undertaxed amount. A payment under a financial instrument should not, however, be treated as giving rise to a hybrid mismatch where the tax relief granted in the payee jurisdiction is solely due to the tax status of the payee or the fact that the instrument is held subject to the terms of a special regime.

(17) In order to avoid unintended outcomes in the interaction between the hybrid financial instrument rule and the loss-absorbing capacity requirements imposed on banks, and without prejudice to State aid rules, Member States should be able to exclude from the scope of this Directive intra-group instruments that have been issued with the sole purpose of meeting the issuer's loss-absorbing capacity requirements and not for the purposes of avoiding tax.

(18) In respect of payments made to a hybrid entity or permanent establishment, a hybrid mismatch could arise where the deduction without inclusion outcome results from differences in the rules governing the allocation of that payment between the hybrid entity and its owner in the case of a payment that is made to a hybrid entity, between the head office and permanent establishment, or between two or more permanent establishments in the case of a deemed payment to a permanent establishment. The definition of hybrid mismatch should only apply where the mismatch outcome is a result of differences in the rules governing the allocation of payments under the laws of the two jurisdictions and a payment should not give rise to a hybrid mismatch that would have arisen in any event due to the tax exempt status of the payee under the laws of any payee jurisdiction.

(19) The definition of hybrid mismatch should also capture deduction without inclusion outcomes that are the result of payments made to a disregarded permanent establishment. A disregarded permanent establishment is any arrangement that is treated as giving rise to a permanent establishment under the laws of the head office jurisdiction but which is not treated as a permanent establishment under the laws of the other jurisdiction. The hybrid mismatch rule should not apply, however, where the mismatch would have arisen in any event due to the tax exempt status of the payee under the laws of any payee jurisdiction.

(20) In respect of payments made by a hybrid entity to its owner, or deemed payments made between the head office and permanent establishment or between two or more permanent establishments, a hybrid mismatch could arise where the deduction without inclusion outcome results from the payment or deemed payment not being recognised in the payee jurisdiction. In that case, where the mismatch outcome is a consequence of the non-allocation of the payment or deemed payment, the payee jurisdiction is the jurisdiction where the payment or deemed payment is treated as being received under the laws of the payer jurisdiction. As with other hybrid entities and branch mismatches that give rise to deduction without inclusion outcomes, no hybrid mismatch should arise where the payee is exempt from tax under the laws of the payee jurisdiction. In respect of this

category of hybrid mismatches, however, a mismatch outcome would only arise to the extent that the payer jurisdiction allows the deduction in respect of the payment or deemed payment to be set off against an amount that is not dual-inclusion income. If the payer jurisdiction allows the deduction to be carried forward to a subsequent tax period, then the requirement to make any adjustment under this Directive could be deferred until such time as the deduction is actually set off against non-dual-inclusion income in the payer jurisdiction.

(21) The hybrid mismatch definition should also capture double deduction outcomes regardless of whether they arise as a result of payments, expenses that are not treated as payments under domestic law or as a result of amortisation or depreciation losses. As with deemed payments and payments made by a hybrid entity that are disregarded by the payee, a hybrid mismatch should only arise, however, to the extent that the payer jurisdiction allows the deduction to be set off against an amount that is not dual-inclusion income. This means that if the payer jurisdiction allows the deduction to be carried forward to a subsequent tax period, the requirement to make an adjustment under this Directive could be deferred until such time as the deduction is actually set off against non-dual-inclusion income in the payer jurisdiction.

(22) Differences in tax outcomes that are solely attributable to differences in the value ascribed to a payment, including through the application of transfer pricing, should not fall within the scope of a hybrid mismatch. Furthermore, as jurisdictions use different tax periods and have different rules for recognising when items of income or expenditure have been derived or incurred, those timing differences should not generally be treated as giving rise to mismatches in tax outcomes. However, a deductible payment under a financial instrument that cannot reasonably be expected to be included in income within a reasonable period of time should be treated as giving rise to a hybrid mismatch if that deduction without inclusion outcome is attributable to differences in the characterisation of the financial instrument or payments made under it. It should be understood that a mismatch outcome could arise if a payment made under a financial instrument is not included in income within a reasonable period of time. Such a payment should be treated as included in income within a reasonable period of time, if included by the payee within 12 months of the end of the payer's tax period or as determined under the arm's length principle. Member States could require that a payment be included within a fixed period of time in order to avoid giving rise to a mismatch outcome and secure tax control.

(23) Hybrid transfers could give rise to a difference in tax treatment if, as a result of an arrangement to transfer a financial instrument, the underlying return on that instrument was treated as derived by more than one of the parties to the arrangement. In those cases, the payment under the hybrid transfer could give rise to a deduction for the payer while being treated as a return on the underlying instrument by the payee. This difference in tax treatment could lead to a deduction without inclusion outcome or to the generation of a surplus tax credit for the tax withheld at source on the underlying instrument. Such mismatches should therefore be eliminated. In the case of a deduction without inclusion, the same rules should apply as for neutralising mismatches from payments under a hybrid financial instrument. In the case of hybrid transfers that have been structured to produce surplus tax credits, the Member State concerned should prevent the payer from using the surplus credit to obtain a tax advantage including through the application of a general anti-abuse rule consistent with Article 6 of Directive (EU) 2016/1164.

(24) It is necessary to provide for a rule that allows Member States to tackle discrepancies in the transposition and implementation of this Directive resulting in a hybrid mismatch despite the fact that Member States act in compliance with this Directive. Where such a situation arises and the primary rule provided for in this Directive does not apply, a secondary rule should apply. Nevertheless, the application of both the primary and secondary rules only apply to hybrid mismatches as defined by this Directive and should not affect the general features of the tax system of a Member State.

(25) Imported mismatches shift the effect of a hybrid mismatch between parties in third countries into the jurisdiction of a Member State through the use of a non-hybrid instrument thereby undermining the effectiveness of the rules that neutralise hybrid mismatches. A deductible payment in a Member State can be used to fund expenditure involving a hybrid mismatch. To counter such imported mismatches, it is necessary to include rules that disallow the deduction of a payment if the corresponding income from that payment is set off, directly or indirectly, against a deduction that arises under a hybrid mismatch giving rise to a double deduction or a deduction without inclusion between third countries.

(26) A dual resident mismatch could lead to a double deduction if a payment made by a dual resident taxpayer is deducted under the laws of both jurisdictions where the taxpayer is resident. As dual resident mismatches could give rise to double deduction outcomes, they should fall within the scope of this Directive. A Member State should deny the duplicate deduction arising in respect of a dual resident company to the extent that this payment is set off against an amount that is not treated as income under the laws of the other jurisdiction.

(27) The objective of this Directive is to improve the resilience of the internal market as a whole against hybrid mismatches. This cannot be sufficiently achieved by the Member States acting individually, given that national corporate tax systems are disparate and that independent action by Member States would only replicate the existing fragmentation of the internal market in direct taxation. It would thus allow inefficiencies and distortions to persist in the interaction of distinct national measures. This would result in a lack of coordination. That objective can rather, due to the cross-border nature of hybrid mismatches and the need to adopt solutions that function for the internal market as a whole, be better achieved at Union level. The Union may adopt measures, in accordance with the principle of subsidiarity as set out in Article 5 of the Treaty on European Union. In accordance with the principle of proportionality, as set out in that Article, this Directive does not go beyond what is necessary in order to achieve that objective. By setting the required level of protection for the internal market, this Directive only aims to achieve the essential degree of coordination within the Union that is necessary to achieve its objective.

(28) In implementing this Directive, Member States should use the applicable explanations and examples in the OECD BEPS report on Action 2 as a source of illustration or interpretation to the extent that they are consistent with the provisions of this Directive and with Union law.

(29) The hybrid mismatch rules in Article 9(1) and (2) only apply to the extent that the situation involving a taxpayer gives rise to a mismatch outcome. No mismatch outcome should arise when an arrangement is subject to adjustment under Article 9(5) or 9a and, accordingly, arrangements that are subject to adjustment under those parts of this Directive should not be subject to any further adjustment under the hybrid mismatch rules.

(30) Where the provisions of another directive, such as those in Council Directive 2011/96/EU [1], lead to the neutralisation of the mismatch in tax outcomes, there should be no scope for the application of the hybrid mismatch rules provided for in this Directive.

(31) The Commission should evaluate the implementation of this Directive 5 years after its entry into force and report to the Council thereon. Member States should communicate to the Commission all information necessary for this evaluation.

(32) Directive (EU) 2016/1164 should therefore be amended accordingly,

HAS ADOPTED THIS DIRECTIVE:

Article 1

Directive (EU) 2016/1164 is amended as follows:

(1) Article 1 is replaced by the following:

'*Article 1*

Scope

1. This Directive applies to all taxpayers that are subject to corporate tax in one or more Member States, including permanent establishments in one or more Member States of entities resident for tax purposes in a third country.

2. Article 9a also applies to all entities that are treated as transparent for tax purposes by a Member State.';

(1) Council Directive 2011/96/EU of 30 November 2011 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States (OJ L 345, 29.12.2011, p. 8).

(2) Article 2 is amended as follows:

(a) in point (4), the last subparagraph is replaced by the following:

'For the purposes of Articles 9 and 9a:

(a) Where the mismatch outcome arises under points (b), (c), (d), (e) or (g) of the first subparagraph of point (9) of this Article or where an adjustment is required under Article 9(3) or Article 9a, the definition of associated enterprise is modified so that the 25 per cent requirement is replaced by a 50 per cent requirement;

(b) a person who acts together with another person in respect of the voting rights or capital ownership of an entity shall be treated as holding a participation in all of the voting rights or capital ownership of that entity that are held by the other person;

(c) an associated enterprise also means an entity that is part of the same consolidated group for financial accounting purposes as the taxpayer, an enterprise in which the taxpayer has a significant influence in the management or an enterprise that has a significant influence in the management of the taxpayer.';

(b) point (9) is replaced by the following:

'(9) "hybrid mismatch" means a situation involving a taxpayer or, with respect to Article 9(3), an entity where:

(a) a payment under a financial instrument gives rise to a deduction without inclusion outcome and:

(i) such payment is not included within a reasonable period of time; and

(ii) the mismatch outcome is attributable to differences in the characterisation of the instrument or the payment made under it.

For the purposes of the first subparagraph, a payment under a financial instrument shall be treated as included in income within a reasonable period of time where:

(i) the payment is included by the jurisdiction of the payee in a tax period that commences within 12 months of the end of the payer's tax period; or

(ii) it is reasonable to expect that the payment will be included by the jurisdiction of the payee in a future tax period and the terms of payment are those that would be expected to be agreed between independent enterprises;

(b) a payment to a hybrid entity gives rise to a deduction without inclusion and that mismatch outcome is the result of differences in the allocation of payments made to the hybrid entity under the laws of the jurisdiction where the hybrid entity is established or registered and the jurisdiction of any person with a participation in that hybrid entity;

(c) a payment to an entity with one or more permanent establishments gives rise to a deduction without inclusion and that mismatch outcome is the result of differences in the allocation of payments between the head office and permanent establishment or between two or more permanent establishments of the same entity under the laws of the jurisdictions where the entity operates;

(d) a payment gives rise to a deduction without inclusion as a result of a payment to a disregarded permanent establishment;

(e) a payment by a hybrid entity gives rise to a deduction without inclusion and that mismatch is the result of the fact that the payment is disregarded under the laws of the payee jurisdiction;

(f) a deemed payment between the head office and permanent establishment or between two or more permanent establishments gives rise to a deduction without inclusion and that mismatch is the result of the fact that the payment is disregarded under the laws of the payee jurisdiction; or

(g) a double deduction outcome occurs.

For the purposes of this point (9):

(a) a payment representing the underlying return on a transferred financial instrument shall not give rise to a hybrid mismatch under point (a) of the first subparagraph where the payment is made by a financial trader under an on-market hybrid transfer provided the payer jurisdiction requires the financial trader to include as income all amounts received in relation to the transferred financial instrument;

(b) a hybrid mismatch shall only arise under points (e), (f) or (g) of the first subparagraph to the extent that the payer jurisdiction allows the deduction to be set off against an amount that is not dual-inclusion income;

(c) a mismatch outcome shall not be treated as a hybrid mismatch unless it arises between associated enterprises, between a taxpayer and an associated enterprise, between the head office and permanent establishment, between two or more permanent establishments of the same entity or under a structured arrangement.

For the purposes of this point (9) and Articles 9, 9a and 9b:

(a) "mismatch outcome" means a double deduction or a deduction without inclusion;

(b) "double deduction" means a deduction of the same payment, expenses or losses in the jurisdiction in which the payment has its source, the expenses are incurred or the losses are suffered (payer jurisdiction) and in another jurisdiction (investor jurisdiction). In the case of a payment by a hybrid entity or permanent establishment the payer jurisdiction is the jurisdiction where the hybrid entity or permanent establishment is established or situated;

(c) "deduction without inclusion" means the deduction of a payment or deemed payment between the head office and permanent establishment or between two or more permanent establishments in any jurisdiction in which that payment or deemed payment is treated as made (payer jurisdiction) without a corresponding inclusion for tax purposes of that payment or deemed payment in the payee jurisdiction. The payee jurisdiction is any jurisdiction where that payment or deemed payment is received, or is treated as being received under the laws of any other jurisdiction;

(d) "deduction" means the amount that is treated as deductible from the taxable income under the laws of the payer or investor jurisdiction. The term "deductible" shall be construed accordingly;

(e) "inclusion" means the amount that is taken into account in the taxable income under the laws of the payee jurisdiction. A payment under a financial instrument shall not be treated as included to the extent that the payment qualifies for any tax relief solely due to the way that payment is characterised under the laws of the payee jurisdiction. The term "included" shall be construed accordingly;

(f) "tax relief" means a tax exemption, reduction in the tax rate or any tax credit or refund (other than a credit for taxes withheld at source);

(g) "dual inclusion income" means any item of income that is included under the laws of both jurisdictions where the mismatch outcome has arisen;

(h) "person" means an individual or entity;

(i) "hybrid entity" means any entity or arrangement that is regarded as a taxable entity under the laws of one jurisdiction and whose income or expenditure is treated as income or expenditure of one or more other persons under the laws of another jurisdiction;

(j) "financial instrument" means any instrument to the extent that it gives rise to a financing or equity return that is taxed under the rules for taxing debt, equity or derivatives under the laws of either the payee or payer jurisdictions and includes a hybrid transfer;

(k) "financial trader" is a person or entity engaged in the business of regularly buying and selling financial instruments on its own account for the purposes of making a profit;

I

(Legislative acts)

DIRECTIVES

COUNCIL DIRECTIVE (EU) 2016/1164

of 12 July 2016

laying down rules against tax avoidance practices that directly affect the functioning of the internal market

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty on the Functioning of the European Union, and in particular Article 115 thereof,

Having regard to the proposal from the European Commission,

After transmission of the draft legislative act to the national parliaments,

Having regard to the opinion of the European Parliament [1],

Having regard to the opinion of the European Economic and Social Committee [2],

Acting in accordance with a special legislative procedure,

Whereas:

(1) The current political priorities in international taxation highlight the need for ensuring that tax is paid where profits and value are generated. It is thus imperative to restore trust in the fairness of tax systems and allow governments to effectively exercise their tax sovereignty. These new political objectives have been translated into concrete action recommendations in the context of the initiative against base erosion and profit shifting (BEPS) by the Organisation for Economic Cooperation and Development (OECD). The European Council has welcomed this work in its conclusions of 13-14 March 2013 and 19-20 December 2013. In response to the need for fairer taxation, the Commission, in its communication of 17 June 2015 sets out an action plan for fair and efficient corporate taxation in the European Union.

(2) The final reports on the 15 OECD Action Items against BEPS were released to the public on 5 October 2015. This output was welcomed by the Council in its conclusions of 8 December 2015. The Council conclusions stressed the need to find common, yet flexible, solutions at the EU level consistent with OECD BEPS conclusions. In addition, the conclusions supported an effective and swift coordinated implementation of the anti-BEPS measures at the EU level and considered that EU directives should be, where appropriate, the preferred vehicle for implementing OECD BEPS conclusions at the EU level. It is essential for the good functioning of the internal

(1) Not yet published in the Official Journal.
(2) Not yet published in the Official Journal.

market that, as a minimum, Member States implement their commitments under BEPS and more broadly, take action to discourage tax avoidance practices and ensure fair and effective taxation in the Union in a sufficiently coherent and coordinated fashion. In a market of highly integrated economies, there is a need for common strategic approaches and coordinated action, to improve the functioning of the internal market and maximise the positive effects of the initiative against BEPS. Furthermore, only a common framework could prevent a fragmentation of the market and put an end to currently existing mismatches and market distortions. Finally, national implementing measures which follow a common line across the Union would provide taxpayers with legal certainty in that those measures would be compatible with Union law.

(3) It is necessary to lay down rules in order to strengthen the average level of protection against aggressive tax planning in the internal market. As these rules would have to fit in 28 separate corporate tax systems, they should be limited to general provisions and leave the implementation to Member States as they are better placed to shape the specific elements of those rules in a way that fits best their corporate tax systems. This objective could be achieved by creating a minimum level of protection for national corporate tax systems against tax avoidance practices across the Union. It is therefore necessary to coordinate the responses of Member States in implementing the outputs of the 15 OECD Action Items against BEPS with the aim to improve the effectiveness of the internal market as a whole in tackling tax avoidance practices. It is therefore necessary to set a common minimum level of protection for the internal market in specific fields.

(4) It is necessary to establish rules applicable to all taxpayers that are subject to corporate tax in a Member State. Considering that it would result in the need to cover a broader range of national taxes, it is not desirable to extend the scope of this Directive to types of entities which are not subject to corporate tax in a Member State; that is, in particular, transparent entities. Those rules should also apply to permanent establishments of those corporate taxpayers which may be situated in other Member State(s). Corporate taxpayers may be resident for tax purposes in a Member State or be established under the laws of a Member State. Permanent establishments of entities resident for tax purposes in a third country should also be covered by those rules if they are situated in one or more Member State.

(5) It is necessary to lay down rules against the erosion of tax bases in the internal market and the shifting of profits out of the internal market. Rules in the following areas are necessary in order to contribute to achieving that objective: limitations to the deductibility of interest, exit taxation, a general anti-abuse rule, controlled foreign company rules and rules to tackle hybrid mismatches. Where the application of those rules gives rise to double taxation, taxpayers should receive relief through a deduction for the tax paid in another Member State or third country, as the case may be. Thus, the rules should not only aim to counter tax avoidance practices but also avoid creating other obstacles to the market, such as double taxation.

(6) In an effort to reduce their global tax liability, groups of companies have increasingly engaged in BEPS, through excessive interest payments. The interest limitation rule is necessary to discourage such practices by limiting the deductibility of taxpayers' exceeding borrowing costs. It is therefore necessary to fix a ratio for deductibility which refers to a taxpayer's taxable earnings before interest, tax, depreciation and amortisation (EBITDA). Member States could decrease this ratio or place time limits or restrict the amount of unrelieved borrowing costs that can be carried forward or back to ensure a higher level of protection. Given that the aim is to lay down minimum standards, it could be possible for Member States to adopt an alternative measure referring to a taxpayer's earnings before interest and tax (EBIT) and fixed in a way that it is equivalent to the EBITDA-based ratio. Member States could in addition to the interest limitation rule provided by this Directive also use targeted rules against intra-group debt financing, in particular thin capitalisation rules. Tax exempt revenues should not be set off against deductible borrowing costs. This is because only taxable income should be taken into account in determining how much interest may be deducted.

(7) Where the taxpayer is part of a group which files statutory consolidated accounts, the indebtedness of the overall group at worldwide level may be considered for the purpose of granting taxpayers entitlement to deduct higher amounts of exceeding borrowing costs. It may also be appropriate to lay down rules for an equity escape provision, where the interest limitation rule does not apply if the company can demonstrate that its equity over total assets ratio is broadly equal to or higher than the equivalent group ratio. The interest limitation rule should apply in relation to a taxpayer's exceeding borrowing costs without distinction of whether the costs originate in

debt taken out nationally, cross-border within the Union or with a third country, or whether they originate from third parties, associated enterprises or intra-group. Where a group includes more than one entity in a Member State, the Member State may consider the overall position of all group entities in the same State, including a separate entity taxation system to allow the transfer of profits or interest capacity between entities within a group, when applying rules that limit the deductibility of interest.

(8) To reduce the administrative and compliance burden of the rules without significantly diminishing their tax effect, it may be appropriate to provide for a safe harbour rule so that net interest is always deductible up to a fixed amount, when this leads to a higher deduction than the EBITDA-based ratio. Member States could reduce the fixed monetary threshold in order to ensure a higher level of protection of their domestic tax base. Since BEPS in principle takes place through excessive interest payments among entities which are associated enterprises, it is appropriate and necessary to allow the possible exclusion of standalone entities from the scope of the interest limitation rule given the limited risks of tax avoidance. In order to facilitate the transition to the new interest limitation rule, Member States could provide for a grandfathering clause that would cover existing loans to the extent that their terms are not subsequently modified, i.e. in case of a subsequent modification, the grandfathering would not apply to any increase in the amount or duration of the loan but would be limited to the original terms of the loan. Without prejudice to State aid rules, Member States could also exclude exceeding borrowing costs incurred on loans used to fund long-term public infrastructure projects considering that such financing arrangements present little or no BEPS risks. In this context, Member States should properly demonstrate that financing arrangements for public infrastructure projects present special features which justify such treatment vis-à-vis other financing arrangements subject to the restrictive rule.

(9) Although it is generally accepted that financial undertakings, i.e. financial institutions and insurance undertakings, should also be subject to limitations to the deductibility of interest, it is equally acknowledged that these two sectors present special features which call for a more customised approach. As the discussions in this field are not yet sufficiently conclusive in the international and Union context, it is not yet possible to provide specific rules in the financial and insurance sectors and Member States should therefore be able to exclude them from the scope of interest limitation rules.

(10) Exit taxes have the function of ensuring that where a taxpayer moves assets or its tax residence out of the tax jurisdiction of a State, that State taxes the economic value of any capital gain created in its territory even though that gain has not yet been realised at the time of the exit. It is therefore necessary to specify cases in which taxpayers are subject to exit tax rules and taxed on unrealised capital gains which have been built in their transferred assets. It is also helpful to clarify that transfers of assets, including cash, between a parent company and its subsidiaries fall outside the scope of the envisaged rule on exit taxation. In order to compute the amounts, it is critical to fix a market value for the transferred assets at the time of exit of the assets based on the arm's length principle. In order to ensure the compatibility of the rule with the use of the credit method, it is desirable to allow Member States to refer to the moment when the right to tax the transferred assets is lost. The right to tax should be defined at national level. It is also necessary to allow the receiving State to dispute the value of the transferred assets established by the exit State when it does not reflect such a market value. Member States could resort to this effect to existing dispute resolution mechanisms. Within the Union, it is necessary to address the application of exit taxation and illustrate the conditions for being compliant with Union law. In those situations, taxpayers should have the right to either immediately pay the amount of exit tax assessed or defer payment of the amount of tax by paying it in instalments over a certain number of years, possibly together with interest and a guarantee.

Member States could request, for this purpose, the taxpayers concerned to include the necessary information in a declaration. Exit tax should not be charged when the transfer of assets is of a temporary nature and the assets are set to revert to the Member State of the transferor, where the transfer takes place in order to meet prudential capital requirements or for the purpose of liquidity management or when it comes to securities' financing transactions or assets posted as collateral.

(11) General anti-abuse rules (GAARs) feature in tax systems to tackle abusive tax practices that have not yet been dealt with through specifically targeted provisions. GAARs have therefore a function aimed to fill in gaps, which

should not affect the applicability of specific anti-abuse rules. Within the Union, GAARs should be applied to arrangements that are not genuine; otherwise, the taxpayer should have the right to choose the most tax efficient structure for its commercial affairs. It is furthermore important to ensure that the GAARs apply in domestic situations, within the Union and vis-à-vis third countries in a uniform manner, so that their scope and results of application in domestic and cross-border situations do not differ. Member States should not be prevented from applying penalties where the GAAR is applicable. When evaluating whether an arrangement should be regarded as non-genuine, it could be possible for Member States to consider all valid economic reasons, including financial activities.

(12) Controlled foreign company (CFC) rules have the effect of re-attributing the income of a low-taxed controlled subsidiary to its parent company. Then, the parent company becomes taxable on this attributed income in the State where it is resident for tax purposes. Depending on the policy priorities of that State, CFC rules may target an entire low-taxed subsidiary, specific categories of income or be limited to income which has artificially been diverted to the subsidiary. In particular, in order to ensure that CFC rules are a proportionate response to BEPS concerns, it is critical that Member States that limit their CFC rules to income which has been artificially diverted to the subsidiary precisely target situations where most of the decision-making functions which generated diverted income at the level of the controlled subsidiary are carried out in the Member State of the taxpayer. With a view to limiting the administrative burden and compliance costs, it should also be acceptable that those Member States exempt certain entities with low profits or a low profit margin that give rise to lower risks of tax avoidance. Accordingly, it is necessary that the CFC rules extend to the profits of permanent establishments where those profits are not subject to tax or are tax exempt in the Member State of the taxpayer. However, there is no need to tax, under the CFC rules, the profits of permanent establishments which are denied the tax exemption under national rules because these permanent establishments are treated as though they were controlled foreign companies. In order to ensure a higher level of protection, Member States could reduce the control threshold, or employ a higher threshold in comparing the actual corporate tax paid with the corporate tax that would have been charged in the Member State of the taxpayer. Member States could, in transposing CFC rules into their national law, use a sufficiently high tax rate fractional threshold.

It is desirable to address situations both in third countries and within the Union. To comply with the fundamental freedoms, the income categories should be combined with a substance carve-out aimed to limit, within the Union, the impact of the rules to cases where the CFC does not carry on a substantive economic activity. It is important that tax administrations and taxpayers cooperate to gather the relevant facts and circumstances to determine whether the carve-out rule is to apply. It should be acceptable that, in transposing CFC rules into their national law, Member States use white, grey or black lists of third countries, which are compiled on the basis of certain criteria set out in this Directive and may include the corporate tax rate level, or use white lists of Member States compiled on that basis.

(13) Hybrid mismatches are the consequence of differences in the legal characterisation of payments (financial instruments) or entities and those differences surface in the interaction between the legal systems of two jurisdictions. The effect of such mismatches is often a double deduction (i.e. deduction in both states) or a deduction of the income in one state without inclusion in the tax base of the other. To neutralise the effects of hybrid mismatch arrangements, it is necessary to lay down rules whereby one of the two jurisdictions in a mismatch should deny the deduction of a payment leading to such an outcome. In this context, it is useful to clarify that measures aimed to tackle hybrid mismatches in this Directive are aimed to tackle mismatch situations attributable to differences in the legal characterisation of a financial instrument or entity and are not intended to affect the general features of the tax system of a Member State. Although Member States have agreed guidance, in the framework of the Group of the Code of Conduct on Business Taxation, on the tax treatment of hybrid entities and hybrid permanent establishments within the Union as well as on the tax treatment of hybrid entities in relations with third countries, it is still necessary to enact binding rules. It is critical that further work is undertaken on hybrid mismatches between Member States and third countries, as well as on other hybrid mismatches such as those involving permanent establishments.

(14) It is necessary to clarify that the implementation of the rules against tax avoidance provided in this Directive should not affect the taxpayers' obligation to comply with the arm's length principle or the Member State's right to adjust a tax liability upwards in accordance with the arm's length principle, where applicable.

(15) The European Data Protection Supervisor was consulted in accordance with Article 28(2) of Regulation (EC) No 45/2001 of the European Parliament and of the Council [1]. The right to protection of personal data according to Article 8 of the Charter of Fundamental Rights of the European Union as well as Directive 95/46/EC of the European Parliament and of the Council [2] applies to the processing of personal data carried out within the framework of this Directive.

(16) Considering that a key objective of this Directive is to improve the resilience of the internal market as a whole against cross-border tax avoidance practices, this cannot be sufficiently achieved by the Member States acting individually. National corporate tax systems are disparate and independent action by Member States would only replicate the existing fragmentation of the internal market in direct taxation. It would thus allow inefficiencies and distortions to persist in the interaction of distinct national measures. The result would be lack of coordination. Rather, by reason of the fact that much inefficiency in the internal market primarily gives rise to problems of a cross-border nature, remedial measures should be adopted at Union level. It is therefore critical to adopt solutions that function for the internal market as a whole and this can be better achieved at Union level. Thus, the Union may adopt measures, in accordance with the principle of subsidiarity as set out in Article 5 of the Treaty on European Union. In accordance with the principle of proportionality, as set out in that Article, this Directive does not go beyond what is necessary in order to achieve that objective. By setting a minimum level of protection for the internal market, this Directive only aims to achieve the essential minimum degree of coordination within the Union for the purpose of materialising its objectives.

(17) The Commission should evaluate the implementation of this Directive four years after its entry into force and report to the Council thereon. Member States should communicate to the Commission all information necessary for this evaluation.

HAS ADOPTED THIS DIRECTIVE:

CHAPTER I

GENERAL PROVISIONS

Article 1

Scope

This Directive applies to all taxpayers that are subject to corporate tax in one or more Member States, including permanent establishments in one or more Member States of entities resident for tax purposes in a third country.

Article 2

Definitions

For the purposes of this Directive, the following definitions apply:

(1) 'borrowing costs' means interest expenses on all forms of debt, other costs economically equivalent to interest and expenses incurred in connection with the raising of finance as defined in national law, including, without being limited to, payments under profit participating loans, imputed interest on instruments such as convertible bonds and zero coupon bonds, amounts under alternative financing arrangements, such as Islamic finance, the finance cost element of finance lease payments, capitalised interest included in the balance sheet value of a related asset, or the amortisation of capitalised interest, amounts measured by reference to a funding return under transfer pricing rules where applicable, notional interest amounts under derivative instruments or hedging arrangements related to an

[1] Regulation (EC) No 45/2001 of the European Parliament and of the Council of 18 December 2000 on the protection of individuals with regard to the processing of personal data by the Community institutions and bodies and on the free movement of such data (OJ L 8, 12.1.2001, p. 1).

[2] Directive 95/46/EC of the European Parliament and the Council of 24 October 1995 on the protection of individuals with regard to the processing of personal data and on the free movement of such data (OJ L 281, 23.11.1995, p. 31).

entity's borrowings, certain foreign exchange gains and losses on borrowings and instruments connected with the raising of finance, guarantee fees for financing arrangements, arrangement fees and similar costs related to the borrowing of funds;

(2) 'exceeding borrowing costs' means the amount by which the deductible borrowing costs of a taxpayer exceed taxable interest revenues and other economically equivalent taxable revenues that the taxpayer receives according to national law;

(3) 'tax period' means a tax year, calendar year or any other appropriate period for tax purposes;

(4) 'associated enterprise' means:

(a) an entity in which the taxpayer holds directly or indirectly a participation in terms of voting rights or capital ownership of 25 percent or more or is entitled to receive 25 percent or more of the profits of that entity;

(b) an individual or entity which holds directly or indirectly a participation in terms of voting rights or capital ownership in a taxpayer of 25 percent or more or is entitled to receive 25 percent or more of the profits of the taxpayer;

If an individual or entity holds directly or indirectly a participation of 25 percent or more in a taxpayer and one or more entities, all the entities concerned, including the taxpayer, shall also be regarded as associated enterprises.

For the purposes of Article 9 and where the mismatch involves a hybrid entity, this definition is modified so that the 25 percent requirement is replaced by a 50 percent requirement.

(5) 'financial undertaking' means any of the following entities:

(a) a credit institution or an investment firm as defined in point (1) of Article 4(1) of Directive 2004/39/EC of the European Parliament and of the Council [1] or an alternative investment fund manager (AIFM) as defined in point (b) of Article 4(1) of Directive 2011/61/EU of the European Parliament and of the Council [2] or an undertaking for collective investment in transferable securities (UCITS) management company as defined in point (b) of Article 2(1) of Directive 2009/65/EC of the European Parliament and of the Council [3];

(b) an insurance undertaking as defined in point (1) of Article 13 of Directive 2009/138/EC of the European Parliament and of the Council [4];

(c) a reinsurance undertaking as defined in point (4) of Article 13 of Directive 2009/138/EC;

(d) an institution for occupational retirement provision falling within the scope of Directive 2003/41/EC of the European Parliament and of the Council [5], unless a Member State has chosen not to apply that Directive in whole or in part to that institution in accordance with Article 5 of that Directive or the delegate of an institution for occupational retirement provision as referred to in Article 19(1) of that Directive;

(e) pension institutions operating pension schemes which are considered to be social security schemes covered by Regulation (EC) No 883/2004 of the European Parliament and of the Council [6] and Regulation (EC) No 987/2009 of the European Parliament and of the Council [7] as well as any legal entity set up for the purpose of investment of such schemes;

(1) Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC (OJ L 145, 30.4.2004, p. 1).

(2) Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010 (OJ L 174, 1.7.2011, p. 1).

(3) Directive 2009/65/EC of the European Parliament and of the Council of 13 July 2009 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) (OJ L 302, 17.11.2009, p. 32).

(4) Directive 2009/138/EC of the European Parliament and of the Council of 25 November 2009 on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II) (OJ L 335, 17.12.2009, p. 1).

(5) Directive 2003/41/EC of the European Parliament and of the Council of 3 June 2003 on the activities and supervision of institutions for occupational retirement provision (OJ L 235, 23.9.2003, p. 10).

(6) Regulation (EC) No 883/2004 of the European Parliament and of the Council of 29 April 2004 on the coordination of social security systems (OJ L 166, 30.4.2004, p. 1).

(7) Regulation (EC) No 987/2009 of the European Parliament and of the Council of 16 September 2009 laying down the procedure for implementing Regulation (EC) No 883/2004 on the coordination of social security systems (OJ L 284, 30.10.2009, p. 1).

(f) an alternative investment fund (AIF) managed by an AIFM as defined in point (b) of Article 4(1) of Directive 2011/61/EU or an AIF supervised under the applicable national law;

(g) UCITS in the meaning of Article 1(2) of Directive 2009/65/EC;

(h) a central counterparty as defined in point (1) of Article 2 of Regulation (EU) No 648/2012 of the European Parliament and of the Council ([1]);

(i) a central securities depository as defined in point (1) of Article 2(1) of Regulation (EU) No 909/2014 of the European Parliament and of the Council ([2]).

(6) 'transfer of assets' means an operation whereby a Member State loses the right to tax the transferred assets, whilst the assets remain under the legal or economic ownership of the same taxpayer;

(7) 'transfer of tax residence' means an operation whereby a taxpayer ceases to be resident for tax purposes in a Member State, whilst acquiring tax residence in another Member State or third country;

(8) 'transfer of a business carried on by a permanent establishment' means an operation whereby a taxpayer ceases to have taxable presence in a Member State whilst acquiring such presence in another Member State or third country without becoming resident for tax purposes in that Member State or third country;

(9) 'hybrid mismatch' means a situation between a taxpayer in one Member State and an associated enterprise in another Member State or a structured arrangement between parties in Member States where the following outcome is attributable to differences in the legal characterisation of a financial instrument or entity:

(a) a deduction of the same payment, expenses or losses occurs both in the Member State in which the payment has its source, the expenses are incurred or the losses are suffered and in another Member State ('double deduction'); or

(b) there is a deduction of a payment in the Member State in which the payment has its source without a corresponding inclusion for tax purposes of the same payment in the other Member State ('deduction without inclusion').

Article 3

Minimum level of protection

This Directive shall not preclude the application of domestic or agreement-based provisions aimed at safeguarding a higher level of protection for domestic corporate tax bases.

CHAPTER II

MEASURES AGAINST TAX AVOIDANCE

Article 4

Interest limitation rule

1. Exceeding borrowing costs shall be deductible in the tax period in which they are incurred only up to 30 percent of the taxpayer's earnings before interest, tax, depreciation and amortisation (EBITDA).

([1]) Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories (OJ L 201, 27.7.2012, p. 1).

([2]) Regulation (EU) No 909/2014 of the European Parliament and of the Council of 23 July 2014 on improving securities settlement in the European Union and on central securities depositories and amending Directives 98/26/EC and 2014/65/EU and Regulation (EU) No 236/2012 (OJ L 257, 28.8.2014, p. 1).

For the purpose of this Article, Member States may also treat as a taxpayer:

(a) an entity which is permitted or required to apply the rules on behalf of a group, as defined according to national tax law;

(b) an entity in a group, as defined according to national tax law, which does not consolidate the results of its members for tax purposes.

In such circumstances, exceeding borrowing costs and the EBITDA may be calculated at the level of the group and comprise the results of all its members.

2. The EBITDA shall be calculated by adding back to the income subject to corporate tax in the Member State of the taxpayer the tax-adjusted amounts for exceeding borrowing costs as well as the tax-adjusted amounts for depreciation and amortisation. Tax exempt income shall be excluded from the EBITDA of a taxpayer.

3. By derogation from paragraph 1, the taxpayer may be given the right:

(a) to deduct exceeding borrowing costs up to EUR 3 000 000;

(b) to fully deduct exceeding borrowing costs if the taxpayer is a standalone entity.

For the purposes of the second subparagraph of paragraph 1, the amount of EUR 3 000 000 shall be considered for the entire group.

For the purposes of point (b) of the first subparagraph, a standalone entity means a taxpayer that is not part of a consolidated group for financial accounting purposes and has no associated enterprise or permanent establishment.

4. Member States may exclude from the scope of paragraph 1 exceeding borrowing costs incurred on:

(a) loans which were concluded before 17 June 2016, but the exclusion shall not extend to any subsequent modification of such loans;

(b) loans used to fund a long-term public infrastructure project where the project operator, borrowing costs, assets and income are all in the Union.

For the purposes of point (b) of the first subparagraph, a long-term public infrastructure project means a project to provide, upgrade, operate and/or maintain a large-scale asset that is considered in the general public interest by a Member State.

Where point (b) of the first subparagraph applies, any income arising from a long-term public infrastructure project shall be excluded from the EBITDA of the taxpayer, and any excluded exceeding borrowing cost shall not be included in the exceeding borrowing costs of the group vis-à-vis third parties referred to in point (b) of paragraph 5.

5. Where the taxpayer is a member of a consolidated group for financial accounting purposes, the taxpayer may be given the right to either:

(a) fully deduct its exceeding borrowing costs if it can demonstrate that the ratio of its equity over its total assets is equal to or higher than the equivalent ratio of the group and subject to the following conditions:

(i) the ratio of the taxpayer's equity over its total assets is considered to be equal to the equivalent ratio of the group if the ratio of the taxpayer's equity over its total assets is lower by up to two percentage points; and

(ii) all assets and liabilities are valued using the same method as in the consolidated financial statements referred to in paragraph 8;

or

(b) deduct exceeding borrowing costs at an amount in excess of what it would be entitled to deduct under paragraph 1. This higher limit to the deductibility of exceeding borrowing costs shall refer to the consolidated group for financial accounting purposes in which the taxpayer is a member and be calculated in two steps:

(i) first, the group ratio is determined by dividing the exceeding borrowing costs of the group vis-à-vis third-parties over the EBITDA of the group; and

(ii) second, the group ratio is multiplied by the EBITDA of the taxpayer calculated pursuant to paragraph 2.

6. The Member State of the taxpayer may provide for rules either:

(a) to carry forward, without time limitation, exceeding borrowing costs which cannot be deducted in the current tax period under paragraphs 1 to 5;

(b) to carry forward, without time limitation, and back, for a maximum of three years, exceeding borrowing costs which cannot be deducted in the current tax period under paragraphs 1 to 5; or

(c) to carry forward, without time limitation, exceeding borrowing costs and, for a maximum of five years, unused interest capacity, which cannot be deducted in the current tax period under paragraphs 1 to 5.

7. Member States may exclude financial undertakings from the scope of paragraphs 1 to 6, including where such financial undertakings are part of a consolidated group for financial accounting purposes.

8. For the purpose of this Article, the consolidated group for financial accounting purposes consists of all entities which are fully included in consolidated financial statements drawn up in accordance with the International Financial Reporting Standards or the national financial reporting system of a Member State. The taxpayer may be given the right to use consolidated financial statements prepared under other accounting standards.

Article 5

Exit taxation

1. A taxpayer shall be subject to tax at an amount equal to the market value of the transferred assets, at the time of exit of the assets, less their value for tax purposes, in any of the following circumstances:

(a) a taxpayer transfers assets from its head office to its permanent establishment in another Member State or in a third country in so far as the Member State of the head office no longer has the right to tax the transferred assets due to the transfer;

(b) a taxpayer transfers assets from its permanent establishment in a Member State to its head office or another permanent establishment in another Member State or in a third country in so far as the Member State of the permanent establishment no longer has the right to tax the transferred assets due to the transfer;

(c) a taxpayer transfers its tax residence to another Member State or to a third country, except for those assets which remain effectively connected with a permanent establishment in the first Member State;

(d) a taxpayer transfers the business carried on by its permanent establishment from a Member State to another Member State or to a third country in so far as the Member State of the permanent establishment no longer has the right to tax the transferred assets due to the transfer.

2. A taxpayer shall be given the right to defer the payment of an exit tax referred to in paragraph 1, by paying it in instalments over five years, in any of the following circumstances:

(a) a taxpayer transfers assets from its head office to its permanent establishment in another Member State or in a third country that is party to the Agreement on the European Economic Area (EEA Agreement);

(b) a taxpayer transfers assets from its permanent establishment in a Member State to its head office or another permanent establishment in another Member State or a third country that is party to the EEA Agreement;

(c) a taxpayer transfers its tax residence to another Member State or to a third country that is party to the EEA Agreement;

(d) a taxpayer transfers the business carried on by its permanent establishment to another Member State or a third country that is party to the EEA Agreement.

This paragraph shall apply to third countries that are party to the EEA Agreement if they have concluded an agreement with the Member State of the taxpayer or with the Union on the mutual assistance for the recovery of tax claims, equivalent to the mutual assistance provided for in Council Directive 2010/24/EU ([1]).

3. If a taxpayer defers the payment in accordance with paragraph 2, interest may be charged in accordance with the legislation of the Member State of the taxpayer or of the permanent establishment, as the case may be.

If there is a demonstrable and actual risk of non-recovery, taxpayers may also be required to provide a guarantee as a condition for deferring the payment in accordance with paragraph 2.

The second subparagraph shall not apply where the legislation in the Member State of the taxpayer or of the permanent establishment provides for the possibility of recovery of the tax debt through another taxpayer which is member of the same group and is resident for tax purposes in that Member State.

4. Where paragraph 2 applies, the deferral of payment shall be immediately discontinued and the tax debt becomes recoverable in the following cases:

(a) the transferred assets or the business carried on by the permanent establishment of the taxpayer are sold or otherwise disposed of;

(b) the transferred assets are subsequently transferred to a third country;

(c) the taxpayer's tax residence or the business carried on by its permanent establishment is subsequently transferred to a third country;

(d) the taxpayer goes bankrupt or is wound up;

(e) the taxpayer fails to honour its obligations in relation to the instalments and does not correct its situation over a reasonable period of time, which shall not exceed 12 months.

Points (b) and (c) shall not apply to third countries that are party to the EEA Agreement if they have concluded an agreement with the Member State of the taxpayer or with the Union on the mutual assistance for the recovery of tax claims, equivalent to the mutual assistance provided for in Directive 2010/24/EU.

5. Where the transfer of assets, tax residence or the business carried on by a permanent establishment is to another Member State, that Member State shall accept the value established by the Member State of the taxpayer or of the permanent establishment as the starting value of the assets for tax purposes, unless this does not reflect the market value.

6. For the purposes of paragraphs 1 to 5, 'market value' is the amount for which an asset can be exchanged or mutual obligations can be settled between willing unrelated buyers and sellers in a direct transaction.

7. Provided that the assets are set to revert to the Member State of the transferor within a period of 12 months, this Article shall not apply to asset transfers related to the financing of securities, assets posted as collateral or where the asset transfer takes place in order to meet prudential capital requirements or for the purpose of liquidity management.

([1]) Council Directive 2010/24/EU of 16 March 2010 concerning mutual assistance for the recovery of claims relating to taxes, duties and other measures (OJ L 84, 31.3.2010, p. 1).

Article 6

General anti-abuse rule

1. For the purposes of calculating the corporate tax liability, a Member State shall ignore an arrangement or a series of arrangements which, having been put into place for the main purpose or one of the main purposes of obtaining a tax advantage that defeats the object or purpose of the applicable tax law, are not genuine having regard to all relevant facts and circumstances. An arrangement may comprise more than one step or part.

2. For the purposes of paragraph 1, an arrangement or a series thereof shall be regarded as non-genuine to the extent that they are not put into place for valid commercial reasons which reflect economic reality.

3. Where arrangements or a series thereof are ignored in accordance with paragraph 1, the tax liability shall be calculated in accordance with national law.

Article 7

Controlled foreign company rule

1. The Member State of a taxpayer shall treat an entity, or a permanent establishment of which the profits are not subject to tax or are exempt from tax in that Member State, as a controlled foreign company where the following conditions are met:

(a) in the case of an entity, the taxpayer by itself, or together with its associated enterprises holds a direct or indirect participation of more than 50 percent of the voting rights, or owns directly or indirectly more than 50 percent of capital or is entitled to receive more than 50 percent of the profits of that entity; and

(b) the actual corporate tax paid on its profits by the entity or permanent establishment is lower than the difference between the corporate tax that would have been charged on the entity or permanent establishment under the applicable corporate tax system in the Member State of the taxpayer and the actual corporate tax paid on its profits by the entity or permanent establishment.

For the purposes of point (b) of the first subparagraph, the permanent establishment of a controlled foreign company that is not subject to tax or is exempt from tax in the jurisdiction of the controlled foreign company shall not be taken into account. Furthermore the corporate tax that would have been charged in the Member State of the taxpayer means as computed according to the rules of the Member State of the taxpayer.

2. Where an entity or permanent establishment is treated as a controlled foreign company under paragraph 1, the Member State of the taxpayer shall include in the tax base:

(a) the non-distributed income of the entity or the income of the permanent establishment which is derived from the following categories:

   (i) interest or any other income generated by financial assets;

   (ii) royalties or any other income generated from intellectual property;

   (iii) dividends and income from the disposal of shares;

   (iv) income from financial leasing;

   (v) income from insurance, banking and other financial activities;

   (vi) income from invoicing companies that earn sales and services income from goods and services purchased from and sold to associated enterprises, and add no or little economic value;

This point shall not apply where the controlled foreign company carries on a substantive economic activity supported by staff, equipment, assets and premises, as evidenced by relevant facts and circumstances.

Where the controlled foreign company is resident or situated in a third country that is not party to the EEA Agreement, Member States may decide to refrain from applying the preceding subparagraph.

or

(b) the non-distributed income of the entity or permanent establishment arising from non-genuine arrangements which have been put in place for the essential purpose of obtaining a tax advantage.

For the purposes of this point, an arrangement or a series thereof shall be regarded as non-genuine to the extent that the entity or permanent establishment would not own the assets or would not have undertaken the risks which generate all, or part of, its income if it were not controlled by a company where the significant people functions, which are relevant to those assets and risks, are carried out and are instrumental in generating the controlled company's income.

3. Where, under the rules of a Member State, the tax base of a taxpayer is calculated according to point (a) of paragraph 2, the Member State may opt not to treat an entity or permanent establishment as a controlled foreign company under paragraph 1 if one third or less of the income accruing to the entity or permanent establishment falls within the categories under point (a) of paragraph 2.

Where, under the rules of a Member State, the tax base of a taxpayer is calculated according to point (a) of paragraph 2, the Member State may opt not to treat financial undertakings as controlled foreign companies if one third or less of the entity's income from the categories under point (a) of paragraph 2 comes from transactions with the taxpayer or its associated enterprises.

4. Member States may exclude from the scope of point (b) of paragraph 2 an entity or permanent establishment:

(a) with accounting profits of no more than EUR 750 000, and non-trading income of no more than EUR 75 000; or

(b) of which the accounting profits amount to no more than 10 percent of its operating costs for the tax period.

For the purpose of point (b) of the first subparagraph, the operating costs may not include the cost of goods sold outside the country where the entity is resident, or the permanent establishment is situated, for tax purposes and payments to associated enterprises.

Article 8

Computation of controlled foreign company income

1. Where point (a) of Article 7(2) applies, the income to be included in the tax base of the taxpayer shall be calculated in accordance with the rules of the corporate tax law of the Member State where the taxpayer is resident for tax purposes or situated. Losses of the entity or permanent establishment shall not be included in the tax base but may be carried forward, according to national law, and taken into account in subsequent tax periods.

2. Where point (b) of Article 7(2) applies, the income to be included in the tax base of the taxpayer shall be limited to amounts generated through assets and risks which are linked to significant people functions carried out by the controlling company. The attribution of controlled foreign company income shall be calculated in accordance with the arm's length principle.

3. The income to be included in the tax base shall be calculated in proportion to the taxpayer's participation in the entity as defined in point (a) of Article 7(1).

4. The income shall be included in the tax period of the taxpayer in which the tax year of the entity ends.

5. Where the entity distributes profits to the taxpayer, and those distributed profits are included in the taxable income of the taxpayer, the amounts of income previously included in the tax base pursuant to Article 7 shall be deducted from the tax base when calculating the amount of tax due on the distributed profits, in order to ensure there is no double taxation.

6. Where the taxpayer disposes of its participation in the entity or of the business carried out by the permanent establishment, and any part of the proceeds from the disposal previously has been included in the tax base pursuant to Article 7, that amount shall be deducted from the tax base when calculating the amount of tax due on those proceeds, in order to ensure there is no double taxation.

7. The Member State of the taxpayer shall allow a deduction of the tax paid by the entity or permanent establishment from the tax liability of the taxpayer in its state of tax residence or location. The deduction shall be calculated in accordance with national law.

Article 9

Hybrid mismatches

1. To the extent that a hybrid mismatch results in a double deduction, the deduction shall be given only in the Member State where such payment has its source.

2. To the extent that a hybrid mismatch results in a deduction without inclusion, the Member State of the payer shall deny the deduction of such payment.

CHAPTER III

FINAL PROVISIONS

Article 10

Review

1. The Commission shall evaluate the implementation of this Directive, in particular the impact of Article 4, by 9 August 2020 and report to the Council thereon. The report by the Commission shall, if appropriate, be accompanied by a legislative proposal.

2. Member States shall communicate to the Commission all information necessary for evaluating the implementation of this Directive.

3. Member States referred to in Article 11(6) shall communicate to the Commission before 1 July 2017 all information necessary for evaluating the effectiveness of the national targeted rules for preventing base erosion and profit shifting risks (BEPS).

Article 11

Transposition

1. Member States shall, by 31 December 2018, adopt and publish the laws, regulations and administrative provisions necessary to comply with this Directive. They shall communicate to the Commission the text of those provisions without delay.

They shall apply those provisions from 1 January 2019.

When Member States adopt those provisions, they shall contain a reference to this Directive or be accompanied by such a reference on the occasion of their official publication. Member States shall determine how such reference is to be made.

2. Member States shall communicate to the Commission the text of the main provisions of national law which they adopt in the field covered by this Directive.

3. Where this Directive mentions a monetary amount in euros (EUR), Member States whose currency is not the euro may opt to calculate the corresponding value in the national currency on 12 July 2016.

4. By way of derogation from Article 5(2), Estonia may, for as long as it does not tax undistributed profits, consider a transfer of assets in monetary or non-monetary form, including cash, from a permanent establishment situated in Estonia to a head office or another permanent establishment in another Member State or in a third country that is a party to the EEA Agreement as profit distribution and charge income tax, without giving taxpayers the right to defer the payment of such tax.

5. By way of derogation from paragraph 1, Member States shall, by 31 December 2019, adopt and publish, the laws, regulations and administrative provisions necessary to comply with Article 5. They shall communicate to the Commission the text of those provisions without delay.

They shall apply those provisions from 1 January 2020.

When Member States adopt those provisions, they shall contain a reference to this Directive or be accompanied by such a reference on the occasion of their official publication. Member States shall determine how such reference is to be made.

6. By way of derogation from Article 4, Member States which have national targeted rules for preventing BEPS risks at 8 August 2016, which are equally effective to the interest limitation rule set out in this Directive, may apply these targeted rules until the end of the first full fiscal year following the date of publication of the agreement between the OECD members on the official website on a minimum standard with regard to BEPS Action 4, but at the latest until 1 January 2024.

Article 12

Entry into force

This Directive shall enter into force on the twentieth day following that of its publication in the *Official Journal of the European Union*.

Article 13

Addressees

This Directive is addressed to the Member States.

Done at Brussels, 12 July 2016.

For the Council

The President

P. KAŽIMÍR

<u>Materials Relating to Act II: Treaty Overrides on Prop. Regs. 59A and 267A</u>

267A Deemed Branch Payments Rule and Commentary

Prop. Regs. 267A REG-104352-18; 83 F.R. 67612-67651; 2019-3 IRB 357

From Preamble

II.D.3. Deemed Branch Payments

Proposed §1.267A-2(c) addresses deemed branch payments. These payments result in a D/NI outcome when, under an income tax treaty, a deductible payment is deemed to be made by a permanent establishment to its home office and offsets income not taxable to the home office, but the payment is not taken into account under the home office's tax law.

In general, the proposed regulations define a deemed branch payment as interest or royalty considered paid by a U.S. permanent establishment to its home office under an income tax treaty between the United States and the home office country. <u>See</u> proposed §1.267A-2(c)(2). Thus, for example, a deemed branch payment includes an amount allowed as a deduction in computing the business profits of a U.S. permanent establishment with respect to the use of intellectual property developed by the home office. <u>See</u>, for example, the U.S. Treasury Department Technical Explanation to the income tax convention between the United States and Belgium, signed November 27, 2006 ("[T]he OECD Transfer Pricing Guidelines apply, by analogy, in determining the profits attributable to a permanent establishment.").

When a specified payment is a deemed branch payment, it is a disqualified hybrid amount if the home office's tax law provides an exclusion or exemption for income attributable to the branch. In these cases, a deduction for the deemed branch payment would offset non-dual inclusion income and therefore give rise to a D/NI outcome. If the home office's tax law does not have an exclusion or exemption for income attributable to the branch, then, because U.S. permanent establishments cannot consolidate or otherwise share losses with U.S. taxpayers, there would generally not be an opportunity for a deduction for the deemed branch payment to offset non-dual inclusion income.

Prop. Reg. §1.267A-2(c)(2) Text

(c) *Deemed branch payments*—(1) *In general*. If a specified payment is a deemed branch payment, then the payment is a disqualified hybrid amount if the tax law of the home office provides an exclusion or exemption for income attributable to the branch. *See* § 1.267A-6(c)(4).

(2) *Definition of deemed branch payment.* The term *deemed branch payment* means, with respect to a U.S. taxable branch that is a U.S. permanent establishment of a treaty resident eligible for benefits under an income tax treaty between the United States and the treaty country, any amount of interest or royalties allowable as a deduction in computing the business profits of the U.S. permanent establishment, to the extent the amount is deemed paid to the home office (or other branch of the home office) and is not regarded (or otherwise taken into account) under the home office's tax law (or the other branch's tax law).

A deemed branch payment may be otherwise taken into account for this purpose if, for example, under the home office's tax law a corresponding amount of interest or royalties is allocated and attributable to the U.S. permanent establishment and is therefore not deductible.

Commentary Reaction to Prop. Reg. 267A Deemed Branch Rule

NEW YORK STATE BAR ASSOCIATION TAX SECTION REPORT ON PROPOSED REGULATIONS UNDER SECTIONS 267A, 245A(e), AND 1503(d) (February 26, 2019)

IV.A.4.l.i.

l. Deemed Branch Payments

i. Deemed branch payments generally

Deemed branch payments under Prop. Reg. §1.267A-2(c)(2) exist only where a non-U.S. corporation has a US branch that qualifies as a "permanent establishment" ("**PE**") under a tax treaty between that corporation's country of residence and the U.S., the non-U.S. corporation uses that treaty's rules for computing the taxable profits of that PE in lieu of using the U.S. rules standing-alone, that treaty's rules for determining the business profits of the PE create a deemed deductible payment of interest or royalties from the PE to the home office, and notwithstanding the treaty's provisions the treaty party's tax law does not require a corresponding Inclusion in taxable income to the home office. This mismatch is to be distinguished from situations where the home office's tax law and the branch's tax law have a mismatch with respect to the allocation between the home office and the branch of actual payments made to or received from third parties. Instead, deemed branch payments are fictional payments that are deemed to exist only for purposes of computing the branch's net income subject to US tax under a treaty. They are deemed to exist only because the United States entered into a tax treaty with the other jurisdiction and provided for the branch to compute its taxable business profit *as if* the branch and the home office were separate entities.[182] They can exist only if the foreign owner of the branch claims the benefits of the treaty with respect to the computation of the branch's taxable business profits (as distinguished from following the results provided for by the Code without the overlay of the treaty).

At this time we have no specific recommendation with regards to deemed branch payments, but we believe that this category raises issues that should be carefully considered.

As noted above, these deemed payments are a product of bilateral tax treaties that the US has entered into with other countries. Under each such treaty, the US and the applicable counterparty have agreed on a method for computing the taxable business profits of PEs operating in their jurisdiction and agreed that they will impose tax on only that amount of business profits. That method includes allowing the PE a deduction for interest or royalties deemed to be paid to the home office, without regard to whether the home office is required to pay tax on that deemed income in the counterparty jurisdiction. Now, the US would be creating a new condition on the allowance of the deduction based upon an intervening change in US law.

We are not addressing whether the US has the legal authority to do this — there is ample commentary on the later-in-time rule in the context of changes in U.S. law that impact existing tax treaties (so-called "treaty overrides"), including by us in prior Tax Section reports.[183] One factor that is discussed in the commentary is whether Congress expressed an intention to override treaties. Here, the authority for the deemed branch payments would be the regulatory grant in Section 267A(e)(2).[184] The discussion in the Joint Committee's Technical Explanation with respect to extending the rules to branches consists of a lengthy footnote that addresses specified payments made by a U.S. corporation to a U.S. branch of a related foreign corporation. In the first example, the U.S. branch is not taxable in the U.S. and in the second example, the U.S. sees the payment as income of the home office. There is no discussion in the legislative history of deemed payments from a branch pursuant to a treaty.

Other considerations relevant specifically to treaty overrides through Treasury Regulations are discussed extensively in *National Westminster Bank, PLC* v. *U.S.*[185]

While the legislative history does not explicitly refer to deemed branch payments, it does, as discussed above, refer to the OECD hybrid reports and expresses an intention to be following the recommendations in those reports to some extent. The OECD Recommendations are also significant here in evaluating the possibility of a treaty override by regulation.

The OECD's Branch Mismatch Report includes, as Recommendation 3, the application of hybrid disallowance rules to deemed payments by a branch to its home office where the home office's tax rules do not include the deemed payment in taxable income (because the payment is not regarded or is otherwise exempt). It is not clear, however, if the recommendation in the report is limited to deemed payments created unilaterally under the law of the jurisdiction where the branch is operating and is not intended to be applied where the deemed payment is the result of a consensus reached between the two applicable countries as to the appropriate profits to be taxed by the jurisdiction where the branch is operating. There are numerous places in the OECD Branch Mismatch Report that indicate that Recommendation 3 is not intended to apply where the two countries have reached an agreement regarding the treatment of the branch.[186] Accordingly, whether the OECD Branch Mismatch Report is support for Congress intending a treaty override and whether it is support for the existence of an international consensus is questionable. The OECD Branch Mismatch Report cites to the anti-hybrid rules adopted by the U.K. in 2017 and those adopted by the E.U. in 2017 as indicators of the international consensus regarding the anti-hybrid rules that should apply to branches and both of those rules are, like Recommendation 3, arguably unclear as to whether they apply only where there is no governing treaty provision, but a fair reading of both of them is that they are so limited.

The treaty provision that provides for this type of a deemed payment is based upon the OECD's approach to determining the business profits of PEs (the "**Authorized OECD Approach**" or "**AOA**") and applies transfer pricing principles as if the branch and the home office were separate (but related) legal entities. The AOA has been embraced by the international community, including the US, and is reflected in the US Model Convention. The specific provision in the US Model Treaty reads as follows:

> For the purposes of this Article, the profits that are attributable in each Contracting State to the permanent establishment referred to in paragraph 1 of this Article are the profits it might be expected to make, in particular in its dealings with other parts of the enterprise, if it were a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions, taking into account the functions performed, assets used and risks assumed by the enterprise through the permanent establishment and through the other parts of the enterprise.

The deemed branch payment rule is an additional rule that would apply *after* the application of the treaty provision. While this may be viewed as supporting a position that the deemed branch payment rule is contrary to the international consensus, there is an alternative perspective to be considered.

The Preamble indicates that the drafters see the deemed branch payment rule as a corollary to the rules that apply to specified payments by entities.[187] This approach makes sense in that the deemed payment exists only because the AOA treats the branch as a separate entity. If that fiction were true, then the hybrid transaction rule likely would have applied. So there is a need to back up the hybrid transaction rule with a deemed branch payment rule in order to ensure that branches (and the AOA) are not used to avoid the application of the basic hybrid transaction rule. Expressed in this way, the rule seems entirely necessary and appropriate. There are also portions of the OECD Branch Mismatch Report that could be understood to establish that Recommendation 3 is based upon this perspective and is intended to have this effect.

In light of the above considerations, including prior case law, and possible uncertainty about the status of the rule, we recommend that, if the rule is retained in final regulations, that there be a discussion of these considerations and the support for the rule.[188]

[182]Interestingly, the rule appears to apply without regard to how the home office's tax law would treat an actual payment of interest or royalties, and in this respect is distinct from most of the other Section 267A categories.

[183]NYSBA Tax Section, Report No. 1398 on Sections 864(c)(8) and 1446(f) (Aug. 2018); NYSBA Tax Section, Report No. 1364 on Proposed Section 2801 Regulations (Jan 2017); Avi-Yonah and Wells, "The BEAT and Treaty Overrides: A Brief Response to Rosenbloom and Shaheen", Tax Analysts' Worldwide Tax Daily (Nov. 7, 2018).

[184]"(e) Regulations. -- The Secretary shall issue such regulations or other guidance as may be necessary or appropriate to carry out the purposes of this section, including regulations or other guidance providing for — (2) rules for the application of this section to branches or domestic entities".

[185]512 F.3d 1347 (Fed. Cir. 2008); *see also* Reinhold and Harrington, *What NatWest Tells US About Tax Treaty Interpretation*, Tax Analysts Doc 2008-5866 (2008).

[186]In addition, the Report refers throughout to the intent to preserving a country's obligations under existing tax treaties. See OECD Branch Mismatch Report at paragraphs 28 (“Any adjustments under the recommendations set out in this report should not affect the allocation of taxing rights under a tax treaty.”); 35 (“provided any adjustment is consistent with a jurisdiction's tax treaty obligations, and tax policy settings in that jurisdiction.”); 26 (“The recommendations in Chapter 1 should not, however, be interpreted as requiring countries to make any change to deliberate policy decisions they have made, including in respect of the territorial scope of their tax regime, and do not purport to affect a country's obligations under a tax treaty.”); 40 (“should also be noted that the residence jurisdiction may be prevented from restricting the scope of the branch exemption in those cases where the tax treaty in effect between the residence and branch jurisdiction contains a provision equivalent to . . . .”); and 57 (“In these cases the residence jurisdiction may be prevented from restricting the scope of the branch exemption under Recommendation 1 owing to the overriding effect of the tax treaty.”).

[187]OIRA Analysis at 67628.

[188]In the event that Final Regulations remove the deemed branch payment rule, we recommend they retain the clarification that deemed branch payments are not disregarded payments subject to Prop. Reg. 1.267A-2(b).

4. The deemed branch payments rule of Prop. § 1.267A-2(c) should be withdrawn because the rule is inconsistent with U.S. treaty obligations

Under Prop. § 1.267A-2(c), if a specified payment is a "deemed branch payment," the payment is a disqualified hybrid amount if the tax law of the home office provides an exclusion or exemption for income attributable to the branch. Deemed branch payments are payments deemed made, under an income tax treaty, by a U.S. branch to its home office, but the payment isn't regarded or otherwise taken into account under the home office's tax law. An example is an amount allowed as a deduction in computing the business profits of a U.S. PE for a deemed royalty paid to the home office for use of the home office's intellectual property.

The proposed rule conflicts with U.S. treaty obligations, which treat a PE as if it were a separate entity. For example, under Article 7(1) of the *United States Model Income Tax Convention* (February 17, 2016), a contracting state can tax the profits attributable to a PE in that contracting state. Under Article 7(2), such profits attributable to a PE are the profits the PE "might be expected to make, in particular in its dealings with other parts of the enterprise, <u>if it were a separate and independent enterprise</u> engaged in the same or similar activities under the same or similar conditions." Similar provisions are in most major U.S. treaties. For a PE to be treated as a separate enterprise, it must be allowed the same deductions a separate entity would be allowed. Disallowing a deduction for royalty and interest payments deemed made by a PE to its home office is inconsistent with the obligation under income tax treaties to treat the PE as a separate enterprise for purposes of computing the profits attributable to the PE. We accordingly recommend the rule in Prop. § 1.267A-2(c) be withdrawn.

59A Internal Dealings Rule and Commentary

Prop Reg 1.59A 59A REG-104259-18; 83 F.R. 65956-65997; 2019-2 IRB 300

From Preamble

III.A.4. Income Tax Treaties

Certain U.S. income tax treaties provide alternative approaches for the allocation or attribution of business profits of an enterprise of one contracting state to its permanent establishment in the other contracting state on the basis of assets used, risks assumed, and functions performed by the permanent establishment. The use of a treaty-based expense allocation or attribution method does not, in and of itself, create legal obligations between the U.S. permanent establishment and the rest of the enterprise. These proposed regulations recognize that as a result of a treaty-based expense allocation or attribution method, amounts equivalent to deductible payments may be allowed in computing the business profits of an enterprise with respect to transactions between the permanent establishment and the home office or other branches of the foreign corporation (“internal dealings”). The deductions from internal dealings would not be allowed under the Code and regulations, which generally allow deductions only for allocable and apportioned costs incurred by the enterprise as a whole. The proposed regulations require that these deductions from internal dealings allowed in computing the business profits of the permanent establishment be treated in a manner consistent with their treatment under the treaty-based position and be included as base erosion payments.

….internal dealings are …priced on the basis of assets used, risks assumed, and functions performed by the permanent establishment in a manner consistent with the arm's length principle. The approach in the proposed regulations creates parity between deductions for actual regarded payments between two separate corporations (which are subject to section 482), and internal dealings (which are generally priced in a manner consistent with the applicable treaty and, if applicable, the OECD Transfer Pricing Guidelines). The rules in the proposed regulations applicable to foreign corporations using this approach apply only to deductions attributable to internal dealings, and not to payments to entities outside of the enterprise, which are subject to the general base erosion payment rules as provided in proposed §1.59A-3(b)(4)(v)(A).

Text of Prop. Reg. 1.59A-3(b)(4)(v)

Coordination with certain tax treaties — (A) Allocable expenses. If a foreign corporation elects to determine its taxable income pursuant to business profits provisions of an income tax treaty rather than provisions of the Internal Revenue Code, or the regulations thereunder, for determining effectively connected income, and the foreign corporation does not apply §§1.882-5 and 1.861-8 to allocate interest and other deductions, then in applying paragraphs (b)(4)(i) and (ii) of this section, the foreign corporation must determine whether each allowable deduction attributed to the permanent establishment in its determination of business profits is a base erosion payment under paragraph (b)(1) of this section.

(B) Internal dealings under certain income tax treaties. If, pursuant to the terms of an applicable income tax treaty, a foreign corporation determines the profits attributable to a permanent establishment based on the assets used, risks assumed, and functions performed by the permanent establishment, then any deduction attributable to any amount paid or accrued (or treated as paid or accrued) by the permanent establishment to the foreign corporation's home office or to another branch of the foreign corporation (an “internal dealing”) is a base erosion payment to the extent such payment or accrual is described under paragraph (b)(1) of this section.

§1.59A-3 Base erosion payments and base erosion tax benefits.

(a) Scope. This section provides definitions and related rules regarding base erosion payments and base erosion tax benefits. Paragraph (b) of this section provides definitions and rules regarding base erosion payments. Paragraph (c) of this section provides rules for determining the amount of base erosion tax benefits. Paragraph (d) of this section provides examples illustrating the rules described in this section.

(b) Base erosion payments — (1) In general. Except as provided in paragraph (b)(3) of this section, a base erosion payment means —

(i) Any amount paid or accrued by the taxpayer to a foreign related party of the taxpayer and with respect to which a deduction is allowable under chapter 1 of subtitle A of the Internal Revenue Code;

AMERICAN BAR ASSOCIATION
SECTION OF TAXATION

Comments on Proposed Regulations Addressing Section 59A

III. Comments . B. Comments regarding Base Erosion Payments and Base Erosion Tax Benefits

1. Background

Within the last several years, multiple jurisdictions have focused significantly on anti-base erosion measures. In 2015, the Organization for Economic Cooperation and Development (the "OECD") issued a series of reports providing insight and proposed guidance on how jurisdictions should approach base erosion and profit shifting ("BEPS") activities.[39] The OECD has defined base erosion as "tax planning strategies that exploit gaps and mismatches in tax rules to artificially shift profits to low or no-tax jurisdictions where there is little or no economic activity (*i.e.*, no substance)."[40]

In similar fashion, and consistent with the articulated goals of the Act, section 59A was enacted to discourage base erosion activity and encourage both U.S. and non-U.S. multinationals to conduct business in the United States. In the Senate Finance Committee's unofficial summary of the Senate Bill, the policy problem was described as follows: "foreign-owned U.S. subsidiaries are able to reduce their U.S. tax liability by making deductible payments to a foreign parent . . . This often results in earnings stripping. . . . Foreign parents often take advantage of these deductions through the use of interest, royalties, management fees, or reinsurance payments from the U.S. subsidiary."[41]

At the same time, the various principles of tax reform as encompassed in the Act as a whole reflect a balance of considerations. As much as certain provisions, such as the BEAT, section 163(j), and section 267A are meant to protect U.S. fiscal interests against base erosion, other provisions such as section 168(k) (regarding bonus depreciation) and section 250 (regarding foreign-derived intangible income) incentivize taxpayers to increase their U.S. economic activities. In addition, the Proposed Regulations reflect a general intent to rely on existing tax principles to determine the treatment of payments or accruals as base erosion payments.[42] Taking these factors into account, we believe that the definition of "base erosion payment" should reflect a balance of the BEAT and broader tax reform policy considerations, while adopting an approach consistent with existing tax principles related to the use of stock as consideration.

As noted above, base erosion payments are defined in section 59A(d)(1) as "any amount paid or accrued by the taxpayer to a foreign person which is a related party of the taxpayer and with respect to which a deduction is allowable" under Chapter 1 of the Code (a "(d)(1) base erosion payment").[43] Base erosion payments include "any amount paid or accrued by the taxpayer" to a related foreign person "in connection with the acquisition by the taxpayer from such person of property" that is depreciable or amortizable (a "(d)(2) base erosion payment").[44]

A BETB is (i) any deduction described in the definition of a (d)(1) base erosion payment which is allowed under Chapter 1 of the Code for the taxable year with respect to any base erosion payment; and (ii) in the case of a (d)(2) base erosion payment, any deduction allowed Chapter 1 of the Code for depreciation (or amortization in lieu of depreciation) with respect to the property acquired with such payment.[45]

3. Interest Expense Allocable to a Foreign Corporation's ECI

….

Finally, we believe that the approach taken in the Proposed Regulations with respect to treaty-based methods that attribute profit based on functions performed, assets used, and risks assumed can reach results that are punitive and are inconsistent with ordinary income tax principles. This section of the Proposed Regulations appears to be directed at treaty methods that follow the authorized OECD approach ("AOA") for the attribution of profits to permanent establishments, which give effect in some cases to "internal dealings" between the permanent establishment and the rest of the enterprise solely for purposes of attributing profits within the same legal entity. As noted in the Preamble, such an approach does not create legal obligations between the U.S. permanent establishment and the rest of the enterprise. While following the AOA may result in an interest deduction that is greater than the result of U.S. profit attribution rules, it does not in fact create intercompany deductions, and is instead better viewed as an alternative way of arriving at the total amount of excess interest that is deductible by the foreign corporation. We therefore recommend that where a taxpayer uses a treaty method that determines profit on the basis of the functions performed, assets used, and risks assumed, its interest deductions in excess of U.S.-booked liabilities should be treated in the same manner as interest on excess U.S.-connected liabilities. That is, we recommend that such amounts be treated as base erosion payments on a pro rata basis in accordance with the portion of the foreign corporation's overall borrowing that is from foreign related parties, rather than being treated as *per se* base erosion payments.

III. Detailed Discussion of Recommendations
C. Proposed Regulations Section 1.59A-3

7. Interest expense allocable to ECI

The Prior Report discussed the applicability of BEAT to the interest expense of a U.S. branch (or other activity related to ECI). In the Prior Report, we recommended that (1) regardless of whether the taxpayer uses the "adjusted U.S. booked liabilities" ("***AUSBL***") method or the "separate currency pools" method, interest expense on U.S.-booked liabilities ("***Branch Interest***") should be treated as paid to the branch's creditor for purposes of BEAT, and (2) the excess amount of a foreign corporation's interest allocated or apportioned to ECI under Treasury Regulations Section 1.882-5 over Branch Interest (such excess amount, "***Excess Interest***") should also be subject to BEAT to the extent that the foreign corporation has borrowed from a foreign related party.[49]

The Proposed Regulations generally provide that a foreign corporation that has interest expense allocable under Section 882(c) to ECI is treated as making a Base Erosion Payment to the extent that such interest expense results from a payment or accrual to a foreign related party.[50] We note, however, that there are several inconsistencies in the Proposed Regulations with respect to the allocation of interest expense to ECI.

a) Treaty allocations to a branch and excess interest

The treatment under the Proposed Regulations of interest expense allocable to ECI pursuant to the business profits provisions of an income tax treaty is inconsistent with the treatment under the Proposed Regulations of interest expense allocable to ECI under Treasury Regulations Section 1.882-5.

More specifically, where a foreign corporation determines the profits attributable to a permanent establishment based on the assets used, risks assumed and functions performed by the permanent establishment, the Proposed Regulations treat transactions between the permanent establishment and the home office or other branches of the foreign corporation (such transactions, "***Internal Dealings***") as being actually paid or accrued for purposes of determining whether there is a Base Erosion Payment.[51] Under Treasury Regulations Section 1.882-5(c)(2)(viii), on the other hand, transactions between separate offices or branches of the same taxpayer are ignored, and the allocation of interest expense for purposes of determining Base Erosion Payments is dependent on the foreign corporation's worldwide borrowings from related foreign parties.

The Preamble explains that the allocation of interest expense under Treasury Regulations Section 1.882-5 is distinct from Internal Dealings, because the former "represents a division of the expenses of the enterprise, rather than a payment between the branch or permanent establishment and the rest of the enterprise," while Internal Dealings "are priced on the basis of assets used, risks assumed, and functions performed by the permanent establishment in a manner consistent with the arm's length principle."[52]

We note that the arm's-length construct described above for characterizing Internal Dealings pursuant to an income tax treaty represents an attempt to fairly apportion the operating results of the U.S. permanent establishment and the home office or other branches of the foreign corporation. This goal is similar to the goal of the allocation rules under Treasury Regulations Section 1.882-5. By drawing a distinction between Internal Dealings and allocations pursuant to Treasury Regulations Section 1.882-5, the Proposed Regulations create a regime that could be more taxpayer-adverse under a treaty as compared with U.S. law in the absence of a treaty.[53] Treasury should consider this approach in light of treaty non-discrimination provisions and, in the case of a taxpayer applying both Internal Dealings and allocations under Treasury Regulations Section 1.882-5 for different businesses in the same year, in light of treaty consistency principles.[54]

[49]The Prior Report acknowledged that a literal reading of Section 59A(d) suggests that BEAT is inapplicable to Excess Interest, since the deduction for Excess Interest is notional and does not itself represent a payment or accrual to any person. *See* Prior Report at 27. The Prior Report, however, also recognizes that such a literal reading is not the only acceptable reading, given that Excess Interest is treated under the Treasury Regulations as an allocation or apportionment to ECI of a portion of the foreign corporation's third-party interest expense. *Id*.

[50]Proposed Regulations Section 1.59A-3(b)(4).

[51]Proposed Regulations Section 1.59A-3(b)(4)(v).

[52]Preamble at 65961.

[53]We acknowledge that the distinction drawn by the Proposed Regulations is arguably supported by the reasoning in *Nat'l Westminster Bank, PLC* v. *United States*, 512 F.3d 1347 (Fed. Cir. 2008), which interpreted the business profits provisions of the 1975 U.S.-U.K. income tax treaty as not "permitting transactions between the permanent establishment and the enterprise to be disregarded" and thus interpreted the treaty as taking a different approach from Treasury Regulations Section 1.882-5. *Id.* at 1354-55, 1359.

[54]*See* Revenue Ruling 84-17, 1984-1 C. B. 308; *see also* New York State Bar Association Tax Section Report No. 1325, Tax Treaty Consistency Principle (July 14, 2015).

OFFI Comments on Proposed Regulations Under Section 59A (Feb. 19, 2019)

IV.A.3.(c) Prop. Reg. § 1.59A-3(b)(4)(v)(B) violates U.S. income tax treaties

As discussed above, the AOA treats the PE as a separate entity solely for purposes of determining an appropriate profit attribution.

As explained by Treasury in its Technical Explanation to several U.S. income tax treaties, and recognized by Treasury and the Service themselves in the Preamble, such method of profits attribution "does not create legal obligations or other tax consequences that would result from transactions having independent legal significance."[97] Such treatment of the AOA given by Treasury is consistent with how the OECD has designed such method of profits attribution, *i.e.*, as being "relevant only for the attribution of profits to the PE under Article 7 and does not carry wider implications as regards, for example, withholding taxes,"[98] that is, for tax purposes. Therefore, by treating internal dealings as regarded transactions that may potentially give rise to base erosion payments, Prop. Reg. § 1.59A-3(b)(4)(v)(B) clearly violates the U.S. income tax treaties that have incorporated the AOA as a method of profit attribution under Article 7.

Moreover, under Article 7(1) of the U.S.-U.K. Treaty,[99] for example, if a foreign resident carries on business in the United States through a PE, the United States may impose tax on any "business profits" that are attributable to the PE. Article 7(3) of the U.S.-U.K. Treaty then provides that the business profits of a PE are determined with deductions for all expenses incurred for the purpose of the PE. In explaining such provision, the Department of Treasury Technical Explanation to the U.S.-U.K. Treaty provides that, under Article 7(3), "deductions shall be allowed for the expenses incurred for the purposes of the permanent establishment, *ensuring that business profits will be taxed on a net basis*" (emphasis added). Thus, the possible treatment of deductions from internal dealings as base erosion payments would violate Article 7(3) of the U.S.-U.K. Treaty (and other U.S. income tax treaties with a similar provision) to the extent that it could cause a foreign corporation to be taxed in an amount higher than the net business profits attributed to the U.S. PE.

Treaties are not given precedence over statutes because of their nature as treaties.[100] Under the Constitution, treaties rank, with federal laws, as the supreme law of the land.[101] Historically, though, absent specific legislative history or explicit statutory override, courts have upheld existing treaties that conflict with subsequent laws.[102] According to the Supreme Court, a "treaty will not be deemed to have been abrogated or modified by a later statute, unless such purpose on the part of Congress has been clearly expressed."[103] Therefore, if courts will not interpret a statute to abrogate a treaty without clear congressional intent, then regulations issued under such statute should also not be treated as overriding U.S. income tax treaties.

In enacting section 59A, though, Congress expressed no explicit intent to override U.S. income tax treaties, whether in the statute or in the legislative history.[104] Accordingly, because Prop. Reg. §1.59A-3(b)(4)(v)(B) contradicts U.S. income tax treaties without adequate statutory authority, internal dealings should be excluded from the definition of a base erosion payment.

[97]Treasury Department Technical Explanation to the 2006 U.S. Model Tax Treaty, Article 7.

[98]The 2010 OECD Report, Part IV, C-1(iii)(f), section 166.

[99]The Convention between the United States of America and the Government of the United Kingdom of Great Britain and Northern Ireland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and on Capital Gains, signed on July 24, 2001, as amended by a protocol signed on July 19, 2002, and as clarified by competent authority agreements dated April 11, 2005, October 6, 2006, and October 18, 2007 ("**U.S.-U.K. Treaty** ").

[100]Section 7852(d).

[101]U.S. Const. art. VI, cl. 2.

[102]*Cook v. United States*, 288 U.S. 102, 120 (1933). Applying this principle in cases involving treaty obligations, the Court has stated that "a treaty will not be deemed to have been abrogated or modified by a later statute unless such purpose on the part of Congress has been clearly expressed." *Trans World Airlines, Inc. v. Franklin Mint Corp.*, 466 U.S. 243, 252 (1984) (quoting *Cook v. United States*, 288 U.S. 102, 120 (1933)); *see also Washington v. Washington Commercial Passenger Fishing Vessel Ass'n*, 443 U.S. 658, 690 (1979) ("Absent explicit statutory language, we have been extremely reluctant to find congressional abrogation of treaty rights."); *Menominee Tribe of Indians v. United States*, 391 U.S. 404, 412-13 (1968) ("the intention to abrogate or modify a treaty is not to be lightly imputed to the Congress" (quoting Pigeon River Co. v. Cox Co., 291 U.S. 138, 160 (1934))). In *Trans World Airlines*, the Court relied on this principle to sustain its conclusion that the Warsaw Convention's cargo liability limit was enforceable in U.S. courts, notwithstanding subsequent acts of Congress that could reasonably have been interpreted to render that Convention unenforceable. *See Trans World Airlines*, 466 U.S. at 251-53.

[103]*Id*. (emphasis added); *see Estate of Burghardtv. Commissioner*, 80 T.C. 705, 717 (1983) (finding no congressional intent to abrogate provision of tax treaty).

[104]On the contrary, indicating Congress's intent not to override U.S. income tax treaties, Tom Barthold, Chief of Staff for the Joint Committee on Taxation, responded to a question from the then Ranking Member of the Senate Foreign Relations Committee about the interaction between the BEAT and the treaties in the Senate Committee on Finance's markup session, saying that "[The BEAT] is structured as an alternative tax compared to the income tax. So *I think our view is that there is not a treaty override inherent in that design*" (emphasis added). Open Executive Session to Consider an Original Bill Entitled the "Tax Cuts and Jobs Act" (Cont'n Nov. 14, 2017): Hearing on H.R. 1 Before the S. Comm. on Finance, 115th Cong. 163 (2017) (question from Sen. Benjamin L. Cardin, D-Md.).

Observations on the BEAT Proposed Regulations' Impact On Banks by Mike Gaffney and Danny Simon (TNI, March 18, 2019)

Treaty Approach

Although most foreign banks use domestic law under reg. section 1.882-5, some use a treaty-based approach to determine the profit or loss attributable to their U.S. PEs, and a subset of them have U.S. treaties that have been updated to include the AOA.[37] Interestingly, perhaps to maintain some parity with the foreign banks using reg. section 1.882-5, the proposed regulations may treat some internal dealings under a treaty as a base erosion payment. As we explain, however, the proposed rule goes too far.

The proposed regulations provide that when a foreign corporation determines the profits attributable to a PE by applying transfer pricing principles by analogy (under an applicable income tax treaty), any deduction attributable to any amount paid or accrued (or treated as paid or accrued) by the PE to the foreign corporation's home office or to another branch of the foreign corporation (an internal dealing) is treated as "regarded" for purposes of applying the BEAT and may therefore constitute a base erosion payment. This is even though treaty-based approaches to attributing profits to a PE recognize these internal dealings within a single legal entity only for profit attribution and do not create actual transactions or payments between related parties.

To put it mildly, recognizing these internal dealings as base erosion payments runs counter to basic fundamental U.S. tax principles. See, for example, the preamble to the proposed GD regulations under which Treasury previously specified that "consistent with U.S. tax principles . . . an agreement between two [qualified business units] of a single taxpayer does not give rise to a transaction because a taxpayer cannot enter into nor profit from a 'transaction' with itself." Treaty-based approaches *allocate* income and expense items among different qualified business units of the same entity — they don't create fictitious transactions between branches or between a branch and its head office. We believe that if a treaty-based approach allocates an amount from a head office to the U.S. branch and that amount is the result of the corporation paying or accruing an amount to a foreign related party, this should be a base erosion payment. However, it is a mistake in tax policy and practice to consider all internal dealing amounts from tax treaties as base erosion payments.

23/ The U.S. treaties with Belgium, Bulgaria, Canada, Germany, Iceland, Japan, and the United Kingdom have been updated to include the AOA. For a description of the approach, see 2010 AOA, *supra* note 23.

USCIB Comment Letter on Prop Reg 59A (Feb. 19, 2019)

I.I. Deductions from Internal Dealings allowed in Computing Business Profits of the PE

Under § **1.59A-3(b)(4)(v)(B)** of the proposed regulations, "deductions" from internal dealings allowed in computing business profits of a U.S. permanent establishment ("PE") are treated as base eroding payments to the extent they would be so treated under § 1.59A-3(b)(1). The proposed regulations conflict with the Authorized OECD Approach ("AOA") with respect to internal dealings. Internal dealings are only relevant for the purposes of determining the profit of the permanent establishment and are not otherwise recognized.[3] The United States has been a supporter of the AOA[4] and that approach has been subject to question by other countries, including countries that would like to recognize those dealings for purposes of imposing withholding taxes. Extending the BEAT to internal dealings would lend support to those positions. USCIB, therefore, recommends that the final regulations reverse the decision of the proposed regulations and exclude internal dealings from treatment as a BEAT payment.

[3] OECD 2010 Report on the Attribution of Profits to Permanent Establishments, July 22, 2010, Part 1, B-2, section 11, at page 13.

[4] Treasury Department Technical Explanation to the 2006 U.S. Model Tax Treaty, Article 7. Page 23, ". . . . the use of the Transfer Pricing Guidelines applies only for purposes of attributing profits within the legal entity. It does not create legal obligations or other tax consequences that would result from transactions having independent legal significance." Although the U.S. Treasury has issued a new U.S. Model Income Tax Treaty and Preamble in 2016, the Treasury did not issue a new Model Technical Explanation.

Silicon Valley Tax Directors Group Comments on Prop Regs. 59A (Feb. 19, 2019)

I.B.[B] The rule in Prop. § 1.59A-3(b)(4)(v) deeming base erosion payments in the context of a U.S. PE exceeds the authority of Treasury and the IRS

Clause **1.59A-3(b)(4)(v)(B)** provides that if, under an income tax treaty, a foreign corporation determines profits attributable to a U.S. PE based on assets used, risks assumed, and functions performed by such PE, then "any deduction attributable to any amount paid or accrued (or treated as paid or accrued)" by the PE either to the foreign corporation home office or to another branch of the foreign corporation — a so-called "internal dealing" — is a base erosion payment to the extent it meets the general requirements for a base erosion payment. We believe the rule in Prop. § 1.59A-3(b)(4)(v) exceeds the authority of Treasury and the IRS under § 59A, because it's contrary to § 59A(d)(1). We accordingly recommend it be withdrawn.

II.B

B. The rule in Prop. § 1.59A-3(b)(4)(v) deeming base erosion payments in the context of a U.S. PE exceeds the authority of Treasury and the IRS

Clause **1.59A-3(b)(4)(v)(B)** provides that if, under an income tax treaty, a foreign corporation determined profits attributable to a U.S. PE based on assets used, risks assumed, and functions performed by such PE, then "any deduction attributable to any amount paid or accrued (or treated as paid or accrued)" by the PE either to the foreign corporation home office or to another branch of the foreign corporation — a so-called "internal dealing" — is a base erosion payment to the extent it meets the general requirements for a base erosion payment in Prop. § 1.59A-3(b)(1). Clause 1.59A-3(b)(4)(v)(A) has a parallel but more complex rule applicable in certain situations if a foreign corporation elects to determine its taxable income using "business profits" provisions of an income tax treaty for determining ECI.

We believe the rule in Prop. § 1.59A-3(b)(4)(v) exceeds the authority of Treasury and the IRS under § 59A.

Paragraph 59A(d)(1) defines a base erosion payment generally as any amount "paid or accrued" by the taxpayer to "a foreign person [that] is a related party of the taxpayer," if a deduction is allowable with respect to such amount. An "internal dealing" doesn't involve an actual payment — it's a construct whose existence is inferred solely for determining an arm's length attribution of profit to a PE.[4] Clause 1.59A-3(b)(4)(v)(A) refers to "any amount paid or accrued (or treated as paid or accrued) by the [PE] . . ." (emphasis added) but a base erosion payment only arises under § 59A(d)(1) if any amount is actually "paid or accrued." In creating the *TCJA*, Congress wrote tax statutes using the parenthetical "(or treated as paid or accrued)" if it intended that deemed amounts paid or accrued also — i.e., in addition to actual amounts paid or accrued — be included in a provision.[5] But Congress didn't use that language in § 59A(d)(1), and this means Congress didn't intend deemed amounts paid or accrued to give rise to base erosion payments.[6]

Paragraph 59A(d)(1) also requires a base erosion payment be made to a foreign person that's a related party to the taxpayer. The requirement that the recipient of a base erosion payment be an actual related foreign person isn't met by a payment arising from an internal dealing because such payment is, of course, purely internal — within the same entity: the foreign corporation with a sufficiently extant U.S. taxable presence.

Because the rule in Prop. § 1.59A-3(b)(4)(v) is contrary to § 59A(d)(1), we recommend it should be withdrawn.

[4]OECD, *2010 Report on the Attribution of Profits to a Permanent Establishment*, ¶ 176. The same document explained (¶ 203), using the example of a notional royalty payment, that "[t]he recognition of the notional royalty is relevant only to the attribution of profits to the PE under Article 7 and should not be understood to carry wider implications as regards withholding taxes. . . ." By parity of reasoning, notional payments arising from internal dealings shouldn't be treated as base erosion payments.

[5]*See, e.g.*, § 245A(d)(1) (referring to "taxes paid or accrued (or treated as paid or accrued)") and § 965(g)(1) (likewise).

[6]*See, e.g.*, *Barnhart v. Simon Coal Co., Inc.*, 534 U.S. 438, 461–462 ("We have stated time and again that courts must presume that a legislature says in a statute what it means and means in a statute what it says there." (citations omitted)).

COMMENTS BY ALLIANCE FOR COMPETITIVE TAXATION ON PROPOSED REGULATIONS IMPLEMENTING SECTION 59A (Feb 19, 2019)

II. A. 1. Internal dealings of a treaty-eligible entity (Prop. Reg. § 1.59A-3(b)(4)(v)(B))

Proposed Regulations

Prop. Reg. § 1.59A-3(b)(4)(v)(B) provides:

If, pursuant to the terms of an applicable income tax treaty, a foreign corporation determines the profits attributable to a permanent establishment based on the assets used, risks assumed, and functions performed by the permanent establishment, then any deduction attributable to any amount paid or accrued (or treated as paid or accrued) by the permanent establishment to the foreign corporation's home office or to another branch of the foreign corporation (an "internal dealing") is a base erosion payment to the extent such payment or accrual is described under [Prop. Reg. § 1.59A-3(b)(1)].

Treasury Explanation

The preamble states that the approach in the Proposed Regulations is intended to create parity between deductions for actual regarded payments between two separate corporations (which are subject to section 482) and internal dealings (which are generally priced in a manner consistent with the applicable treaty and, if applicable, the OECD Transfer Pricing Guidelines).[1]

ACT Recommendation

ACT recommends that internal dealings be excluded from the definition of base erosion payments.

Reasons for ACT Recommendation

The method of attributing profits to a permanent establishment ("PE") under an applicable income tax treaty referenced by Prop. Reg. § 1.59A-3(b)(4)(v)(B) is commonly referred to as the Authorized OECD Approach ("AOA"). However, because under U.S. federal income tax rules, internal dealings within a single corporation are generally disregarded, the AOA is limited to the specific purpose of attributing profits to a PE.[2] The OECD 2010 Report on the Attribution of Profits to Permanent Establishments (the "2010 OECD Report") emphasizes the limited application of the AOA:[3]

The hypothesis by which a PE is treated as a functionally separate and independent enterprise is ***a mere fiction necessary for purposes of determining the business profits of this part of the enterprise under Article 7***. The authorised OECD approach should not be viewed as implying that the PE must be treated as a separate enterprise entering into dealings with the rest of the enterprise of which it is a part ***for purposes of any other provisions of the Convention***. (. . .)

In this context, it should be noted that ***the aim of the authorised OECD approach is not to achieve equality of outcome between a PE and a subsidiary in terms of profits*** but rather to apply to dealings among separate parts of a single enterprise the same transfer pricing principles that apply to transactions between associated enterprises. (Emphasis added.)

The 2010 OECD Report reiterates that recognizing internal dealings "does not carry wider implications as regards, for example, withholding taxes."[4]

Similarly, the U.S. Treasury Technical Explanation to the 2006 U.S. Model Tax Treaty provides:[5]

[A]ny of the methods used in the Transfer Pricing Guidelines, including profits methods, may be used as appropriate and in accordance with the Transfer Pricing Guidelines. However, the use of the Transfer Pricing Guidelines ***applies only for purposes of attributing profits within the legal entity. It does not create legal obligations or other tax consequences that would result from transactions having independent legal significance***. (Emphasis added.)

Regulations under other provisions of the Code generally do not recognize internal dealings within a single corporation or taxpayer. Under Prop. Reg. § 1.863-3(h)(3)(iii), for example, "[a]n agreement among QBUs of the same taxpayer to allocate income, gain or loss from transactions with third parties is not a transaction because a taxpayer cannot enter into a contract with itself."[6] Similarly, under Treas. Reg. § 1.882-5, interbranch transactions of any type between separate offices or branches of the same taxpayer do not result in the creation of an asset or a liability.[7] Further, under Treas. Reg. § 1.1503(d)-5(c)(1)(ii), items of income, gain, deduction, and loss that are otherwise disregarded for U.S. tax purposes are not taken into account for determining the income or dual consolidated loss attributable to a separate unit.[8]

Accordingly, treating internal dealings as base erosion payments for BEAT purposes is inconsistent with the limited application of the AOA and contrary to the general U.S. tax principle of disregarding intra-taxpayer transactions.

Moreover, BEAT only applies if there is an amount "paid or accrued."[9] Internal dealings, on the other hand, are fictional transactions created for the mere purpose of determining business profits attributable to a PE, and as such, do not produce any payment or accrual. Nothing in section 59A suggests that a base erosion payment may include an amount "deemed" paid or accrued or "treated as" paid or accrued. Subjecting to section 59A hypothetical transactions that do not actually exist is inconsistent with the statutory language of section 59A.

Further, imposing U.S. tax on account of internal dealings under section 59A violates the U.S. income tax treaties that have incorporated the AOA under the business profits article. This is because taxing amounts treated as paid by a U.S. PE to the home office under section 59A conflicts with the treaty exemption from U.S. taxation of these amounts.[10] Absent explicit legislative history or statutory override, existing treaties generally are not abrogated by subsequent laws that come into conflict.[11] In enacting section 59A, Congress expressed no intent to override U.S. income tax treaties.[12]

For the above reasons, ACT recommends that internal dealings (within the meaning of Prop. Reg. § 1.59A-3(b)(4)(v)(B)) be excluded from the definition of base erosion payments.

Regulatory Authority for Recommendation

Treasury has authority under section 59A(i) to "prescribe such regulations or other guidance as may be necessary or appropriate to carry out the provisions of [section 59A]." In addition, Treasury has the authority to adopt "all needful rules and regulations" under section 7805(a).

[2]*See*, *e.g.*, Department of the Treasury Technical Explanation to the U.S.-U.K. Tax Treaty, Art. 7.

[3]OECD 2010 Report on the Attribution of Profits to Permanent Establishments, Part 1, B-2, Section 11, July 22, 2010, www.oecd.org/ctp/transfer-pricing/45689524.pdf.

[4]The 2010 OECD Report, Part IV, C-1(iii)(f), section 166.

[5]Treasury Department Technical Explanation to the 2006 U.S. Model Tax Treaty, Art. 7. No substantive changes were made to Article 7 of the subsequent 2016 U.S. Model Tax Treaty that would affect the above Technical Explanation.

[6]*See also* Treas. Reg. § 1.446-3(c)(1)(i) ("An agreement between a taxpayer and a qualified business unit (as defined in section 989(a)) of the taxpayer, or among qualified business units of the same taxpayer, is not a notional principal contract because a taxpayer cannot enter into a contract with itself.").

[7]*See* Treas. Reg. §§ 1.882-5(b)(1)(iv) and (c)(2)(viii).

[8]*See* Treas. Reg. § 1.1503(d)-7(c) Example 23.

[9]*See* section 59A(d).

[10]*See, e.g.*, Convention between the United States of America and the Government of the United Kingdom of Great Britain and Northern Ireland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and on Capital Gains, signed on July 24, 2001, as amended by a protocol signed on July 19, 2002, and as clarified by competent authority agreements dated April 11, 2005, October 6, 2006, and October 18, 2007 (the "U.S.-U.K. Treaty"), Art. 7(1).

[11] *Cook v. United States*, 288 U.S. 102, 120 (1933). Applying this principle in cases involving treaty obligations, the Court has stated that "a treaty will not be deemed to have been abrogated or modified by a later statute unless such purpose on the part of Congress has been clearly expressed." *Trans World Airlines, Inc. v. Franklin Mint Corp.*, 466 U.S. 243, 252 (1984) (quoting *Cook v. United States*, 288 U.S. 102, 120 (1933)); *see also Washington v. Washington Commercial Passenger Fishing Vessel Ass'n*, 443 U.S. 658, 690 (1979) ("Absent explicit statutory language, we have been extremely reluctant to find congressional abrogation of treaty rights."); *Menominee Tribe of Indians v. United States*, 391 U.S. 404, 412-13 (1968) ("the intention to abrogate or modify a treaty is not to be lightly imputed to the Congress" (quoting *Pigeon River Co. v. Cox Co.*, 291 U.S. 138, 160 (1934)).

[12] Congress had historically acknowledged that absent explicit override, treaties are given the regard which it is due under the ordinary rule of interpreting the interactions of statutes and treaties. *See* Technical and Miscellaneous Revenue Act of 1988, H.R. 4333, 100th Cong. § 2 (1988) ("[W]here a treaty obligation calls for a certain tax result with respect to a particular item of income (whether that result is to exempt that item of tax or reduce the rate of U.S. tax on that item), that result differs from the result called for under a Code provision, and that treaty obligation has not been superseded for internal U.S. law purposes, the agreement acknowledges that taxpayers and the IRS can look beyond the Code to determine the proper tax treatment of the item of income in question.").

<u>Materials Relating to Act III Bar Room Brawl Over Digital Taxes</u>

European Commission, Council Directive COM(2018) 148 final *Excerpt*

Proposal for a

COUNCIL DIRECTIVE

on the common system of a digital services tax on revenues resulting from the provision of certain digital services

Brussels, 21.3.2018

<u>EXPLANATORY MEMORANDUM</u>

1. CONTEXT OF THE PROPOSAL

Reasons for and objectives of the proposal

The Digital Single Market is one of the main political priorities of the European Commission[1], which aims at opening up digital opportunities for people and businesses in a market of over 500 million EU consumers. In order to deliver on its potential, the Digital Single Market needs a modern and stable tax framework which stimulates innovation, tackles market fragmentation and allows all players to tap into the new market dynamics under fair and balanced conditions. Ensuring fair taxation of the digital economy is also part of the European Commission's agenda on a fair and efficient tax system in the European Union[2].

The digital economy is transforming the way we interact, consume and do business. Digital companies are growing far faster than the economy at large, and this trend is only set to continue. Digital technologies bring many benefits to society and, from a tax perspective, they create opportunities for tax administrations and offer solutions to reduce administrative burdens, facilitate collaboration between tax authorities, as well as addressing tax evasion.

However, policy makers are currently struggling to find solutions which can ensure a fair and effective taxation as the digital transformation of the economy accelerates, given that the existing corporate taxation rules are outdated and do not capture this evolution. In particular, the current rules no longer fit the present context where online trading across borders with no physical presence has been facilitated, where businesses largely rely on hard-to-value intangible assets, and where user generated contents and data collection have become core activities for the value creation of digital businesses.

At the international level, the Organisation for Economic Co-operation and Development (OECD) already recognised, in its Action 1 report[3] which was released in 2015 as part of the OECD/G20 Base Erosion and Profit Shifting (BEPS) project, that digitalisation and some of the resulting business models present challenges for international taxation. Following that report, the G20 Finance Ministers reiterated their support for the OECD's work on taxation and digitalisation. Hence, the OECD has been working on an interim report[4] on the taxation of the digital economy which was presented to the G20 Finance Ministers in March 2018. The interim report examines the need to adapt the international tax system to the digitalisation of the economy and identifies the elements to be taken into account by those countries wishing to introduce interim measures to address the tax challenges arising from digitalisation.

At Union level, such challenges were identified in the Communication of the Commission "A Fair and Efficient Tax System in the European Union for the Digital Single Market"[5], adopted on 21 September 2017. The current initiative was also mentioned in President Juncker's letter of intent accompanying the State of the Union Address 2017[6]. As regards Member States, several EU Finance Ministers co-signed a political statement ("Joint initiative on the taxation of companies operating in the digital economy") that supported EU law compatible and effective solutions "based on the concept of establishing a so-called 'equalisation tax' on the turnover generated in Europe by the digital companies"[7]. This was followed by the conclusions adopted on 19 October 2017 by the European Council[8] that underlined the "*need for an effective and fair taxation system fit for the digital era*". Furthermore, the ECOFIN Council Conclusions of 5 December 2017[9] noted the interest of many Member States for temporary measures, such as a levy based on revenues from digital activities in the Union, and considered that these measures could be assessed by the Commission.

This proposal answers these calls for action, and addresses in an interim way the problem that the current corporate tax rules are inadequate for the digital economy.

The current corporate tax rules were conceived for traditional businesses. The existing tax rules are built on the principle that profits should be taxed where the value is created. However, they were mainly conceived in the early 20th century for traditional "brick and mortar" businesses and define what triggers a right to tax in a country (where to tax) and how much of corporate income is allocated to a country (how much to tax) largely based on having a physical presence in that country. That means that non-tax residents become liable to tax in a country only if they have a presence that amounts to a permanent establishment there. However, such rules fail to capture the global reach of digital activities where physical presence is not a requirement anymore in order to be able to supply digital services. Moreover, digital business have different characteristics than traditional ones in terms of how value is created, due to their ability to conduct activities remotely, the contribution of end-users in their value creation, the importance of intangible assets, as well as a tendency towards winner-takes-most market structures rooted in the strong presence of network effects and the value of big data.

The application of the current corporate tax rules to the digital economy has led to a misalignment between the place where the profits are taxed and the place where value is created, notably in the case of business models heavily reliant on user participation. This poses a double challenge from a tax perspective. Firstly, the input obtained by a business from users, which actually constitutes the creation of value for the company, could be located in a tax jurisdiction where the company carrying out a digital activity is not physically established (and thus not established for tax purposes according to the current rules) and where therefore the profits generated from such activities cannot be taxed. Secondly, even where a company has a permanent establishment in the jurisdiction where the users are located, the value created by user participation is not taken into account when deciding how much tax should be paid in each country. This has also consequences from the perspective of the risk to artificially avoid permanent establishment rules, creates distortion of competition between digital market players, and has a negative impact on revenues.

The Commission has acknowledged that the ideal approach would be to find multilateral, international solutions to taxing the digital economy given the global nature of this challenge. The Commission is working closely with the OECD to support the development of an international solution. However, progress at international level is challenging, due to the complex nature of the problem and the wide variety of issues that need to be addressed, and reaching international consensus may take time. This is why the Commission has decided to take action and is proposing today to adapt the corporate tax rules at Union level so that they are fit for the characteristics of digital businesses[10] and to recommend that Member States extend this comprehensive solution to their double taxation treaties with non-Union jurisdictions[11]. Whilst the ECOFIN Council also stressed in its conclusions of 5 December 2017 its preference for a global solution endeavouring to closely monitor future international developments and consider appropriate responses, it welcomed EU action. Despite the present proposals, work at the OECD level is essential in order to reach a global consensus on this topic. The Commission will closely follow the developments.

In the wait of the comprehensive solution, which may take time to adopt and implement, Member States face pressure to act on this issue, given the risk that their corporate tax bases are significantly eroded over time, and also due to the perceived unfairness of the situation. While unilateral measures are in place or are concretely planned in 10 Member States for addressing this problem in a limited way, the trend has been increasing and the measures adopted are very diverse in terms of scope and their rationale. Such uncoordinated measures taken by Member States individually risk further fragmenting the Single Market and distort competition, hampering the development of new digital solutions and the Union's competitiveness as a whole.

Hence, it is necessary for the Commission to act and to propose a harmonised approach on an interim solution that tackles this problem in a targeted way. To this extent, this proposal sets out the common system of a tax on the revenues derived from the supply of certain digital services by taxable persons (hereinafter "Digital Services Tax" or "DST"). The specific objective of this proposal is to put forward a measure that targets the revenues stemming from the supply of certain digital services and that is easy to implement and helps to level the playing field in the interim period until a comprehensive solution is in place.

This is in line with the general objectives of this proposal, whose aim is:

- to protect the integrity of the Single Market and to ensure its proper functioning;

- to make sure that the public finances within the Union are sustainable and that the national tax bases are not eroded;

- to ensure that social fairness is preserved and that there is a level playing field for all businesses operating in the Union; and

- to fight against aggressive tax planning and to close the gaps that currently exist in the international rules which makes it possible for some digital companies to escape taxation in countries where they operate and create value.

Consistency with existing policy provisions in the policy area

This proposal is part of the efforts being undertaken at Union and international level in order to adapt the current tax framework to the digital economy.

At international level, the challenge of ensuring that all actors in the digital economy are fairly taxed on their income was already identified under the Action 1 of the OECD/G20 BEPS project and the OECD has been working on an interim report on the taxation of the digital economy which was presented to the G20 Finance Ministers in March 2018.

At Union level, fair tax rules for the taxation of the digital economy are part of the Commission's fair taxation agenda, which will complement the improvements of the corporate tax framework achieved in recent years. In this respect, the Commission relaunched in 2016 the proposal on a Common Consolidated Corporate Tax Base (CCCTB)[12], which will provide a competitive, fair and robust framework for taxing companies in the Single Market. In the area of VAT, the Commission is also addressing the challenges posed by the digital economy with its proposal on e-commerce which the Council adopted in December 2017[13], which is in line with other legislative measures laid down in the 2016 Action Plan on VAT[14].

This proposal is part of a package which also includes a proposal for a Directive on a comprehensive solution[15], a Recommendation to Member States to reflect the comprehensive solution in their double taxation treaties with non-Union jurisdictions[16] and a Communication setting the context and explaining the articulation between the proposals[17]. The principles underpinning this proposal and, in particular, the notion of user value creation are aligned with the proposal for a Directive on a comprehensive solution and the Recommendation, as explained in the Communication. Notably, this interim measure covers those cases where the contribution of users to the creation of value for a company is more significant, while the concept of user value creation is also the factor which the comprehensive solution aims to reflect in the corporate tax framework.

Consistency with other Union policies

This proposal is also consistent with the Digital Single Market strategy[18], where the Commission committed to ensure access to online activities for individuals and businesses under conditions of fair competition, as well as to open up digital opportunities for people and business and enhance Europe's position as a world leader in the digital economy.

2. LEGAL BASIS, SUBSIDIARITY AND PROPORTIONALITY

Legal basis

The proposed Directive is based on Article 113 of the Treaty on the Functioning of the European Union (TFEU). This provision enables the Council, acting unanimously in accordance with a special legislative procedure and after consulting the European Parliament and the European Economic and Social Committee, to adopt provisions for the harmonisation of Member States' legislation concerning other forms of indirect taxation to the extent that such harmonisation is necessary to ensure the establishment and the functioning of the internal market and to avoid distortion of competition.

Subsidiarity (for non-exclusive competence)

The proposal is consistent with the principle of subsidiarity as set out in Article 5(3) of the Treaty on European Union (TEU). In the wait of a common and coordinated action at Union level to reform the corporate tax framework to cover the digital activities of companies, Member States may introduce unilateral interim measures to address the challenges of taxing the digital economy companies. Some of such measures, which can be of a very diverse nature, are already in place or are being planned by Member States. In this respect, EU action is necessary in order to mitigate the fragmentation of the Single Market and the creation of distortions of competition within the Union due to the adoption of such divergent unilateral actions at national level. Moreover, an EU solution rather than different national policies entails a reduction in the compliance burden for businesses subject to the new rules, and also gives a strong sign to the international community as to the commitment of the EU to act when it comes to ensuring the fair taxation of the digital economy.

Proportionality

The preferred option is consistent with the principle of proportionality, that is, it does not go beyond what is necessary to meet the objectives of the Treaties, in particular the smooth functioning of the Single Market. As follows from the subsidiarity test, it is not possible for Member States to address the problem without hampering the Single Market. Moreover, the present proposal aims at setting a common structure of the tax, while leaving sufficient margin of manoeuvre for Member States when it comes to actual setting of certain administrative aspects related to the measure, such as accounting, record-keeping and other obligations intended to ensure that the DST due is effectively paid. Member States can also adopt measures concerning the prevention of evasion, avoidance and abuse with respect to DST, and they retain the capacity to enforce payment of DST and to carry out tax audits according to their own rules and procedures. See also section 9.4.2 of the impact assessment accompanying this proposal[19].

Choice of the instrument

A Directive is proposed, which is the only available instrument under Article 113 of the TFEU.

House Ways and Means, Senate Finance Leaders' Statement on Unilateral Digital Services Taxes, OECD Negotiations to Address the Tax Challenges of the Digitalization of the Economy

APRIL 10, 2019 — **PRESS RELEASES**

Washington, D.C. – Today, the top Republican on the House Ways and Means Committee Kevin Brady (R-TX), Senate Finance Committee Chairman Chuck Grassley (R-IA), House Ways and Means Committee Chairman Richard Neal (D-MA), and Senate Finance Committee Ranking Member Ron Wyden (D-OR) released the following statement:

"The tax challenges that have arisen due to digitalization of the economy affect businesses headquartered all over the world, and solutions to these challenges are best negotiated multilaterally. We are supportive of the United States participating in the ongoing OECD negotiations on these solutions. We call on other countries to focus on and engage productively in the OECD dialogue in order to reach measured and comprehensive solutions, and abandon unilateral measures. Even on an interim basis, unilateral actions, such as digital services taxes proposed by some countries, can adversely affect U.S. businesses and have negative economic and diplomatic effects.

"We look forward to engaging with the Treasury Department throughout this process and evaluating the outcome of the OECD's work and its impact on U.S. taxpayers and the U.S. treasury."

Background: Under the OECD/G-20 Inclusive Framework on base erosion and profit shifting (BEPS), over 125 countries are currently negotiating solutions to address the tax challenges of the digitalization of the economy. The G-20 finance ministers and other senior government representatives are meeting in Washington this week. The French National Assembly passed a unilateral digital services tax that would disproportionately affect U.S. technology companies. The law is expected to be taken up by the French Senate soon.

Rep. Brady has been a leader in pushing back on various digital tax proposals from foreign countries, fighting for U.S. companies to not be subject to double taxation from this blatant revenue grab.

LaHood Leads Effort to Combat Discriminatory Tax Proposals Targeting U.S. Businesses

WASHINGTON, D.C. — Congressman Darin LaHood (R-IL) led a letter to President Donald Trump urging his administration use all appropriate tools to address France and other European countries proposed digital services tax that targets US companies, US exports, and the US tax base. Rep. LaHood was joined by 15 Republicans on the Ways and Means Committee.

"Proposals by the French and other countries designed to explicitly target US companies through a digital services tax is wholly unacceptable and the US should be prepared to use any necessary tools to combat these actions," **stated Rep. LaHood.** "Efforts by the French and others contradict longstanding global consensus-based practices and would result in double taxation on American businesses. We cannot sit on the sidelines as countries attempt to fund their governments by seizing the revenue of American businesses. I am proud to lead this effort and I urge President Trump and his Administration to forcefully engage on this issue, making it known that these types of practices won't stand."

The Digital Services Tax

Across Europe, countries are proposing discriminatory three to five percent revenue taxes on digital services U.S. technology firms provide. These Digital Service Taxes (DST) are narrow in scope and are specifically designed to target U.S. digital companies that export services into European countries. These proposals directly contradict the international trade commitments made by the European Union and the global consensus-based Organization for Economic Cooperation and Development (OECD) process.

France's Proposal

In March of 2019, the French government proposed a unilateral DST on digital advertising, online platforms, and the transfer of data specifically aimed at U.S. technology companies. Under the proposal, U.S. companies could be charged up to 5 percent on gross revenue and it would be enacted retroactively to January 1, 2019. The French have made it explicitly clear that this proposal is designed for the purpose of going after American businesses and Finance Minister Lemaire has indicated this will raise the French over 500 million euros.

Beyond Europe, the World is Keenly Watching

The French proposal comes on the heels of the European Union's decision late last year to reject new revenue taxes narrowly targeted at U.S. digital companies. In addition, Germany, the United Kingdom, Italy, Spain, and Austria have proposed implementing similar digital service taxes. As European countries consider these discriminatory actions, the global community is looking on and preparing to follow the lead of others in targeting U.S. tech companies. American businesses shouldn't have their revenue seized to subsidize governments around the world and the U.S. should be prepared to engage on this issue.

April 3, 2019

President Donald J. Trump
The White House
1600 Pennsylvania Ave. NW
Washington, DC 20500

Dear Mr. President,

We are writing to express our serious concern regarding France's proposed digital services tax that targets US companies, US exports, and the US tax base. We urge you and your Administration to use all appropriate tools to address this issue.

On March 6, the French Government proposed a digital services tax that is designed and explicitly intended to target US companies. It sets a narrow definition of the types of services subject to tax, as well as specific revenue thresholds, that together ensure that US companies are the main taxpayers. Indeed, France's Finance Minister has been explicit about his intent to target US companies with this tax. Finally, to make matters worse, France proposes to make this tax retroactive to January 1 and to apply it to revenues, not profits. Other trading partners in Europe and elsewhere are considering similar discriminatory taxes, compounding the problem.

You have outlined a vision of negotiating zero tariffs, zero non-tariff barriers and zero subsidies in transatlantic trade, and we strongly agree with this objective. Yet as leading trade experts have noted, such a digital tax is discriminatory and operates like a “de facto” tariff on US exports and represents a move in exactly the wrong direction.

In addition to being an unfair trade barrier, France's digital services tax threatens the US tax base. The French Government asserts that US companies should be paying more tax in France and less tax in the US. The appropriate allocation of taxing rights is an issue that France should not dictate to the US through unfair trade actions. Instead, governments need to agree on common principles, work that Secretary Mnuchin has been ably leading at the OECD. France is looking to claim EUR500 million per year, the UK has passed similar legislation due to take effect next year, and other countries have said they will follow suit. We cannot sit by while these countries fund their government spending by seizing revenue that does not belong to them.

France, the UK, and other countries should immediately cease any unilateral actions that target US companies and instead focus their energy and efforts on the multilateral solutions that are being developed at the OECD. We urge your Administration to engage forcefully on these issues, including addressing them as a trade barrier.

Sincerely,

Darin LaHood
Member of Congress

Vern Buchanan
Member of Congress

Kenny Marchant
Member of Congress

Mike Kelly
Member of Congress

Jason Smith
Member of Congress

David Schweikert
Member of Congress

Brad Wenstrup
Member of Congress

A. Drew Ferguson, IV DMD
Member of Congress

Devin Nunes
Member of Congress

Adrian Smith
Member of Congress

Tom Reed
Member of Congress

George Holding
Member of Congress

Tom Rice
Member of Congress

Jackie Walorski
Member of Congress

Jodey Arrington
Member of Congress

Ron Estes
Member of Congress

CC:
The Honorable Steven Mnuchin, Secretary of the Treasury
Ambassador Lighthizer, United States Trade Representative

U.S. Senate Finance Leaders Ask Mnuchin to Weigh In on Digital Services Taxes

January 29, 2019

The Honorable Steven T. Mnuchin
Secretary of the Treasury
Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

Dear Secretary Mnuchin:

We write to express our serious concern regarding unilateral action by foreign countries to establish digital services taxes designed to discriminate against U.S.-based multinational companies. It is important that you make clear to the representatives of these countries the need to abandon unilateral actions and work through the multilateral process at the Organisation for Economic Co-operation and Development (OECD). We support your active participation in this multilateral process.

In October 2018, then-Senate Finance Committee Chairman Orrin Hatch and Ranking Member Ron Wyden sent a letter to the Presidents of the European Council and the European Commission expressing strong concerns about the European Commission's proposal to enact a discriminatory and indefinite digital services tax targeted at certain U.S.-based multinational companies, under the guise of addressing some of the challenges arising from deployment by multinational companies of digital business models and new technologies across the global economy. The letter called on the European Council and European Commission to abandon this proposal and on member states to delay implementing unilateral measures similar to the digital services tax. Further, the letter recommended that countries work within the OECD to reach consensus on a multilateral solution to these issues.

As the current Chairman and Ranking Member of the Senate Finance Committee, we reiterate those sentiments and the need for a multilateral solution that is fair, does not discriminate against certain U.S.-based multinational companies, does not create a new transatlantic barrier to trade, and avoids double taxation. We agree with your view on the need for our OECD partners to complete the multilateral process and avoid taking unilateral actions.

Unfortunately, some countries are moving forward unilaterally with digital services taxes that follow similar frameworks as the previous European Commission proposal. It is important for these countries to understand the potential for long-term harm arising under these proposals and the need for each to refocus efforts on reaching multilateral consensus. The release of the OECD's Policy Note today shows the process is moving forward, and unilateral action will only serve to undercut that progress.

We are supportive of the United States Treasury Department's active participation in the ongoing negotiations at the OECD regarding these new tax challenges. We urge you and your OECD counterparts to work expeditiously to achieve agreement on a measured and comprehensive approach to how international tax rules might be crafted to address such challenges.

Given that the Senate Finance Committee has jurisdiction over U.S. laws governing cross-border tax and trade matters, we strongly encourage you and your staff to stay in close contact with us and our staff as negotiations progress and multilateral solutions are developed.

We appreciate your efforts on these matters.

Sincerely,

Charles E. Grassley
Chairman
U.S. Senate Committee on Finance

Ron Wyden
Ranking Member
U.S. Senate Committee on Finance

cc:
Robert E. Lighthizer, United States Trade Representative

Attachment:
Letter to The Honorable Donald Tusk, President of the European Council, and The Honorable Jean-Claude Juncker, President of the European Commission, October 18, 2018

OPPORTUNITY ZONES – WHAT FUND MANAGERS, INVESTORS AND DEVELOPERS SHOULD KNOW

Presented By:

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Opportunity Zones – What Fund Managers, Investors and Developers Should Know

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Krishna P. Vallabhaneni
Treasury Department

1

Topics

- General Anti-Abuse Rule
- Treatment of QOF Asset Sales
- Application of Working Capital Safe Harbor to Long-Term Projects
- Work in Progress
- Feeder Funds

2

The General Anti-Abuse Rule

§ 1.1400Z2(f)–1(c) *Anti-abuse rule*—(1) *In general.* Pursuant to section 1400Z–2(e)(4)(C), the rules of section 1400Z–2 and §§ 1.1400Z2(a)–1 through 1.1400Z2(g)–1 must be applied in a manner consistent with the purposes of section 1400Z–2. Accordingly, if a significant purpose of a transaction is to achieve a tax result that is inconsistent with the purposes of section 1400Z–2, the Commissioner can recast a transaction (or series of transactions) for Federal tax purposes as appropriate to achieve tax results that are consistent with the purposes of section 1400Z–2. Whether a tax result is inconsistent with the purposes of section 1400Z–2 must be determined based on all the facts and circumstances.

Preamble

"The purposes of sections 1400Z–1 and 1400Z–2 are to increase business activity and economic investment in qualified opportunity zones." 84 Fed. Reg. 18656

The Treasury Department and the IRS expect that most taxpayers will apply the rules in section 1400Z–2 and §§ 1.1400Z2(a)–1 through 1.1400Z2(g)–1 in a manner consistent with the purposes of section 1400Z–2. However, to prevent abuse, proposed § 1.1400Z2(f)–1(c) provides that if a significant purpose of a transaction is to achieve a tax result that is inconsistent with the purposes of section 1400Z–2, the Commissioner can recast a transaction (or series of transactions) for Federal tax purposes as appropriate to achieve tax results that are consistent with the purposes of section 1400Z–2. Whether a tax result is inconsistent with the purposes of section 1400Z–2 must be determined based on all the facts and circumstances. For example, this general anti-abuse rule could apply to treat a purchase of agricultural land that otherwise would be qualified opportunity zone business property as a purchase of non-qualified opportunity zone business property if a significant purpose for that purchase were to achieve a tax result inconsistent with the purposes of section 1400Z–2 (see part I.B of this Explanation of Provisions). 84 Fed. Reg. 18668-69

The Treasury Department and the IRS request comments on this proposed anti-abuse rule, including whether additional details regarding what tax results are inconsistent with the purposes of section 1400Z–2 is required or whether examples of particular types of abusive transactions would be helpful. 84 Fed. Reg. 18669.

Comparison with the Partnership Anti-Abuse Rule

§ 1.1400Z2(f)–1(c) *Anti-abuse rule*—(1) *In general.* Pursuant to section 1400Z–2(e)(4)(C), the rules of section 1400Z–2 and §§ 1.1400Z2(a)–1 through 1.1400Z2(g)–1 must be applied in a manner consistent with the purposes of section 1400Z–2. Preamble: "The purposes of sections 1400Z–1 and 1400Z–2 are to increase business activity and economic investment in qualified opportunity zones."

§ 1.701-2(a) **Intent of subchapter K.** Subchapter K is intended to permit taxpayers to conduct joint business (including investment) activities through a flexible economic arrangement without incurring an entity-level tax.

Example One

Debbie forms a QOF, which forms a QOZB. The QOZB constructs a golf course and leases it to the QOF, which operates it.

Is this abusive? The prohibition on sin businesses applies only to QOZBs. QOZBs are permitted to engage in a leasing business, and there's no prohibition on QOZBs leasing to sin businesses.

The new markets tax credit regulations prohibit leasing real property to a lessee engaged in a sin business. §1.45D-1(d)(5)(ii). The QOZ proposed regulations do not.

The golf course "increase[s] business activity and economic investment in [a] qualified opportunity zone."

Example Two

Krishna and Julie organize a QOF partnership to be the manager and general partner of a new private equity fund. The QOF will lease space in a QOZ from an unrelated lessor for fair market value.

Daniel, David, and Michael are first year analysts who will each work in the zone for 40 hours/week. Krishna and Julie will each work 40 hours/week, but outside the zone.

The PE fund will have unrelated investors, will be a buy and hold strategy, and will have an 11 year investment period. No income or gain is expected in the PE fund before termination. The PE fund pays 2% annual management fees to the QOF and issues the QOF a 20% carried interest. The QOF does not make an investment in the PE fund.

Krishna and Julie have $200,000 of unrelated capital gains, which equals the combined annual salary of David, Daniel, and Michael, and the first year of rent. Krishna and Julie contribute the $200,000 to the QOF, which is used by the QOF to prepay salary and rent.

All of the management fees earned by the QOF that are not used to pay future salary and rent are distributed to Krishna and Julie. The QOF uses the alternative valuation method. After ten years, Krishna and Julie sell their QOF for $1 billion.

Example Two (continued)

1. The lease is QOZBP. The lease has value for purposes of the 90% test, and the lease is the only positive asset for purposes of the 90% test because no other asset has a cost.
2. The carried interest and management contract are not QOZBP, but they has zero value for purposes of the 90% test.
3. The QOF satisfies the hours test because more employees work in the QOZ than out (and it is not clear whether Krishna and Julie are counted at all because they are partners and not employees or independent contractors).
4. Krishna and Julie can defer $200,000 of capital gains and avoid tax on $30,000 of that gain.
5. After ten years, Krishna and Julie can sell the QOF and avoid all tax on the carried interest (unlimited exclusion), or the QOF can sell its carried interest and avoid all tax (assume it gives rise only to capital gain).
6. Is this abusive? The statute expressly permits 10% bad assets to be held in a QOF and the regulations determine value based on cost.

Example Three

David forms a QOF. The QOF negotiates to buy a piece of land with a building on it. The QOF insists, as a condition to closing, that the seller demolish the building. The QOF paves the land, constructs an attendant station, and opens up a parking lot.

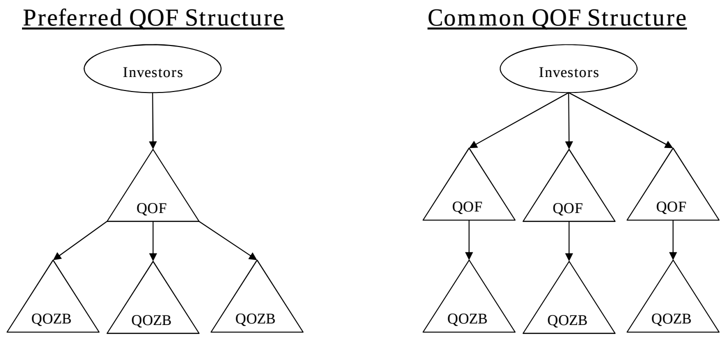
Is this abusive? Would it help if a parking garage were constructed rather than merely a parking lot? Does it matter whether there is a reasonable expectation of a profit over 10 years? How is this transaction inconsistent with the purpose of the statute?

The Preamble provides that the anti-abuse rule could apply to treat a purchase of agricultural land that otherwise would be qualified opportunity zone business property as a purchase of non-qualified opportunity zone business property if a significant purpose for that purchase were to achieve a tax result inconsistent with the purposes of section 1400Z–2. However, paving the lot has created a business where none previously existed.

QOF Interest v. Asset Sales

- Section 1400Z-2(c) provides that where a taxpayer holds an interest in a QOF for at least 10 years, the taxpayer may elect to step up its basis in the QOF interest to FMV on the date that the interest is sold or exchanged. This provision effectively allows the elimination of all gain that would otherwise be recognized upon the disposition of a QOF interest held for more than 10 years.
- Prior to the most recent set of a regulations, it appeared that the benefit of this gain elimination rule was available only where there was a sale of a QOF interest, and not upon the sale by a QOF of its assets.
- This has created significant hurdles for structuring a single QOF to hold assets that are expected to be sold separately.

QOF Interest v. Asset Sales



QOF Interest v. Asset Sales

- The second set of proposed regulations allow an investor in a QOF partnership interest to elect to exclude from gross income its allocable share of the capital gain from the disposition of QOZ property by the QOF, provided that the disposition occurs after the investor has a 10-year holding period. A similar election is available to shareholders of a QOF REIT with respect to capital gain dividends.
- However, the election to exclude amounts from gross income applies only to capital gains, and not to amounts properly characterized as ordinary income.
- In addition, the election by its terms applies only to gain from dispositions of QOZ property by the QOF itself, and does not technically apply to gain recognized by a QOZB held by the QOF.

Working Capital Safe Harbor

- The QOZ regulations provide a 31-month working capital safe harbor for QOF investments in QOZ businesses that acquire, construct, or rehabilitate tangible business property in a QOZ.
- The safe harbor allows QOZB to treat its cash, cash equivalents, and debt instruments with a term of 18 months or less as working capital that does not disqualify the trade or business from being a QOZ business so long as:
  - there is a written plan that identifies the working capital as held for the acquisition, construction, or substantial improvement of tangible property in a QOZ,
  - there is written schedule consistent with the ordinary start-up of a trade or business for the expenditure of the working capital assets within 31 months of the receipt by the business of the assets, and
  - the business substantially complies with the schedule.
- Where the working capital safe harbor applies, it also provides that:
  - Any gross income derived from the working capital is counted toward satisfaction of the 50-percent gross income test, and
  - If the tangible property held by the QOZB is expected to satisfy the requirements to be treated as QOZBP as a result of the planned expenditure of the working capital, then such tangible property is not treated as failing to satisfy those requirements solely because the scheduled consumption of the working capital is not yet complete.

Working Capital Safe Harbor

- QOZBP is tangible property used in a trade or business of a QOF if:
  - such property was acquired by the QOF by purchase from an unrelated party after Dec. 31, 2017,
  - either the "original use" of such property in the QOZ commences with the QOF or the QOF "substantially improves the property" and
  - during substantially all of the QOF's holding period for such property, substantially all of the use of such property was in a QOZ.
- In order for tangible property being developed pursuant to the working capital safe harbor to be treated as QOZBP during the development period, the property must be expected to satisfy the requirements to be treated as QOZBP as a result of the planned expenditure of the working capital. Will this treatment be unavailable if the QOZB will need to expend both its working capital and additional loan proceeds before the property will be placed in service?
- The new proposed regulations clarify that a single QOZB can utilize multiple overlapping or sequential 31-month safe harbor periods, provided that for each such period, the QOZB satisfies all of the requirements that would apply if such period were the only one utilized by the QOZB.
- Can a QOZB utilize multiple sequential safe harbor periods to develop a single project where the project will not be placed in service (and thus will not be used in a trade or business) by the end of the first safe harbor period?

Treatment of Work in Progress

Example 1

On January 1, 2019, ProjectCo LLC (a joint venture between a qualified opportunity fund and a developer) acquired a multi-family building with the intent of rehabilitating it. Construction is expected to take 2 years, during which no income is expected. It will also take 2 years for ProjectCo to duplicate its basis in the acquired building. On the closing date, the qualified opportunity fund contributes cash to ProjectCo, which ProjectCo immediately uses to acquire the building and to pay the general contractor. ProjectCo intends to draw on the construction loan only when it actually needs funds to pay for construction costs.

Example 2

Same facts as Example 1, except that ProjectCo acquires unimproved land and intends to build a multi-family building. Construction is expected to take 2 years, during which no income is expected. As in example 1, there is no working capital.

Question

Is ProjectCo a good "qualified opportunity zone business" (QOZB) during the 2-year construction period?

Treatment of Work in Progress

Answer

Depends on whether "work in progress" (and the value of the land/old building) qualifies as "qualified opportunity zone business property" ("QOZBP") or is non-qualified property for purposes of the 70% tangible asset test.

Open Questions

1. Is the land/building/work in progress considered to be used in a trade or business during the first two years when no revenue is generated?
    - § 1400Z-2(d)(2)(D) defines QOZBP as "tangible property used in a trade or business".
2. In Example 1 - is the building treated as having been "substantially improved" retroactively on January 1, 2019, assuming the property will in fact be substantially improved within the following 30-months?
    - § 1400Z-2(d)(2)(D) provides that "property shall be treated as substantially improved ... only if during any 30-month period ... additions to basis ... exceed the adjusted basis of such property at the beginning of such 30-month period."

In Example 2 - is the building treated as satisfying the original use test during the construction period assuming it will in fact satisfy that requirement when construction is completed?

Treatment of Work in Progress

Proposed Safe Harbors Do Not Help ProjectCo

1. Working capital safe harbor. Not relevant because ProjectCo has no (need for) working capital - all the cash invested by the qualified opportunity fund was immediately spent and no cash is drawn at any time from the construction loan unless needed.
   - Also, if ProjectCo were a qualified opportunity fund, the working capital safe harbor would not have applied (only applies to QOZBs).
2. 90% holding period. Partnership interests in ProjectCo are qualified opportunity zone property as long as ProjectCo qualifies as a QOZB during 90% of the holding period by the qualified opportunity fund – but if ProjectCo does not qualify for 2 years, the qualified opportunity fund would need to hold the interests in the QOZB for at least 20 years.

Policy

Presumably ProjectCo is doing what the opportunity zone program was designed to encourage, yet for the first 2 years it is unclear whether it (and any qualified opportunity fund that invests in it) qualifies.

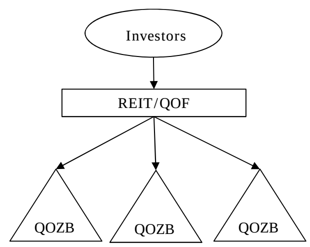
Does it make sense to add a separate safe harbor for work in progress, treating it as qualified opportunity zone business property as long as there is a reasonable expectation based on a written construction schedule that the construction will be completed and revenue will be collected within 30/31/36/48 months?

Feeder Funds

- As previously discussed, investors selling their equity interests in a qualified opportunity fund ("QOF") after having held them for 10 years enjoy better tax benefits than investors in a QOF that sells its assets:
  - No depreciation recapture.
  - Appreciation in value of property that is not qualified opportunity zone property is also not subject to tax.
- This encourages QOFs to structure their exit strategy as an equity sale rather than an asset sale.
- Because it is more difficult to find a buyer willing to acquire the equity of an entity that owns multiple projects, many QOFs are designed to hold only a single project.
- Managers of many QOFs wishing to create a large diversified fund are either using a QOF REIT structure or a parallel QOF structure.
  - Both structures involve additional transaction costs and are less than optimal.

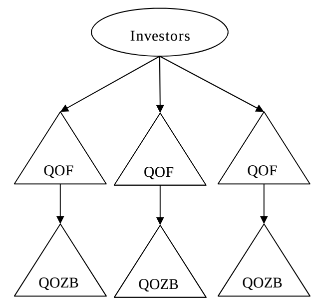
Feeder Funds

QOF REIT Structure



Some of the disadvantages:
- REIT related compliance costs.
- Fund level debt does not increase tax basis in the stock of the REIT, and debt financed distributions in excess of E&P result in an inclusion event.
- Depreciation deductions do not flow-through to the partners.
- Carried interest taken by the manager may be taxable (no safe harbor for profits interest received for services)/cross promote issue.
- Differing management fees may cause a preferential dividend issue.
- Complicated exit strategy.

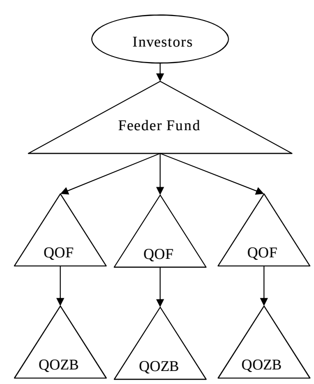
Parallel QOF Structure



Some of the disadvantages:
- Uncertain treatment of any cross-promote
- Timing and diversification issues, where future projects have not yet been identified.
- Complicated exit strategy – multiple sellers of equity if structured as sale of equity in the QOFs.

Feeder Funds

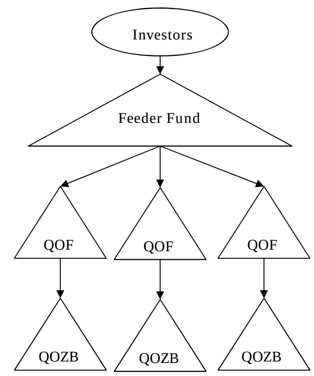
- Unless the IRS and Treasury amend the proposed regulations granting the same benefits to equity and asset sales, fund managers will be considering the use of feeder fund structures which resolve some of the complexities of the QOF REIT structure and the parallel QOF structure.
- However, §1400Z-2(a)(1)(A) appears to require the "taxpayer" to be the investor in the QOF, not the feeder partnership.
- The 2018 Proposed Regulations permitted the creation of a feeder structure as long as the feeder fund was the entity that realized the capital gain which is being deferred.
- The 2019 Proposed Regulations allow taxpayers to contribute their interests in a QOF to another partnership in a 721 contribution without an inclusion event – allowing the creation of a feeder structure by:
  - First, having the taxpayers invest directly in the QOF in exchange for interests in the QOF.
  - Second, having the taxpayers transfer their interests in the QOF to the feeder partnership in exchange for interests in the feeder partnership.



Does it make sense to allow taxpayers to invest directly in the feeder and have the feeder invest directly in the QOFs simplifying the progress?

Feeder Funds

- A feeder fund structure also has its own complexities for taxpayers and the IRS (similar to the complexities that were addressed by allowing 721 contributions):
  - How to make sure that the deferred gain is not shared by any other partner and allocated solely to the partner that incurred it.
  - If a feeder partnership sells one of its investments in a QOF before December 31, 2026, which of the investors will have an inclusion event (all investors or only those investors whose contributions can be traced to the specific QOF investment)?
  - How can the investors and the IRS monitor the feeder and make sure that the feeder invests the capital received from the investor in a QOF within the 180-day deadline? Do you require the feeder to certify this to its investors?



Report No. 1407
January 10, 2019

The Honorable David J. Kautter
Assistant Secretary (Tax Policy)
Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

The Honorable Charles P. Rettig
Commissioner
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

The Honorable William M. Paul
Principal Deputy Chief Counsel and
Deputy Chief Counsel (Technical)
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

Re: *Report No. 1407 – Report on Proposed Qualified Opportunity Zone Regulations under Section 1400Z-2*

Dear Messrs. Kautter, Rettig, and Paul:

I am pleased to submit Report No. 1407, commenting on proposed regulations (the "**Proposed Regulations**") and Rev. Rul. 2018-29 issued on October 19, 2018, by the Department of the Treasury and Internal Revenue Service (together, "**Treasury**") under the "qualified opportunity zone" ("**QOZ**") provisions of the Code, which were added by new Section 1400Z-2 in the legislation informally known as the Tax Cuts and Jobs Act of 2017.

Congress enacted Section 1400Z-2 to encourage investment in low-income communities by allowing for deferral of capital gains that are properly reinvested in those areas. We commend the Treasury for its efforts in providing substantial and timely guidance. The Proposed

Regulations clearly embody a flexible approach to the QOZ rules and the comments and recommendations in this Report are proffered in the spirit of promoting this flexibility in a manner that balances many competing objectives.

This Report does not address all aspects of the QOZ regime or the Proposed Regulations, but rather it focuses on the issues that we believe are most in need of clarification in the near term. These issues include many of those on which the Treasury has requested comment, as well as certain additional questions we believe are most significant and should be addressed through future guidance.

We appreciate your consideration of our recommendations. If you have any questions or comments regarding this Report, please feel free to contact us and we will be glad to assist in any way.

Respectfully submitted,

Karen G. Sowell

Karen G. Sowell
Chair

Enclosure

Cc:

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Department of the Treasury

Hannah Hawkins
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Internal Revenue Service

New York State Bar Association Tax Section

REPORT ON PROPOSED QUALIFIED OPPORTUNITY ZONE REGULATIONS

UNDER SECTION 1400Z-2

January 10, 2019

TABLE OF CONTENTS

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I. Introduction

This Report[1] comments on proposed regulations (the "**Proposed Regulations**")[2] and Rev. Rul. 2018-29[3] issued on October 19, 2018 by the Department of the Treasury and Internal Revenue Service (together, "**Treasury**") under new Section 1400Z-2.[4] The Proposed Regulations were issued in order to implement the "qualified opportunity zone" ("**QOZ**") provisions of the Code, which were added by the legislation informally known as the Tax Cuts and Jobs Act of 2017 (the "**Act**").[5]

This Report does not address all aspects of the QOZ regime or the Proposed Regulations, but rather it focuses on the issues that we believe are most in need of clarification in the near term. These issues include many of those on which the Treasury has requested comment, as well as certain additional questions we believe are most significant and should be addressed through future guidance. This Report also does not discuss the provisions of Section 1400Z-1, which relate to the designation of the QOZs themselves. We note that according to the preamble to the Proposed Regulations (the "**Preamble**"), Treasury intends to issue additional proposed regulations, which will invite comments on the issue of reinvestment of gains by "qualified opportunity funds" ("**QOFs**"), among other things.[6] We expect to submit additional comments in connection with forthcoming guidance.

Congress enacted Section 1400Z-2 to encourage investment in low-income communities by allowing for deferral of capital gains that are properly reinvested in those areas. We commend the Treasury for its efforts in providing substantial and timely guidance on Section 1400Z-2. The Proposed Regulations clearly embody a flexible approach to the QOZ rules and the comments and recommendations in this Report are proffered in the spirit of promoting this flexibility in a manner that balances many competing objectives.

[1] The principal author of this Report was Jonathan Talansky, with significant drafting by Gregory Lucas, Nikolai Karetnyi, David Levy, Lea Li, Michael Schulman, Peter Connors, James Brown, Marcy Geller, Jennifer Ray, Roger Lorence, Mariya Khvatskaya, Tyler Robbins, and Daniel Altman. Substantial contributions were made by Robert Cassanos, Andy Braiterman, Robert Kantowitz, Stephen Land, Michael Schler, and Karen Gilbreath Sowell. Helpful comments from Alan Blecher, Jonathan Brenner, Jason Factor, Michael Hurwitz, Stuart Leblang, John Lutz, David Miller, Andrew Needham, Elliot Pisem, Eric Sloan, and Linda Swartz, are also reflected in the Report. This Report reflects solely the views of the Tax Section of the New York State Bar Association ("**NYSBA**") and not those of the NYSBA Executive Committee or the House of Delegates.

[2] REG-115420-18, Federal Register Vol. 83, No. 209, October 29, 2018 at 54279-54296.

[3] 2018-45 IRB 765 (the "**Revenue Ruling**"). The Revenue Ruling was issued along with the Proposed Regulations and addresses certain critical elements of the "substantial improvement" and "original use" requirements discussed at length in this Report.

[4] Except as otherwise noted, all "Section" references in this Report are to sections of the Internal Revenue Code of 1986, as amended (the "**Code**").

[5] The Act is formally known as "An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018," P.L. 115-97. As used in this Report, and as defined in Section 1400Z-1(a), a QOZ is a population census tract that meets the definition of a "low-income community" under Section 45D and that is designated as such based on a nomination by governors and certification by Treasury. There are currently over 8,700 QOZs in all 50 states, the District of Columbia, Puerto Rico, and the Virgin Islands.

[6] A QOF is defined in Section 1400Z-2(d), as described below. All qualifying investments under the QOZ regime will flow through QOFs.

II. Summary of Recommendations

Our recommendations, discussed in greater detail in section IV of this Report, are summarized below.

1. Original Use and Substantial Improvement

- The "**Original Use Requirement**" (as defined below) should be based on the physical presence of property within a QOZ and whether the property has been used in its current form in such QOZ. If proposed technical corrections are enacted, however, we acknowledge that where property has been previously used in its current form, the location of such use would not be relevant for purposes of the Original Use Requirement.

- If Treasury allows a period of abandonment or underutilization of tangible personal property to erase its prior use for purposes of the Original Use Requirement, such period should be at least 5 years.

- The first holding of the Revenue Ruling that the Original Use Requirement is "not applicable" to land should be confirmed. However, if Treasury allows an extended period of abandonment or underutilization of tangible personal property to erase the prior use of such tangible personal property for purposes of the Original Use Requirement, Treasury should require a longer period for real property.

- QOFs and QOZBs (as defined below) should be able to satisfy the Original Use Requirement with respect to newly constructed property that has yet to be occupied or used in a business, including real properly constructed by the QOF or QOZB itself.

- Treasury should consider whether it may be appropriate to permit the value of land to be ignored for purposes of the QOF and QOZB tests where the improvements to be built on the land would otherwise have caused the land to qualify as QOZBP (as defined below) but for the failure to meet the "**Purchase Requirement**" (as defined below).

- Treasury should adopt a framework that evaluates land and improvements as a single "unit" for purposes of the "substantial improvement" requirement (the "**SI Requirement**") wherein additions to the basis of the land itself would be aggregated with the amount spent on improvements.

- In order to rely on the SI Requirement with respect to real property improvements and attain the benefits of the Revenue Ruling by not having to separately improve the land, the value of the property being improved should represent some minimum percentage of the value of the land.

- Demolition work, to the extent it results in an increase to the basis of the land, should count towards the substantial improvement of the land for the purposes of the SI Requirement.

- Treasury should provide additional clarity on how each "project" is separately defined and, relatedly, how QOFs and QOZBs can satisfy the "with respect to" standard under the SI Requirement. Expenditures and improvements that are substantially related to acquired property and serve the needs of the users of the acquired property should be treated as additions to basis "with respect to" such property for purposes of the SI Requirement.

- Treasury should consider anti-abuse rules aimed at preventing taxpayers from using the SI Requirement to circumvent the policies of the QOZ rules, such as by passively benefiting from the appreciation in value of QOZ real estate.

2. Pass-Through Entities

- Treasury should consider whether taxpayers with eligible capital gains should be permitted to invest in QOFs through aggregator or "feeder" vehicles.

- Partners of partnership that do not make a deferral election should be permitted to make such deferral elections with respect to their distributive share of items of gross eligible gains.

- Additional Form 8949 instructions should be provided to give more clarity to partners with respect to the appropriate reporting of deferral elections.

- For partners of a non-electing partnership that does not provide sufficient information with respect to each item of gross eligible gain, Treasury should consider whether the partners may make a deferral election with respect to the net amount of capital gain from the partnership, as reflected on the Schedule K-1.

3. The 180-Day Rule

- Treasury should confirm that capital gains from an installment sale are only eligible for deferral where the original sale or exchange took place in 2018 or later and should clarify how the 180-day rule would apply in the installment sale context more generally.

- Treasury should consider whether final regulations should provide relief for partners in partnerships who seek to reinvest in QOFs during the time period between the end of the partnership's 180-day period and the last day of the partnership's taxable year in which the partner's share of the partnership's gain is taken into account under Section 706(a).

- In order to prevent potential abuse, Treasury should consider how long a partnership needs to be in existence for it to be an eligible taxpayer to make a deferral election, and for its partners to be able to make an election of their distributive shares of gains recognized through the partnership. The alternative 180-day windows should be turned off where a partnership is formed with a primary purpose of extending the 180-day window.

- Treasury should adopt a rule for REIT capital gain dividends under which a REIT shareholder's 180-day period begins on the last day of the REIT's taxable year, rather than on the date that the dividend is paid to the REIT shareholder.

4. Fungible QOF Interests – FIFO and Pro Rata Methods

- The final regulations should not include the "**FIFO Method**" and the "**Pro Rata Method**" (as defined below).

- For acquisitions and partial dispositions of fungible stock consisting of either "**Mixed Interests**" or "**Mixed Eligible Interests**" (as defined below), (1) taxpayers should be permitted to identify which shares of stock acquired have what attributes for purposes of Section 1400Z-2 and, on a partial disposition of those shares, identify which of those share are disposed of using the same method as provided for under current law for purposes of determining basis and holding period of such shares and (2) mandated FIFO Method should be used in the absence of adequate identification.

- For partnership interests consisting of either Mixed Interests or Mixed Eligible Interests, whether or not fungible, Treasury should specify that all "Ineligible Interests" (as defined below) be treated as a single interest separate from all Eligible Interests and that each Eligible Interest either acquired on a day different from the acquisition date of any other Eligible Interest or representing deferred gain of a character different than the character of gain of any other Eligible Interest be treated as a "separate" interest.

5. 2047 Termination of Gain Exclusion Election

- Treasury should allow for an automatic basis step-up election for QOF interests immediately before December 31, 2047 (if such a date is retained in the final regulations).

6. Pre-Existing Entities

- Treasury should consider whether there are requirements that should be relaxed with respect to entities that acquired QOZBP prior to the date that the Proposed Regulations were issued (but after January 1, 2018) using eligible capital gains invested by taxpayers, but that may not have complied with all the QOZ requirements.

- Final regulations should also contain rules regarding QOFs that were disregarded entities at the time property was acquired, for example by allowing QOZBP to have been acquired by the QOF (or QOZB) or a predecessor entity (which may include a disregarded entity) after December 31, 2017.

7. Business and Investment Start-Up Periods

- Treasury should consider adopting a rule clarifying that where an arrangement (in which investors contribute their share of capital to a QOF, along with an interest-like component, and these amounts are distributed to earlier investors to align all of the equity percentages) is in substance a single equity contribution by a group of investors over a limited safe harbor period of 12 months, Section 707 will not apply to deny QOZ benefits.

- Treasury should look to the regulations promulgated under Section 45D as a basis for final regulations defining a reasonable start-up period during which any new corporation or partnership organized for the purpose of becoming a QOZB will not fail to qualify as such simply because it is in the start-up phase.

- We recommend that Treasury promulgate rules providing that a new corporation or partnership that otherwise qualifies as a QOZB will be deemed to be engaged in the active conduct of a trade or business if, at the time a QOF acquires its interest in such entity, the QOF reasonably expects that the entity will generate revenues satisfying the gross income test in Section 1397C(b)(2) within three years.

8. The Working Capital Safe Harbor

- Treasury should expand the "working capital safe harbor" (the "**WC Safe Harbor**") to include any working capital reasonably expected to be used for the formation or acquisition of a new QOZ business, or reflected in the business plan, marketing plan, or development plan of an existing business and reasonably expected to be used in the business.

- Final regulations should include examples of plans and schedules that will and will not satisfy the WC Safe Harbor, with particular focus on the specificity required.

- Treasury should clarify that any amounts that are spent in a manner that would have qualified under the WC Safe Harbor if they had been included on the schedule will be treated as satisfying the WC Safe Harbor so long as any deviations or modifications resulted from legitimate commercial considerations and were not effectuated with a principal purpose of avoiding the NQFP (as defined below) limitation.

9. QOZB Income Sourcing

- Treasury should issue guidance clarifying that a corporation or partnership will satisfy the requirements of Section 1397C(b)(2) if 50 percent of the total gross income of such entity is derived from the active conduct of a trade or business within all QOZs in which such entity conducts such trade or business.

- Treasury should adopt rules governing the determination of the source of income as inside or outside a QOZ and such rules should be based on the income-sourcing rules promulgated under Section 45D.

10. Single-Tier vs. Two-Tier QOZ Structures

- Treasury should consider whether final regulations could reduce the distinctions between single- and double-tier QOZ structures by, for example, providing for a safe harbor with a similar effect to the WC Safe Harbor.

- Property in the process of improvement by a QOF should be treated as satisfying the SI Requirement while such work is in progress.

11. Profits Interests and Non Pro-Rata Economic Interests

- Final regulations should provide that interests in a QOF partnership issued for services are Ineligible Interests. If the interest is issued for both capital and services, it should be bifurcated.

- Final regulations should address situations in which a QOZB issues equity to a QOF in respect to services provided by holders of interests in the QOF.

- Arm's length special allocations and disproportionate economics should be respected where the economic rights associated with the Eligible Interests are commensurate with those of Ineligible Interests held by unrelated parties in the same QOF.

- Final regulations should adopt a general anti-abuse rule to prevent the improper shifting of economic value between related taxpayers or between different interests held by the same taxpayer.

12. Section 1231 Gains

- Final regulations should clarify the deferral mechanics for Section 1231 gains.

13. Treatment of Leases

- Treasury should confirm that leased property, whether or not leased from a related party, is to be taken into account at cost for purposes of the Sub All Test.

- Final regulations should require substantially all of the use of any tangible property leased by a QOF or a QOZB to be in a QOZ.

- Treasury should provide that leased property need not satisfy the Purchase Requirement or the Original Use Requirement in order to qualify under the Business Property Test.

14. Loss Attributable to Section 1400Z-2 Basis

- Final regulations should clarify the results under Sections 1400Z-2(b)(2)(B)(iii) and (iv), where a taxpayer's QOF investment becomes worthless or is otherwise disposed of in a taxable transaction with zero amount realized.

15. QOZ Basis Issues and Subchapter K

- Treasury should clarify the rules regarding a QOF's inside basis in its own assets.

- For purposes of determining the amount of deferred gain included in income under Section 1400Z-2(b) on the Gain Trigger Date (as defined below), only Section 1400Z-2 basis is taken into account, and Section 705 principles still otherwise apply to a taxpayer's interest in a QOF.

- Final regulations should confirm that (subject to depreciation recapture and anti-duplication principles) the Section 1400Z-2(c) basis step up is to "gross fair market value" to account for partnership liabilities.

- Treasury should confirm that Section 751 requires a partner to recognize ordinary income on a sale of a QOF partnership interest in an amount that would be allocated to the partner on the QOF partnership's sale of its hot assets.

- In the case of an investment by a partnership in a QOF, final regulations should confirm that the basis increases under Sections 1400Z-2(b)(2)(B)(iii) (fifth anniversary increase), -2(b)(2)(B)(iv) (seventh anniversary increase), -2(b)(2)(B)(ii) (December 31, 2026, increase), and -2(c) (ten year increase) occur both with respect to the partnership's interest in the QOF and the partners' interests in the partnership.

- Treasury should clarify whether or not a taxpayer with eligible gains may contribute a non-cash asset in kind to a QOF and make a deferral election that relies on such in-kind contribution.

- Final regulations should provide an anti-duplication rule for determinations of basis, income and loss to avoid double counting of the same economic benefits or losses.

16. Prohibited Businesses

- Final regulations should provide that the "alcoholic beverages" restriction is limited to traditional "liquor stores" that sell alcoholic beverages to retail customers for consumption off premises, and not to restaurants, wineries, breweries or distilleries.

17. Offsetting-Positions Transactions

- Treasury should consider a rule excluding from eligible gain treatment any gain recognized with respect to a transaction entered into in order to generate eligible gain.

- If Treasury retains the offsetting position rule, it should consider limiting its scope in certain respects.

18. Failure to Qualify as a QOF and Reasonable Cause

- Final regulations should clarify the QOZ penalty and relief provisions, especially the "reasonable cause" and "willful neglect" standards.

III. Background – Section 1400Z-2 and the Proposed Regulations[7]

A. Section 1400Z-2: Special Rules for Capital Gains Invested in QOZs

Section 1400Z-2 allows a taxpayer to elect to defer capital gains to the extent that such gains are timely invested in a QOF during the 180-day period beginning on the date of such sale or exchange. For these purposes, the gains must arise from a sale to, or exchange with, an unrelated person.[8] Any deferred amounts are included in income in the taxable year which includes the earlier of (1) the date on which the investment is sold, and (2) December 31, 2026 (such earlier date, the "**Gain Trigger Date**").[9] Additionally, where the taxpayer holds the QOF investment for at least ten years, Section 1400Z-2(c) allows for an election (the "**Gain Exclusion Election**") to increase the basis of the investment to equal its fair market value on the date of its sale or exchange.

The statute provides that the taxpayer's initial basis in the QOF investment is zero, and the basis is increased to reflect the gain recognized on the Gain Trigger Date. If, prior to the Gain Trigger Date, the taxpayer achieves a five year holding period, a basis increase equal to 10 percent of the deferred gain is allowed, and if the taxpayer achieves a seven year holding period by such date, there is an additional increase equal to 5 percent of the deferred gain.[10]

Section 1400Z-2(d) contains the definitional provisions for QOFs. A QOF is an investment vehicle organized for the purpose of investing in "qualified opportunity zone property" ("**QOZP**") and that holds at least 90% of its assets in QOZP, as measured based on an average of two semiannual testing dates (the "**90% Test**").[11] QOZP consists of "qualified opportunity zone stock," "qualified opportunity zone partnership interests," (together, "**QOZB Interests**") and "qualified opportunity zone business property" ("**QOZBP**"). QOZBP is defined

[7] The following summary is not an exhaustive outline of the statutory provisions, but instead focuses on the portions of the QOZ rules that are most germane to the Proposed Regulations (and this Report).

[8] Section 1400Z-2(e)(2) provides that for purposes of the QOZ provisions, relatedness is defined under Section 267(b) or 707(b)(1), substituting 20 percent for 50 percent.

[9] Section 1400Z-2(a)(1), (b). Under Section 1400Z-2(b)(2), the amount includible on such date cannot exceed the excess of the fair market value of the investment as of such date and the taxpayer's basis in the investment. This rule allows a taxpayer to receive the tax benefit of any depreciation in value of the QOF investment prior to such date.

[10] Section 1400Z-2(b)(2)(B).

[11] The statute also imposes a monthly penalty on a QOF that fails to meet the 90% Test, equal to the amount of the failure multiplied by the Section 6621(a)(2) underpayment rate. Section 1400Z-2(f)(3) sets forth a reasonable cause exception to the penalty.

as tangible property used in a trade or business of the QOF, where (1) the QOF acquired such property for cash from an unrelated person in a non-carryover basis transaction after December 31, 2017 (the "**Purchase Requirement**"),[12] (2) either the QOF is the "original user" of such property (the "**Original Use Requirement**"),[13] or the QOF "substantially improves" the property (the "**SI Requirement**"), and (3) during substantially all the QOF's holding period for such property, substantially all of the use of such property was in a QOZ ((1) through (3), the "**Business Property Test**"). Section 1400Z-2(d)(ii) states that the SI Requirement is met only if, during any 30-month period beginning on the date of acquisition of the property, "additions to basis" with respect to the property in the hands of the QOF exceed the adjusted basis of the property in the hands of the QOF at the beginning of such period. The statute does not define the Original Use Requirement.

For an interest in a subsidiary corporation or partnership to qualify as a QOZB Interest, it must be acquired by the QOF from the corporation or partnership solely in exchange for cash after December 31, 2017, and at the time of issuance, as well as during substantially all of the QOF's holding period for such interest, the subsidiary must qualify as a "qualified opportunity zone business" ("**QOZB**").[14] Finally, a QOZB is a trade or business (other than certain enumerated businesses[15]) in which substantially all of the tangible property owned or leased is QOZBP (the "**Sub All Test**"), and which satisfies the following requirements set forth in Section 1397(C)(b): (1) at least 50 percent of the total gross income of such entity is derived from the active conduct of such business; (2) a substantial portion of the intangible property of such entity is used in the active conduct of the business; and (3) less than 5 percent of the average of the aggregate unadjusted bases of the property of such entity is attributable to nonqualified financial property ("**NQFP**").[16]

Section 1400Z-2(e) contemplates that taxpayers may hold interests in QOFs funded through eligible gains and other capital ("**Mixed Funds**"). In such cases, the QOF investment is bifurcated and treated as two separate interests **–** "**Eligible Interests**" and "**Ineligible Interests**," each as defined herein.

[12] The Purchase Requirement cross references the "purchase" definition in Section 179(d)(2).

[13] House Republicans have proposed striking the words "in the qualified opportunity zone" from Section 1400Z-2(d)(2)(D)(i)(II) such that the Original Use Requirements would require that "the original use of such property commences with the qualified opportunity fund." *See* Tax Technical and Clerical Corrections Act Discussion Draft, U.S. House of Representative Committee on Ways and Means, January 2, 2019.

[14] Section 1400Z-2(d)(2)(B), (C).

[15] A QOZB cannot operate a private or commercial golf course, country club, massage parlor, hot tub facility, suntan facility, racetrack or other facility used for gambling, or any store the principal business of which is the sale of alcoholic beverages for consumption off premises (the "**Prohibited Businesses**").

[16] Section 1400Z-2(d)(3)(A). NQFP includes "debt, stock, partnership interests, options, futures contracts, forward contracts, warrants, notional principal contracts, and annuities," but does not include "reasonable amounts of working capital held in cash, cash equivalents, or debt instruments with a term of 18 months or less." Section 1397C(e)(1). The NQFP restriction is discussed in this Report in the context of the WC Safe Harbor.

B. Key Provisions of the Proposed Regulations

1. Proposed Regulations Section 1.1400Z-2(a)-1

Proposed Regulations Section 1.1400Z-2(a)-1 provides definitions and related operating rules for applying Section 1400Z-2. The terms "eligible taxpayer," "eligible gain," and "eligible interests" are defined in Proposed Regulations Section 1.1400Z-2(a)-1(b). An "eligible taxpayer" includes any person that may recognize gains for purposes of federal income tax accounting. "Eligible gain" is any capital gain that would be recognized before January 1, 2027, but for Section 1400Z-2(a)(1), and that does not arise from a related-party transaction. This regulatory section further provides special rules for the treatment of gains under Section 1256 contracts and straddles.[17] An "eligible interest" is an equity interest issued by a QOF, including preferred stock and partnership interests with special allocations, but excluding debt instruments as defined in Section 1275(a)(1) and Treasury Regulations Section 1.1275-1(d).

Proposed Regulations Section 1.1400Z-2(a)-1(b)(4) provides rules governing the 180-day reinvestment period. Generally, the 180-day period begins on the day on which the gain would have been recognized, but for the election under Section 1400Z-2.[18] In the case of a capital gain dividend by a real estate investment trust (a "**REIT**"), the period begins on the day on which the dividend is paid.[19] Additionally, a taxpayer may continue to defer previously deferred gain by reinvesting the proceeds of a sale of a QOF interest in another QOF in a timely fashion. Proposed Regulations Section 1.1400Z-2(a)-1(b)(5) provides for the preservation of the tax attributes of the deferred gain once triggered. Where a taxpayer holds fungible interests in a QOF that were acquired at different times and disposes of a portion of those interests, Proposed Regulations Section 1.1400Z-2(a)-1(b)(6) provides that the first-in-first-out method ("**FIFO Method**") must be used to identify which interests are disposed of, and if a portion of fungible interests acquired on a single day are disposed of, the rules mandate the pro-rata method of identification (the "**Pro-Rata Method**").

Proposed Regulations Section 1.1400Z-2(a)-1(c) provides special rules for pass-through entities, including rules regarding deferral elections by partnerships, how partners may elect to defer passed-through gains under Section 1400Z-2(a)(2) in cases where the partnership does not elect to defer, and on how the 180-day period is calculated for such partners. A welcome aspect of the Proposed Regulations provides that where a partnership realizes eligible capital gains, either the partnership or any of its partners may elect to defer such gain. In the case of a partner, the 180-day period may begin on the last day of the partnership's taxable year.[20] Proposed Regulations Section 1.1400Z-2(a)-1(c)(3) provides that analogous rules apply to S corporations, trusts, and estates.

[17] Proposed Regulations Section 1.1400Z-2(a)-1(b)(2)(iii), (iv).

[18] Proposed Regulations Section 1.1400Z-2(a)-1(b)(4)(i).

[19] Proposed Regulations Section 1.1400Z-2(a)-1(b)(4)(ii)(B).

[20] Proposed Regulations Section 1.1400Z-2(a)-1(c)(2)(iii)(A).

2. Proposed Regulations Section 1.1400Z-2(c)-1

Proposed Regulations Section 1.1400Z-2(c)-1 addresses the Gain Exclusion Election, and provides that the election is not available for dispositions after December 31, 2047. This section of the Proposed Regulations also clarifies that the exclusion from gross income is not impaired solely because a designation of a QOZ ceases to be in effect.[21]

3. Proposed Regulations Section 1.1400Z-2(d)-1

Proposed Regulations Section 1.1400Z-2(d)-1 provides guidance on (1) self-certification as a QOF, (2) the valuation of a QOF's assets, (3) qualification of various types of property as QOZP, and (4) qualification as a QOZB. These rules also permit pre-existing entities to qualify as QOFs.[22]

For purposes of valuing a QOF's assets under the 90% Test, if the QOF has an applicable financial statement (within the meaning of Treasury Regulations Section 1.475(a)-4(h)), then the values of the assets shown on that statement are used. Otherwise, the QOF's cost of such assets are used.

Proposed Regulations Section 1.1400Z-2(d)-1(c)(7) reserves comment on the Original Use Requirement, and clarifies that to satisfy the SI Requirement with respect to a building located on land within a QOZ, only additions to basis of the building are taken into account, and no separate SI Requirement applies with respect to the land.[23] Proposed Regulations Section 1.1400Z-2(d)-1(d) defines QOZB, and, importantly, provides a 70% standard for the Sub All Test.[24]

The Proposed Regulations provide for a working capital safe harbor (the "**WC Safe Harbor**") for purposes of the NQFP restriction. Specifically, under Proposed Regulations Section 1.1400Z-2(d)-1(d)(5)(iv), working capital assets are treated as reasonable in amount (and therefore not as NQFP) if all of the following three requirements are satisfied: (1) the amounts are designated in writing for the acquisition, construction, and/or substantial improvement of tangible property in a QOZ, (2) there is a written schedule consistent with the ordinary start-up of a trade or business for the expenditure of the working capital assets, and under such schedule, the working capital assets must be spent within 31 months of the receipt by the business of the assets, and (3) the working capital assets are actually used in a manner that is substantially consistent with the first two requirements.

The Proposed Regulations confirm that meeting the WC Safe Harbor also will enable a QOZB to satisfy the other two requirements of Section 1397C(b), and, significantly, where WC Safe Harbor working capital is being used to produce tangible property that is expected to meet

[21] As a general matter, the QOZ designation expires for census tracts after ten years, and this had caused some concern amongst taxpayers intending to hold QOF investments beyond such time. *See* Section 1400Z-1(f).

[22] Proposed Regulations Section 1.1400Z-2(d)-1(a)(3).

[23] See discussion of the Revenue Ruling below.

[24] Proposed Regulations Section 1.1400Z-2(d)-1(d)(3)(i).

the SI Requirement, then the in-process property will not be treated as failing the SI Requirement solely because the scheduled consumption of the working capital is not yet complete.[25]

4. Proposed Regulations Section 1.1400Z-2(e)-1

Proposed Regulations Section 1.1400Z-2(e)-1 addresses the treatment of mixed-fund investments in a QOF and states that deemed contributions of money described in Section 752(a) do not create or increase an investment in a QOF and the basis increase resulting from the deemed contribution is therefore not taken into account in determining the partner's investment in the QOF.

C. Revenue Ruling 2018-29

The Revenue Ruling addresses a QOF that purchases an existing building located on land in a QOZ. Sixty percent ($480x) of the $800x purchase price for the property is attributable to the value of the land and forty percent ($320x) is attributable to the value of the existing building, which was previously used as a factory. Within 24 months after the date of the QOF's purchase, it invests an additional $400x in converting the building to residential rental property. The Revenue Ruling contains the following holdings: (1) the Original Use Requirement cannot be met with respect to the building, (2) the Original Use Requirement is not applicable to the land on which the building is located, (3) the substantial improvement of the building is measured by the QOF's additions to the adjusted basis of the building, and (4) measuring substantial improvement to the building by additions to the QOF's adjusted basis of the building does not require the QOF to separately substantially improve the land upon which the building is located. The Revenue Ruling does not analyze the treatment of the land under the 90% Test, which suggests that as long as a building on land is substantially improved, the land is counted as a good asset (or is ignored).

IV. Detailed Discussion of Recommendations

A. Original Use and Substantial Improvement

In order for property to qualify as QOZBP, it must meet the Original Use Requirement or the SI Requirement. The Proposed Regulations address in-process improvements funded by WC Safe Harbor working capital. Other than the Revenue Ruling, the Proposed Regulations provide no other guidance on these requirements. In the Preamble, Treasury solicited comments on "all aspects of the definition of 'original use' and 'substantial improvement.'" We believe that in order for the QOZ rules to accomplish their intended goals, these statutory standards must be given additional content. In this Report we have not described, or even summarized, all of the considerations we deem relevant to the analysis, but instead have focused on those aspects of the requirements that are likely to arise with more frequency and for which taxpayers need more immediate guidance.

[25] Proposed Regulations Section 1.1400Z-2(d)-1(d)(5)(vii).

1. Original Use

(a) Tangible Personal Property

We recommend that final regulations clarify that the Original Use Requirement focuses on whether the property has been used in its current form by anyone other than the QOF. We believe that "use" should be construed as actual use and not mere presence. Therefore, the mere fact that tangible personal property was held for sale in a QOZ (as inventory) should not preclude satisfaction of the Original Use Requirement by a QOF that acquires such property and uses it in a QOZB (or by a subsequent QOF or QOZB that itself holds the property as inventory). Treasury has also requested comment on whether a period of abandonment or underutilization of tangible personal property can erase its prior use in a QOZ. We note that under the "empowerment zone" provisions of the Code, for purposes of determining whether property is "qualified zone property," if property is vacant for at least a one year period, any use prior to that period is disregarded in determining whether the "original use" requirement is met.[26] Whether or not this rule is a good analogue to the QOZ tests, we believe that incorporating a similar provision under Section 1400Z-2 would be difficult to square with Congressional intent and would result in tax motivated transactions in which QOZBP would be held dormant and then sold to a QOF. Instead, we generally support a plain meaning of the Original Use Requirement.[27] If Treasury does adopt a "dormancy period" under the Original Use Requirement, we believe that a period of at least 5 years would be necessary to prevent abuse for personal property. Finally, if a QOZB acquired heavily refurbished personal property (for example, a vehicle) that had been previously used in the QOZ but that is no longer in substantially the same form, then we believe the property should be able to satisfy the Original Use Requirement.

(b) Real Property

Consistent with our recommendation set forth above, we agree with the holding of the Revenue Ruling to the effect that the Original Use Requirement is "not applicable" to land (which we take to mean that a QOF *cannot*, by definition, be the original user of land), and we recommend that final regulations confirm this principle more broadly. However, if Treasury allows an extended period of abandonment or vacancy to erase prior use of real property, we believe that in order to prevent abuse, a period longer than the 5 year period we recommended for personal property is necessary.

The Revenue Ruling, which involved a purchase of an existing building previously used as a factory and erected prior to 2018, leaves open the question of whether a period of non-use would make the Original Use Requirement available for real property, and therefore the adoption of such a period would not, in our view, be inconsistent with the Revenue Ruling.

[26] Treasury Regulations Section 1.1394-1(h).

[27] We note that under Section 168(k), there are various exceptions to "original use" based on certain instances of transitory ownership. *See*, *e.g.*, Treasury Regulations Section 1.168(k)-1(b)(3)(iii)(A). *See also* New York State Bar Association Tax Section Report No. 1405, at 40-41.

We also recommend that Treasury confirm in final regulations that QOFs and QOZBs may satisfy the Original Use Requirement with respect to newly constructed property that has yet to be occupied or used in a business, including real properly constructed by the QOF or QOZB itself. Although situations in which a QOF or QOZB constructs a new building on purchased land may be covered by our recommendation described below regarding the SI Requirement, there are circumstances (such as a QOF that contemplates the construction of a building or other improvements on land that is ground leased) where the SI Requirement may be technically inapplicable and where permitting the Original Use Requirement to be met would further the purposes of Section 1400Z-2.

Treasury should also consider whether it may be appropriate to permit the value of land to be ignored for purposes of the QOZB and QOF tests where the improvements to be built on the land would otherwise have caused the land to qualify as QOZBP but for the failure to meet the Purchase Requirement. For example, suppose that a taxpayer seeks to enter into a joint venture with other investors who have eligible capital gains, and construct an apartment building on the land. The construction will require expenditures well in excess of the value of the land, and perhaps four or five times its value. The taxpayer does not want to dispose of more than 80% of the land, and therefore will remain a related party with respect to the QOZB when the land is contributed to the QOZB.[28] The investors' cash is used in a manner that satisfies the WC Safe Harbor. While the construction in progress would appear to clearly meet the Original Use Requirement, a QOZB may be unable to satisfy the Sub All Test at each testing date if the land itself is counted as tangible property that is not QOZBP.[29] We believe that fact patterns such as these are commonplace, and it is unclear what policy goals are served by forcing the current landowner to either divest itself of more than 80% of the project or enter into a complex ground lease with the joint venture in order to be able to qualify the project under the QOZ rules. Ignoring the value of the land in these cases would allow development to occur in a way that does not create a bias against landowners who happen to own their properties at the time of the enactment of the QOZ rules. It would also be consistent with the Revenue Ruling's approach of ignoring the value of land for certain purposes in a manner that fosters development.

2. *Substantial Improvement*

(a) Unimproved Land or Land with Minimal Improvements

We believe that further guidance is critical under the SI Requirement and the Original Use Requirement as applied to unimproved or vacant land (which may include land with relatively minor existing improvements or land with a building that requires demolition).[30] Acquiring raw land for ground-up development is a common transactional pattern in many QOZs

[28] We note that this Report does not address in detail the Purchase Requirement. However, we would note that this rule in many cases gives rise to the need for significant restructuring and complex arrangements. A current owner of land in a QOZ cannot contribute the land to a joint venture with a QOF and treat the land as QOZBP. The Purchase Requirement instead compels the landowner to sell the land to a third party or to enter into sub-optimal ground lease structures with the joint venture.

[29] The WC Safe Harbor would presumably not help because it does not treat the cash as QOZBP prior to its being converted into tangible property, but instead insulates the cash from NQFP characterization.

[30] Similar concerns arise where a QOZB acquires land with improvements or structures that will not be part of the new development.

and is implicitly approved in the example set forth in Proposed Regulations Section 1.1400Z-2(d)-1(d)(5)(vii). In urban areas in particular, land value can be significant, and we understand that the legal uncertainties associated with these investments are likely chilling QOZ investment activity. The Revenue Ruling deals only with the acquisition of land together with an existing building, and leaves open the question of unimproved land. While the Revenue Ruling expressly holds on its facts that the land at issue *need not* be improved, it is not clear whether land *can* be "substantially improved" (under Section 1400Z-2) under different facts.

The Preamble states that "[E]xcluding the basis of land from the amount that needs to be doubled under [the SI Requirement] for a building to be substantially improved facilitates repurposing vacant buildings in qualified opportunity zones." We believe that the rules must go further and provide more clarity to taxpayers who seek to redeploy capital gains to fund impactful, ground-up real estate development projects involving assets such as affordable housing, hotels, office and industrial properties.

Accordingly, we recommend that the final regulations adopt a framework that evaluates land and improvements as a single "unit" for purposes of the SI Requirement (such proposal, the "**Unitary Standard**"). Under the Unitary Standard, if a QOF or QOZB acquires vacant land for $X, the SI Requirement would require another $X to be invested in improvements to the land. We believe that applying the QOZ rules in this manner manifests a reasonable interpretation of the statutory phrase "additions to basis with respect to the property," as being broader than a strict evaluation of the land's basis.[31] Instead, the SI Requirement would look at the entire development site and determine the additions to basis with respect to the site (including the land). For these purposes, additions to the basis of the land itself would be aggregated with the amount spent on improvements. Suppose a QOZB acquires land in a QOZ for $250. What is the analysis under the SI Requirement if the QOZB spends $200 on construction of a building and $50 on fixing the land? We believe that under these facts, so long as the $250 is spent within the statutory 30-month period, the land and the building should allow the QOZB to qualify. Not only is this consistent with one of the goals of the QOZ legislation, but it would be a natural interpretation of the example in Proposed Regulations Section 1.1400Z-2(d)-1(d)(5)(vii), which clearly suggests that a purchase of raw land followed by construction on that land is an appropriate way to satisfy the SI Requirement. Furthermore, final regulations should allow land to be treated as meeting the SI Requirement while the improvements are in process, using the principles of Proposed Regulations Section 1.1400Z-2(d)-1(d)(5)(vii).[32]

[31] We note that the language in the Proposed Regulations is slightly different than the statutory language. Specifically, Proposed Regulations Section 1.1400Z-2(d)-1(c)(8)(i) provides that "…tangible property is treated as substantially improved by a QOF only if, during any 30-month period beginning after the date of acquisition of the property, *additions to the basis of the property* in the hands of the QOF exceed an amount equal to the adjusted basis of the property at the beginning of the 30-month period in the hands of the QOF" (emphasis added). We recommend that the regulatory language be modified to conform to the language in Section 1400Z-2(d)(2)(D)(i)(II).

[32] We would note that the concept of "retroactive" qualification of property is contained in the Proposed Regulations. Specifically, under Proposed Regulations Section 1.400Z-2(d)-1(d)(5)(vii), in process improvements are not treated as failing the SI Requirement while cash is being expended under the WC Safe Harbor. However, we believe that this rule should be applicable beyond situations where the WC Safe Harbor is relevant, including in cases where activity is being conducted at the QOF level. *See* discussion in Section IV.H.

Applying the SI Requirement in this manner will, in our view, prevent inappropriate results in the case of an acquisition of land with minimal improvements. The Proposed Regulations and the Revenue Ruling would seem to permit capital expenditures equal to the value of the improvements to satisfy the SI Requirement, which apparently results in qualification of both the land and the building. Where the improvements are not substantial in relation to the value of the land, we believe that such a rule is not within the scope of Congressional intent, since at the extreme they would permit taxpayers to "land bank" by sitting on mostly unproductive land for the requisite ten year holding period and ultimately realizing the appreciation in the land on a tax-free basis. While the "trade or business" and "active conduct" requirements found within the QOZ rules do limit this strategy to some degree, they are insufficient to prevent abuse in many cases.

(b) The Revenue Ruling

We recognize that the Unitary Standard described above may appear at odds with the Revenue Ruling, at least in so far as the Revenue Ruling treats acquired land and improvements as two separate assets under the QOZ rules. However, we believe that the Revenue Ruling should be limited to its facts. Accordingly, we recommend that Treasury adopt a rule establishing that in order to rely on the SI Requirement with respect to real property improvements and attain the benefits of the Revenue Ruling by not having to separately improve the land, the value of the property being improved must represent some minimum percentage of the value of the land. We have considered what minimum percentage would be required in these cases, and we note that in the Revenue Ruling, the value of the building was equal to 2/3 of the value of the land. We would support such a threshold, but in any event the standard chosen should ensure that taxpayers are not able to "bootstrap" land appreciation into the QOZ benefit. We believe that the Unitary Standard for the SI Requirement, together with the more limited application of the Revenue Ruling, represents a reasonable way to apply the QOZ rules to different categories of QOZ real estate projects while remaining true to Congressional intent and the policies underlying Section 1400Z-2.

(c) Demolition

A number of uncertainties exist in the context of QOZ parcels that are in need of remediation due to environmental toxins or other hazardous conditions. It is our understanding that in many situations, heavy environmental clean-up (which often entails demolition and other activities) can take years to complete, and in some cases may represent a significant portion (even a majority) of the cost of the project. Because the QOZ rules are focused on census tracts that may be blighted or in disrepair, we believe that final regulations should address these situations.

Suppose a QOF acquires a site for $250, and incurs $200 of expenses in demolishing the building, and $100 in erecting a new building. We believe that the Unitary Standard we have proposed would permit the SI Requirement to be satisfied under these facts. We recommend that Treasury clarify that the demolition work, to the extent it results in an increase to the basis of the land, counts towards the substantial improvement of the land, and that under these facts, the SI Requirement will be met in light of the $205 of total spending.

(d) Additions to Basis "with respect to" QOZBP

We believe that the final regulations should provide additional clarity on how each "project" is separately defined and, relatedly, how QOFs and QOZBs can satisfy the "with respect to" standard under the SI Requirement. For example, if a QOZB acquires five separate but contiguous parcels of land in a QOZ for $100x, and seeks to qualify all five parcels by constructing a building on one of the parcels at a cost of $100x, the final regulations should clarify that the parcels all must be a part of the same "project" or "site" in order to be treated as improved by the single building. Similarly, when it comes to assets such as affordable housing complexes, a QOZB may acquire a property and carry out construction that takes the form of direct improvements to the acquired buildings, as well as the creation of recreation centers, playgrounds, and other ancillary structures. We recommend that Treasury adopt final regulations providing that expenditures and improvements that are substantially related to acquired property and serve the needs of the users of the acquired property will be treated as additions to basis "with respect to" such property for purposes of the SI Requirement. We also recommend that Treasury consider whether anti-abuse rules are needed in order to prevent taxpayers from using these aspects of the SI Requirement to circumvent the policies of the QOZ rules by, among other things, passively benefiting from the appreciation in value of real estate located in QOZs.

B. Pass-Through Entities

1. Aggregator or Feeder Funds

As described in Part III.B, the Proposed Regulations allow both a partnership as well as its partners to make a gain deferral election, and they provide special timing rules with respect thereto.[33] Since it is common for investment gains to be realized through such structures, these rules will allow taxpayers to elect deferral under the QOZ rules without the need for burdensome restructuring, and we support the Proposed Regulations in this regard.

Consistent with the general "aggregate" partnership theory embodied in the Proposed Regulations, we also recommend that Treasury consider whether the taxpayers with eligible capital gains should be able to invest in QOFs through aggregator or "feeder" vehicles. The statute does not appear to permit this structure currently, since Section 1400Z-2 requires that "the taxpayer" realizing the gain be the one to invest in a QOF. To reduce administrative complexity, such a rule could require that such entities be wholly owned by investors with eligible gains. Permitting these structures may facilitate a more streamlined onboarding process for QOFs, and obviate the need for direct privity between the individual taxpayers with eligible gains and the QOFs themselves.[34] Instead, two or more investors with eligible gains that seek to invest in the same QOF could do so through a feeder entity. However, we acknowledge the additional complexity that could result from such a rule, including those relating to tax basis that are discussed at length in Section IV.O.

[33] Our recommendations relating specifically to the 180-day period in the partnership context are described in Part C.2.

[34] Additionally, under the current rules, the Gain Exclusion Election is only available when interests in the QOF are sold, so permitting aggregation in this manner reduces the number of sellers in these transactions.

2. Partnership Distributive Share Issues

The Proposed Regulations anticipate that taxpayers will make deferral elections on Form 8949, which will be attached to their U.S. federal income tax returns for the taxable year in which the gain otherwise would have been recognized. Draft form instructions to this form were released on November 14, 2018 (the "**Draft Form Instructions**"). According to the Draft Form Instructions, taxpayers should report the underlying gain as they would under current rules, without making any adjustment, and report the deferral of the eligible gain separately. Investments in different QOFs, or in the same QOF on different dates (or with different character), are reported on separate line items on the form, however eligible gains of the same character from different transactions that are invested on the same date in the same QOF could be grouped together. Taxpayers are not required to trace or allocate the funds invested in a QOF to a specific gain being deferred, but the investment in the QOF must have occurred within the 180-day period beginning on the date the deferred gain was realized. We offer the following examples to illustrate the mechanics of these rules in the partnership context:

> Example 1. Individual A is a partner in P, an entity treated as a domestic partnership for U.S. federal income tax purposes and is a calendar year taxpayer. A owns a 30% capital interest in P, and all items of income, deduction, gains and losses in P are allocated pro rata in proportion to the partners' capital interests. Both A and P are calendar year taxpayers. On April 3, 2018, P sells Blackacre to a buyer that is less than 20% related to P, realizing a $100 gain that will be recognized on that day as a long-term capital gain, absent a deferral election. P can invest the gain into a QOF by September 30, 2018 and make a deferral election with respect to that gain.
>
> Example 2. Same as Example 1, except that in 2018, P also sells Whiteacre to an unrelated party, recognizing a loss of $80 that would be treated as a long-term capital loss. P has no other capital gains or losses in 2018. Although P only has $20 net capital gain for year 2018, P can make a deferral election with respect to the entire $100 of eligible gain it recognized from selling Blackacre, and invest $100 in a QOF by September 30, 2018.
>
> Example 3. Same as Example 2, except that P does not make a deferral election with respect to the gain it recognized from selling Blackacre. A receives a Schedule K-1 from P in early 2019, indicating that her share of 2018 net long-term capital gain from P is $6, representing her 30% share of P's net long-term capital gain of $20. Absent the QOZ rules, A will report her $6 net long-term capital gain from P as a line item on Form 8949. Based on the Draft Form Instructions, it seems that A is only able to defer her net capital gain from P, instead of her entire $30 share of gain from the sale of Blackacre.

It is unclear whether the result illustrated in Example 3 is intended. Outside the partnership context, taxpayers are free to make a deferral election with respect to gross capital gains from some transactions, while carrying forward gross capital losses from other transactions. As illustrated by Example 2, if the partnership itself makes the deferral election, it could make the election with respect to items of gross capital gain, thereby, affording partners in the electing partnerships the QOZ tax benefit with respect to their shares of such gross gain items.

Example 4. Same as Example 3, except that shortly after selling Blackacre, P informs its partners that it does not intend to make a deferral election with respect to gain from that sale, and informs its partners of their shares of the gain, which for A is $30. A invests $30 in a QOF within 180 days of the disposition of Blackacre. Later in the same year, P sells Whiteacre with a $80 long-term capital loss. After taxable year 2018 ends, P provides its partners with Schedule K-1s, which reflect A's share of P's net long-term capital gain as $6. It is unclear if and how A will be able to make the deferral election for her entire $30 investment in the QOF.

Non pro-rata economics and more elaborate partnership waterfalls can exacerbate some of the issues noted above.

Example 5. Same as Example 4, except that P does not make distributions and allocations to its partners pro rata to its partners' capital interests. Instead, P uses targeted allocations, and has a distribution waterfall where after reaching a specified internal rate of return for all partners (the "IRR hurdle"), A will receive a 20% promote allocation. A also has a 30% capital interest in P. In 2018, immediately after the disposition of Blackacre, P's income and gains reach the IRR hurdle, and A would be entitled to 35% of all 2018 items of income and gain based on P's results as of that point. P informs its partners that it does not intend to make a deferral election with respect to its gain from selling Blackacre, and informs its partners of their shares of the gain, which for A is $35. A invests $35 in a QOF within 180 days of the disposition of Blackacre. Later in the same year, P sells Whiteacre with a $80 long-term capital loss. After the sale of the Whiteacre at loss, at the end of 2018, income of P is no longer above the IRR hurdle, and A will not be entitled any promote distribution. Based on the targeted allocation, A is entitled to only 30% of all items of income, deductions, gains and losses. A's distributive share of net long-term capital gain reflected on the Schedule K-1 of P is only $6. It is unclear if and how A will be able to make the deferral election with her entire $35 investment in the QOF.

As illustrated by the above examples, the elective timing rules for partners in a non-electing partnership under Proposed Regulations Section 1.1400Z-2(a)-1(c)(2) put pressure on partnerships to provide information to partners before the end of the taxable year. For partnerships that do not make allocations and distributions purely pro rata based on percentage interests, it is also unclear how to determine a partner's share of a particular item of gross gain before the end of the taxable year. In addition, an eligible capital gain with respect to the partnership may be ineligible for a partner because of the relatedness level, and the partnership may not be able to disclose the identity and beneficial ownership of the purchaser when it recognizes gain. When partnerships do not provide partners with information regarding their shares of items of capital gain within 180 days after the close of the relevant taxable year, it is impossible for partners to make deferral elections with respect to eligible gains that they recognize through partnerships.

More importantly, based on the Proposed Regulations and the Draft Form Instructions, it is not clear whether partners in a non-electing partnership can make a deferral election with respect to their shares of the gross amount of an item of eligible gain recognized by the Partnership. Even if such elections were permissible, the notion of the distributive share of a gross capital gain item is not meaningful for many partnerships with more complicated economic waterfalls as described above. To allow for gain deferral elections with respect to distributive shares of gross items of capital gain from a partnership, information from the partnership to its partners with respect to each item of capital gain it recognizes will be required. For partnerships like investment funds making hundreds of transactions producing capital gains and losses, this could be burdensome or, more likely, impossible.

Since the QOZ rules and the Proposed Regulations do not affirmatively require partnerships to provide QOZ-related information to its partners when the partnerships do not make deferral elections with respect to partnership-level capital gains, it is up to the partnership and its partners to negotiate whether the partnership will provide such information. We recommend that partners of non-electing partnerships be permitted to make gain deferral elections with respect to their distributive share of items of gross eligible gains. Further, we recommend that additional Form 8949 instructions be provided to give more clarity to partners with respect to the appropriate reporting of deferral elections. Finally, for partners of a non-electing partnership that does not provide sufficient information with respect to each item of gross eligible gain, Treasury should consider whether the partners may make a deferral election with respect to net amount of capital gain from the partnership, as reflected on the Schedule K-1.

C. The 180-Day Rule

Under Section 1400Z-2(a)(1)(A), a taxpayer that seeks to defer gain through investment in a QOF has only a 180-day period to do so, beginning on the date of the sale or exchange giving rise to the gain. Proposed Regulations Section 1.1400Z-2(a)-1(b)(4)(i) provides that the 180-day period generally "begins on the day on which the gain would be recognized for Federal income tax purposes if the taxpayer did not elect under section 1400Z-2 to defer recognition of that gain." Proposed Regulations Section 1.1400Z-2(a)-1(b)(4)(ii) offers four examples illustrating how the 180-day rule would apply in the contexts of (1) regular-way trades of stock, (2) capital gain dividends received by RIC and REIT shareholders, (3) undistributed capital gains received by RIC and REIT shareholders, and (4) additional deferral of previously deferred gains. The Preamble requests comments on whether final regulations should include exceptions to the 180-day rule and whether the final regulations should include additional illustrations of the application of the 180-day rule in various circumstances (and if so, which circumstances). Although we believe the four examples provided in the Proposed Regulations are helpful, there are numerous other circumstances in which similar illustrations would be welcome.

1. Installment Sales

We believe that an application of the 180-day rule that would permit taxpayers to invest installment sale proceeds in respect of pre-2018 realization events would be counter to the intent of the QOZ rules. Section 1400Z-2 is intended to incentivize taxpayers to realize capital gains and invest the proceeds in QOZs. For gains that are already triggered, but not recognized because of the installment sale rules, such incentive is not necessary, and is therefore outside of the ambit of the rules. We recommend that final regulations confirm that capital gains from an installment sale are only eligible for deferral where the original sale or exchange took place in 2018 or later.

We also recommend that the final regulations clarify how the 180-day rule would apply in the installment sale context more generally. A strict reading of the statute requires that the 180-day period begins on the date of the sale or exchange. If regulations do not address installment sales more directly, the taxpayers may be unable to defer gains from an installment sale recognized more than 180 days after the sale, unless the taxpayer elected out of the installment method. On the other hand, if Treasury were to adopt a rule that began the 180-day period on the date that an installment payment is received, it should consider whether such a rule would permit abusive transactions that artificially extended the gain deferral window well beyond the statutory 180-day period.

2. Flow-Through Entities

The Proposed Regulations provide helpful clarification and flexibility with respect to capital gains realized by partnerships, as described above. The Proposed Regulations provide two time windows during which partners can make their QOF investment. First, the investment can be made within 180 days after the last day of the partnership's taxable year in which the partner's share of the partnership's gain is taken into account under Section 706(a). Alternatively, a partner may elect instead to use the partnership's deferral period – that is, the 180-day period starting on the date the partnership recognized the gain.

We commend the Treasury for affording flexibility to partners in partnerships, many of whom do not receive information from their partnerships in real time. However, we believe that Treasury should consider whether final regulations should provide relief for partners in partnerships who seek to reinvest in QOFs during the time period between these two alternative reinvestment windows. This quirk of the timing rule can be illustrated through the examples below:

> Example 6. Same as Example 1, except that P does not make a deferral election, and therefore A will have to take into account in 2018 her share of the $100 gain recognized by P on April 3, 2018. Assuming that the buyer of Blackacre is also not more than 20% related to A, A can make a deferral election with respect to her $30 share of the gain and invest $30 into a QOF by June 29, 2019 (which is 180 days after the last day of P's taxable year) to defer taxation on her share of P's gain.
>
> Example 7. Same as Example 6, except that shortly after the sale of Blackacre, P notifies its partners that it does not intend to make a deferral election with respect to the gain it recognized from the sale. A identifies an opportunity to invest in a QOF in August 2018. Under the elective rule, A can treat its 180-day period with respect to her share of the gain as being the same as P's 180-day period, and thus invest $30 into a QOF in August 2018 and make the deferral election. However, if the closing of the QOF is delayed, and A is not able to invest $30 in the QOF until October 2018, A cannot make a deferral election with respect to her $30 investment in the QOF under either of the elective rules.

Example 7 highlights a somewhat arbitrary timing constraint for partners in a partnership. For eligible gain recognized by the partnership in the first half of its taxable year, there will be a "dead zone" between the end of the 180-day period starting upon the partnership's recognition of the gain, and the beginning of the 180-day period beginning on the last day of the partnership's tax year. Treasury should consider whether it is within its authority to permit QOF investment by partners of non-electing partnerships during the period between the two 180-day windows, as there appears to be no good reason for such artificial "dead zone."

3. Anti-Abuse Rule

The use of partnerships can allow taxpayers to avoid certain restrictions under the QOZ rules, as illustrated by the following examples.

> Example 8. A owns a 30% tenancy in common interest in Blackacre. B and C own the rest of the interest in Blackacre. A, B and C intend to sell Blackacre on April 3, 2019, which will result in a $100 gain for the entire property, and A's $30 gain will be treated as long-term capital gain. A will recognize $30 gain upon disposition of Blackacre, absent a deferral election with respect to the gain. A can invest $30 in a QOF by September 30, 2019 and make a deferral election with respect to the $30 gain from selling Blackacre.
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> Example 9. Same as Example 8, except that A has not identified a QOF to invest in, so A convinces B and C to form Q, a calendar year partnership, by contributing their tenancy in common interests in Blackacre to Q in exchange for partnership interests in Q. Q then sells Blackacre on April 3, 2018 for a $100 gain. Q notifies its partners that it does not intend to make a deferral election with respect to gain it recognized from selling Blackacre. Shortly after the close of the 2018 taxable year, A makes a $30 investment into a QOF, and makes a deferral election with respect to capital gain it recognized through Q.
>
> Example 10. Same as Example 8, except that the potential buyer of Blackacre is 50% related to A (while unrelated to B and C), so A cannot make a deferral election with respect to the gain it recognized from selling its tenancy in common interest in Blackacre. A convinces B and C to form Q, a calendar year partnership, by contributing their tenancy in common interests in Blackacre to Q in exchange for partnership interests in Q. After the sale of Blackacre, Q can invest the $100 gain it recognized from selling Blackacre in a QOF by September 30, 2018 and make a deferral election with respect to that gain, because the buyer is less than 20% related to Q.

As illustrated by these examples, the elective rules under Proposed Regulations Section 1.1400Z-2(a)-1(c) can be used to expand the time window of investment or to circumvent the restrictions of gains recognized from related party sales. This type of planning could be curtailed by allowing a partnership to make a deferral election only if the partnership has been in existence and has held the asset for some specified minimum period of time. Treasury should consider how long the partnership needs to be in existence for it to be an eligible taxpayer to make a deferral election, and for its partners to be able to make an election of their distributive shares of gains recognized through the partnership. At a minimum, we recommend that Treasury consider an anti-abuse rule that would turn off the alternative 180-day windows where a partnership is formed with a primary purpose of extending the 180-day window.

4. REIT Capital Gain Dividends

Example 2 of Proposed Regulations Section 1.1400Z-2(a)-1(b)(4)(ii) states that "[i]f an individual RIC or REIT shareholder receives a capital gain dividend . . . the shareholder's 180-day period with respect to that gain begins on the day on which the dividend is paid." Because Section 857(b)(3) generally provides that (1) REIT capital gain dividends can only be declared on the net capital gain of the REIT, which will not even be verifiable until the REIT's taxable year has ended, and (2) a REIT has until 30 days after the close of its taxable year to identify a dividend as a capital gain dividend, taxpayers will not know whether a REIT dividend would be eligible for deferral through investment in a QOF until after the 180-day period has already expired.[35] This contrasts with the treatment of partnership gains in Proposed Regulations Section 1.1400Z-2(a)-1(c)(2), which provides that, to the extent a partnership does not elect to defer eligible capital gain, each partner may elect to invest that gain in a QOF, with the 180-day period beginning on the last day of the partnership's taxable year. There does not seem to be any apparent reason that partners in a partnership should be treated differently than REIT shareholders for purposes of the 180-day rule. In both contexts, without a special timing rule, the taxpayer may not become aware of the eligibility to make an eligible investment in a QOF until over 180 days after the distribution was made. Accordingly, we recommend that Treasury adopt a rule for REIT capital gain dividends under which the 180-day period begins on the last day of the REIT's taxable year, rather than on the date that the dividend is paid to the REIT shareholders. Such a rule would put REIT shareholders in a similar position to partners for purposes of the 180-day rule.

The considerations described above highlight the disparate treatment under the Proposed Regulations between REIT shareholders who hold their shares directly versus those REIT shareholders who hold their REIT shares through partnerships. Whereas the former face the possibility that their REIT capital gain dividends will be ineligible for investment in a QOF, the latter could receive the same dividend but, due to the operation of Proposed Regulations Section 1.1400Z-2(a)-1(c)(2), would benefit from a 180-day period that begins on the last day of the partnership's taxable year.

D. Fungible QOF Interests - FIFO and Pro Rata Methods

The Proposed Regulations generally require taxpayers to use the FIFO Method for determining which interests in a QOF have been disposed of when, on a single day, the taxpayer disposes of less than all its otherwise fungible interests (where such interests were acquired on different days). Under this method, the earliest acquired of such fungible interests are treated as disposed of first. Fungible interests may be equivalent shares of stock in a corporation or partnership interests with identical rights. In cases where capital gains with different attributes are invested in a QOF on the *same* day, such that the FIFO Method is insufficient to determine which of the resulting QOF interests were sold in a subsequent disposition of some but not all of these interests, the Proposed Regulations mandate the Pro Rata method.

The Proposed Regulations specify that the FIFO method determines (1) whether such interest was either subject to a gain deferral election ("**Eligible Interest**") or not subject to such

[35] In fact, a REIT may even pay a capital gain dividend with respect to capital gain realized later in the year.

an election ("**Ineligible Interest**")[36], when the taxpayer holds both types of interests (together "**Mixed Interests**"), (2) the character of gain recognized when the taxpayer holds Eligible Interests that represent deferred gain with different tax attributes (e.g., either short-term or long-term gain) ("**Mixed Eligible Interests**"), and (3) the extent of any basis step up in an Eligible Interest prior to 2027 by reason of its holding period.[37] The FIFO Method is thus relevant only for certain, specifically enumerated purposes. For example, after 2026, the FIFO Method is potentially relevant only if the fungible interests in the QOF are Mixed Interests, since the FIFO Method does not apply after 2026 if the taxpayer holds only fungible Eligible Interests acquired at different times (i.e., satisfies the 10 year holding period on different dates).[38] Consequently, the FIFO Method does not cover what would seem to be a likely scenario – namely, where a taxpayer will meet the 10-year holding period on a rolling basis with respect to qualifying investments it made over a period of time into a QOF.

> Example 11. P invests $50 of long term capital gain into a QOF on December 1, 2018, and then another $50 of long term capital gains into the QOF on December 1, 2019. On June 30, 2029, P sells half of its QOF interest and seeks to make a Gain Exclusion Election. Curiously, the FIFO Method does not apply for purposes of determining what portion of the interests sold on that day have met the requisite holding period, as that is not one of the purposes described in Proposed Regulations Section 1.1400Z-2(a)-1(b)(6)(ii).

The Proposed Regulations require taxpayers to use the Pro Rata Method of identification if, after application of the FIFO Method, the taxpayer is treated as disposing of less than all interests that were acquired on one day and that are either Mixed Interests or Mixed Eligible Interests. Under the Pro Rata Method, a proportionate allocation must be made to determine which interests were disposed of. Although the Proposed Regulations do not state that the Pro Rata Method is limited to fungible interests, they imply that the method is intended to be so limited (as is the FIFO Method), and the Preamble indicates that the Pro Rata Method is to be used "where the FIFO method does not provide a complete answer."[39]

The Proposed Regulations do not address whether non-economic differences (*e.g.*, voting and non-voting) or small economic differences (*e.g.*, redemption rights for different dates close in time) result in QOF interests being non-fungible. The Proposed Regulations also do not address whether the requirement to use these methods could be avoided by holding fungible interests with different tax attributes indirectly through different entities.[40]

36 Proposed Regulations Section 1.1400Z-2(e)-1 refers to an "investment of money" not subject to an election constituting an Ineligible Interest. It is unclear why the Proposed Regulations include this reference to "money," which the statute does not. We do not think it is needed, for example, to coordinate with the related rule that deemed contributions of money under Section 752 does not create a separate investment. While other requirements under Section 1400Z-2 limit the practical ability of a QOF to accept in-kind contributions, we recommend that Treasury clarify whether the QOZ rules permit in-kind contributions to QOFs.

37 Proposed Regulations Section 1.1400Z-2(a)-1(b)(6)(ii).

38 The FIFO Method does apply for purposes of determining the 10-year holding period of an Eligible Interest if the taxpayer also holds fungible Ineligible Interests.

39 If the Pro Rata Method is adopted, whether its application is limited to fungible interests should be clarified.

40 Basis and holding period of stock is normally determined under Section 1012 on an account by account basis, to facilitate broker reporting of basis. The Proposed Regulations appear not to use that approach and instead appear to

The rationale for the FIFO and Pro Rata Methods is unclear. These proposals are not contemplated in the statute or legislative history. They seem primarily intended to limit the extent to which taxpayers are permitted to otherwise maximize their benefits under Section 1400Z-2 when determining which interests, if fungible, are disposed of when less than all fungible interests are disposed of.[41] We are unaware of any evidence, however, that Congress intended for the benefits of Section 1400Z-2 to be limited in this manner. On the contrary, doing so would seem inconsistent with Congress' decision not to include in the final legislation containing Section 1400Z-2[42] a proposal passed by the Senate that would have mandated the use of a FIFO Method for stock (but not for partnership interests).[43]

For stock, current law provides a clear and administratively workable means for taxpayers and the government to make the determinations under Section 1400Z-2 that are relevant to partial dispositions of fungible Mixed Interests and fungible Mixed Eligible Interests. More specifically, under current law, on the disposition of some but not all shares of identical stock with non-identical basis or holding periods, a taxpayer is permitted to specifically identify which shares of stock are being disposed of (and a FIFO Method is used only as a default).[44] In our view, if the FIFO and Pro Rata Methods were not adopted, this rule would support permitting the use of a specific identification method for purposes of determining the tax attributes of identical stock in a QOF when less but not all of such stock is disposed of. It would also have the virtue of reducing complexity insofar as it would avoid introducing yet another parallel set of operating rules relevant particularly for QOZ purposes. For this reason, and because Congress recently rejected a legislative FIFO proposal, we recommend that final regulations generally rely on current law for making these determinations for stock, instead of adopting the FIFO and Pro Rata Methods.

The rationale for the mandatory FIFO and Pro Rata Methods for QOF partnership interests is even less clear. We agree with the proposals' premise that a workable application of Section 1400Z-2 to Mixed Interest and Mixed Eligible Interest requires the interests' separation into their components. We do not believe, however, that this separation should be limited to Mixed Interests and fungible Mixed Eligible Interests. Furthermore, for Mixed Eligible Interests, we do not believe that this separation should be limited to periods before 2027 (as provided for under the Proposed Regulations). For the statute to work, this separation should be extended to non-fungible Mixed Eligible Interests. To clarify how this separateness is established and maintained, we further recommend that final regulations explicitly state that tax attributes of the components of Mixed Interests and Mixed Eligible Interests are determined as though they are acquired and held by different taxpayers. Finally, for the same reasons that we recommend rejecting the FIFO and Pro Rata Methods for stock, we recommend taxpayers be permitted to identify which fungible separate partnership interest is disposed of and on which

require the FIFO and pro rata methods to be applied across accounts. If these proposals are adopted, it would be helpful to clarify whether the methods apply across accounts.

41 Current law would permit the specific identification method for only identical stock. *See* Treasury Regulations Sections 1.1012-1(c); 1.358-2.

42 P.L. 115-97.

43 115 H.R. 1, EAS, § 13533, pp. 246, 247

44 *See* Treasury Regulations Section 1.1012-1(c).

such interest a distribution is made, with proration mandated only in the absence of adequate identification.

We recommend that the final regulations address more directly and clearly the separation of partnership interests consisting of Mixed Interests or Mixed Eligible Interests because the basis and holding periods of partnership interests under current law is determined on a unified basis, for purposes of contributions, allocations, distributions and dispositions, regardless of whether the interest is unitized or represents different economic rights (e.g., preferred and common interest in the partnership). For example, if a partner contributes $100 to a partnership in exchange for an interest worth $100 and then, after a year, when such interest has doubled in value, contributes another $100 for an additional interest worth $100 and thereafter, but within the year, sells a third of her interest for $100 (to an unrelated party and not the partnership), the partner would recover only a third of her basis ($66) and thus recognize gain of $34, and a third of that gain would be short-term and the other two-thirds would be long-term (assuming no "hot assets" in the partnership or other basis adjustments, e.g., by reason of partnership allocations during the period of the investment). If instead of selling the one-third interest to an unrelated party, the partner redeemed from the partnership a third of her interest for $100, no gain would be recognized, and the partner's basis would be reduced by $100.[45]

In contrast to the "unified" interest approach taken by subchapter K, Section 1400Z-2(e) contemplates that Mixed Interests are treated as separate interests. Similarly, Mixed Eligible Interests must be separated into their component parts to determine the tax consequences of dispositions of and distributions on such interests.

For example, suppose in the example above the first purchased interest was acquired in 2018 as an Eligible Interest, and the second had identical rights and was an Ineligible Interest acquired thereafter. Instead of assuming that the one-third interest is sold for $100, however, assume that after 10 years from the first investment, a quarter of the Mixed Interest is sold for $100, implying that, after the second contribution, the Mixed Interest appreciated from $300 to $400 and that economically one-third of that $100 appreciation is attributable to the Ineligible Interest.

We believe that the correct tax policy result is (1) for $85 of deferred gain to be recognized in 2026, resulting in the Mixed Interest having an aggregate basis of $200, and (2) the exclusion of all gain in the subsequent sale of the one-quarter interest to the extent such sale is attributable to the Eligible Interest. Our recommendation would reach that result by treating each interest as though it were held by a different taxpayer and by permitting the taxpayer to specify which portions of each interest are being sold. If the taxpayer were to specify that only the Eligible Interest is sold, then no gain would be recognized. If the taxpayer failed to specify, a pro rata portion of each would be treated as sold (i.e., one-quarter of the $33.33 of appreciation attributable to the Ineligible Interest recognized).

If, in this example, the taxpayer did not sell the one-quarter interest for $100 but instead redeemed one-quarter of the interest for $100, our recommendation would permit the taxpayer to

[45] *See* Treasury Regulations Section 1.1223-3.

specify on which interest the distribution is treated as made. The distribution would thus reduce basis to zero of whichever interest selected, and thus would not trigger gain in either case. However, the identification could have a significant impact of the amount of gain subsequently recognized if there is further appreciation.

Suppose, for example, that the taxpayer treated all of the distribution as attributable to the Eligible Interest, resulting in the value of the Eligible Interest decreasing from $266.67 to $166.67 of the then total value of $300 (or 55.56%), and sometime later sold all the Mixed Interest for $400 (i.e., the Mixed Interest appreciated by $100 after the distribution). The taxpayer would recognize $77.77 of gain in respect of the Ineligible Interest ($400*44.44%-$100) and no gain in respect of the Eligible Interest. Now suppose instead that the taxpayer specified the $100 distribution was attributable to the Ineligible Interest, thereby recovering all the basis in such interest and resulting in its value decreasing from $133.33 to $33.33 of the total then value of $300 (or 11.11%). The subsequent sale of all the Mixed Interest for $400 would result in only $44.44 of gain attributable to the Ineligible Interest and no gain in respect of the Eligible Interest.

A summary of our recommendations regarding the FIFO and Pro Rata Methods are set forth below:

- We recommend that the final regulations not include the FIFO and Pro Rata Methods.

- For acquisitions and partial dispositions of fungible stock consisting of either Mixed Interests or Mixed Eligible Interests, we recommend that (1) taxpayers be permitted to identify which shares of stock acquired have what attributes for purposes of Section 1400Z-2 and, on a partial disposition of those shares, identify which of those share are disposed of using the same method as provided for under current law for purposes of determining basis and holding period of such shares and (2) mandated FIFO be used in the absence of adequate identification.

- For partnership interests consisting of either Mixed Interests or Mixed Eligible Interests, whether or not fungible, we recommend that final regulations specify that all Ineligible Interests be treated as a single interest separate from all Eligible Interests and that each Eligible Interest either acquired on a day different from the acquisition date of any other Eligible Interest or representing deferred gain of a character different than the character of gain of any other Eligible Interest be treated as a "separate" interest. We further recommend that the final regulations clarify that "separate" for this purpose means that the tax consequences of allocations, distributions and dispositions of each separate interest are determined as though it were held by a different taxpayer. Finally, when one or more separate interests have the same economic rights ("**Fungible Separate Partnership Interests**") we recommend that (1) the regulations permit a taxpayer to specify (x) which Fungible Separate Partnership Interests are disposed of when less than all Fungible Separate Partnership Interests are disposed of and (y) on which Fungible Separate Partnership Interests a distribution is made when a distribution is made on any Fungible Separate Partnership Interests and (2) if the taxpayer fails to specify, then the disposition or distribution be prorated across Fungible Separate Partnership Interests based on their relative values.

E. 2047 Termination of Gain Exclusion Election

Prior to the issuance of the Proposed Regulations, commenters raised a multitude of concerns relating to the ability to make a Gain Exclusion Election in light of the expiration of the QOZ designations on December 31, 2028.[46] We commend Treasury for addressing this squarely by providing in Proposed Regulations Section 1.1400Z-2(c)-1(a) that "the ability to make an election under Section 1400Z-2(c) for investments held for at least 10 years is not impaired solely because, under Section 1400Z-1(f), the designation of one or more qualified opportunity zones ceases to be in effect." The Gain Exclusion Election would have nearly been rendered null if the expiration of QOZ designation precluded the election.

However, the Proposed Regulations then provide that this relief "does not apply to elections under section 1400Z-2(c) that are related to dispositions occurring after December 31, 2047." The Preamble describes that this date provides a minimum of 20.5 years for a taxpayer that makes the latest possible investment in a QOF to hold its investment before losing the ability to make a disposition that may be accompanied by a Gain Exclusion Election. In other words, the Proposed Regulations would allow taxpayers who make the investment at the latest possible time permitted by the statute to hold the investment for the full ten year holding period, plus another ten years.

The Preamble specifically states that the additional ten-year period was inserted to avoid situations where the taxpayer may have to dispose of the QOF interest shortly after completion of the required ten-year holding period. Otherwise, a taxpayer might diverge from "otherwise desirable business conduct" or may lose the statutory benefit. Treasury has requested comments on whether some other time period would better align with taxpayers' various economic incentives. Treasury has raised the question of whether future regulations should provide for a presumed basis step-up election immediately before the ability to elect a basis step-up expires. We commend this proposal and recommend that the final regulations allow for an automatic basis step-up election immediately before December 31, 2047 (if such a date is retained in the final regulations) so that taxpayers may take advantage of the benefits of such election.

F. Pre-Existing Entities

Generally, the Proposed Regulations provide that pre-existing entities may qualify as QOFs if such entities meet the QOZ requirements as of the relevant testing dates, and in particular, the requirement that QOZBP must be acquired after December 31, 2017.[47] We commend Treasury for this aspect of the Proposed Regulations. Nonetheless, we believe that additional flexibilities are likely necessary to allow more pre-existing entities to qualify as QOFs.

[46] Section 1400Z-1(f). It is not unclear why Congress did not include a provision in the statute that addresses this timing point, as it did under the D.C. Enterprise Zone provision of Section 1400B(b)(5).

[47] Proposed Regulations Section 1.1400Z-2(d)-1(a)(3).

Specifically, Treasury should consider whether there are requirements that should be relaxed with respect to entities that acquired QOZBP prior to the date that the Proposed Regulations were issued (but after January 1, 2018) using eligible capital gains invested by taxpayers, but that may not have complied with all the QOZ requirements, including by reason of the fact that some of those requirements did not even exist at the time of the property acquisition. For example, assume a taxpayer and a group of other investors recognized capital gains in February 2018 and contributed the proceeds to an investment vehicle, which then further contributed the proceeds to an existing entity, which purchased QOZBP from an unrelated seller on April 7, 2018. Some time in late 2018 or early 2019, the taxpayer desires to elect deferral with respect to those gains, and would need to certify the existing entity as of April 7. However, the taxpayer capitalized the existing entity (for which it desires QOF treatment) through an investment vehicle, and not directly, and the investment vehicle was not the taxpayer that realized the gain.[48]

We recommend that final regulations contain rules regarding entities that taxpayers desire to treat as QOFs but were disregarded entities at the time property was acquired. Consider the following example:

> Example 12. LLC is a disregarded entity for U.S. tax purposes, and is wholly owned by PRS, a regarded entity that owns many assets and could not qualify as a QOF. LLC acquires property X (which otherwise qualifies as QOZBP) on March 1, 2018. Later in 2018, or in 2019, investors with eligible gains want to invest their gains in the development and improvements of property X. They desire to cause LLC to self-certify as a QOF prior to their investment, however, regardless of when the QOF designation will take effect, it is possible that property X will *never* qualify for treatment as QOZBP, since it was acquired (for tax purposes) by PRS, an entity that was not, and will never be, a QOF. Instead, LLC will have to arrange for a new sale of property X to a QOF with different ownership.

We recommend that Treasury consider whether it could address this situation by adopting a rule to the effect that QOZBP will be treated as acquired by a QOF from an unrelated party after December 31, 2017 if such property was acquired by a predecessor entity of the QOF (which may include a disregarded entity) after December 31, 2017.

G. Business and Investment Start-Up Periods

We note that many funds raise capital in a series of stages over a defined time period, typically 6-12 months. It is typical for later investors in these funds to invest in any assets of the fund at cost, by contributing their share of fund investments and expenses to the fund, along with an interest-like component. These amounts are distributed to the earlier investors to align all of the equity percentages. Many advisers have expressed concern that many of these arrangements may be treated as disguised sales of equity (at least where the QOF at issue is a tax partnership) and therefore preclude later investors from making deferral elections with respect to the investments (since they would be treated as having acquired interests from earlier investors and

48 If Treasury permits investments in QOFs through aggregator vehicles, as discussed in Section IV.B.1, this particular fact pattern would not be problematic.

not directly from the QOF). We recommend that Treasury consider adopting a rule clarifying that where such an arrangement occurs over a limited safe harbor period of 12 months, (i) it will be treated for U.S. federal income tax purposes as a single equity contribution by each investor, and (ii) Section 707 will not apply to deny QOZ benefits.

The definition of QOZB Interests explicitly contemplates that a newly organized corporation or partnership can be a QOZB.[49] At the same time, however, the statute requires that, during "substantially all" of the QOF's holding period for such stock or partnership interests, the entity qualify as a QOZB.[50] An entity will not qualify as a QOZB unless, among other things (1) it is engaged in a trade or business, (2) at least 50 percent of its total gross income is derived from the active conduct of such business, and (3) substantially all of its tangible property is QOZBP. For any new entity that requires more than a few months to become operational, these requirements would be difficult, if not impossible, to satisfy because QOZB status is tested every six months and start-up activities that do not rise to the level of a trade or business arguably do not qualify. In the absence of rules that reconcile these conflicting provisions, the number of new businesses eligible for QOZ benefits would be severely limited, which would discourage the establishment of new businesses in QOZs.

We recommend that Treasury issue regulations defining a reasonable start-up period during which any new corporation or partnership organized for the purpose of becoming a QOZB will not fail to qualify as such simply because it is in the start-up phase. The regulations promulgated under Section 45D, the New Markets Tax Credit, serve as appropriate precedent.

The New Markets Tax Credit provides an annual tax credit to investors that contribute cash to a community development entity ("**CDE**") that uses the funds to make equity investments in new or pre-existing qualified active low-income community businesses. A qualified active low-income community business is any corporation or partnership if it is engaged in the active conduct of a qualified business and satisfies certain other requirements, including a gross income requirement identical to the 50 percent gross income test set forth in Section 1400Z-2(d)(3)(A)(ii).[51] Under Treasury Regulations Section 1.45D-1(d)(4)(iv), an entity is treated as engaged in the active conduct of a trade or business for purposes of this test if, at the time of its investment, the CDE reasonably expects that the entity will generate revenues within three years after the date the investment is made.

The similar policy goals of Sections 45D and 1400Z-2 provide strong support for the view that the substantially identical statutory language of the two provisions (including the language in Section 1397C(b)(2) incorporated by reference into Section 1400Z-2) should be interpreted in a similar manner. Thus, we recommend that Treasury promulgate rules providing that a new corporation or partnership that otherwise qualifies as a QOZB will be deemed to be engaged in the active conduct of a trade or business if, at the time a QOF acquires its interest in such entity, the QOF reasonably expects that the entity will generate revenues satisfying the gross income test in Section 1397C(b)(2) within three years.

[49] *See* Sections 1400Z-2(d)(2)(B)(i)(II) and (C)(ii).
[50] *See* Sections 1400Z-2(d)(2)(B)(i)(III) and (C)(iii).
[51] Section 45D(d)(2); Treasury Regulations Section 1.45D-1(d)(4)(i).

Even if a start-up satisfies or is deemed to satisfy the trade or business requirement, it will not achieve QOZB status unless all of its tangible property (owned or leased) is QOZBP. A business in the initial stages of development may not yet own or lease any tangible property, however. To ensure that such a business has a reasonable opportunity consistent with its business needs to acquire or lease tangible property for use in a QOZ, we recommend that Treasury issue rules allowing new corporations or partnerships engaged in a trade or business to be treated as satisfying the Business Property Test under certain circumstances, and for a reasonable period of time, where the business plan calls for substantially all of the tangible property of the entity to be QOZBP.

H. The Working Capital Safe Harbor

We commend Treasury for adopting the WC Safe Harbor and we believe that it will enable taxpayers to hold and deploy working capital in an orderly and commercially reasonable manner. The WC Safe Harbor operates at the QOZB level. Under Section 1400Z-2(d)(3)(A)(ii), an entity will not be considered a QOZB unless, among other things, it satisfies the requirements of Section 1397C(b)(8), which limits the entity's ability to hold NQFP. As defined in Section 1397C(e), NQFP specifically excludes a reasonable amount of working capital in the form of cash, cash-equivalents, and certain short-term debt instruments. Proposed Regulations Section 1.1400Z-2(d)-1(d)(5)(iv) provides that any such working capital assets will be treated as reasonable in amount if (1) they are designated in writing for the acquisition, construction, and/or substantial improvement of tangible property in a qualified opportunity zone, (2) there is a written schedule that is consistent with the ordinary start-up of a trade or business for the expenditure of the assets that calls for the working capital to be spent within 31 months, and (3) the amounts are actually used in a manner that is substantially consistent with their designation and the schedule of expenditures.

Although the WC Safe Harbor provides welcome guidance, the Proposed Regulations do not offer any specificity regarding the characteristics of a qualifying schedule or the consequences of spending some or all of the working capital in a manner that deviates from the schedule, including for purposes not specified in the schedule, or failing to spend all of the capital within the 31-month period. They also do not address the treatment of working capital that is needed for businesses that are not asset-heavy. For example, service businesses will often require working capital for formation, acquisition, or expansion pending revenue sufficient to cover expenses, including, for example, amounts held to pay employees and independent contractors. This raises concerns that a business still in the early stages of development or growth might fail to achieve QOZB status even if it satisfies the WC Safe Harbor. Moreover, as drafted, the WC Safe Harbor, which by its terms is limited to "the acquisition, construction, and/or substantial improvement of tangible property," is much narrower than the statutory language, which permits a reasonable amount of working capital without regard to the specific manner in which it is deployed. This creates uncertainty as to the meaning of (and the very application of) the WC Safe Harbor in the context of an operating business. Section 1400Z-2 clearly is aimed at incentivizing the establishment of operating businesses, as well as real estate development, in QOZs and should not be interpreted in a manner that could inappropriately inhibit the establishment of new operating businesses in QOZs.

We recommend that Treasury expand the WC Safe Harbor to include any working capital reasonably expected to be used for the formation or acquisition of a new opportunity zone business, or reflected in the business plan, marketing plan, or development plan of an existing business and reasonably expected to be used in the business. We further recommend that any final regulations include examples of plans and schedules that will and will not satisfy the WC Safe Harbor, with particular focus on the specificity required. For example, we do not believe that a schedule that calls for the expenditure of cash "for QOZ projects in the east coast of the United States" (for instance) should pass muster under the WC Safe Harbor. Conversely, a schedule that provides that cash will be spent in connection with a defined set of particular projects ought to qualify.[52] As discussed in Section IV.J, we also recommend that QOFs be permitted to rely on the WC Safe Harbor when operating a QOZ business directly and not through a QOZB.

Guidance is also necessary with respect to the treatment of any working capital included on a schedule of expenditures that meets the WC Safe Harbor requirements, but that, for *bona fide* business reasons, is spent in a manner that deviates from the schedule or is not spent within the prescribed 31-month period. In the former instance, we recommend that Treasury clarify that any such amounts that are spent in a manner that would have qualified under the WC Safe Harbor if they had been included on the schedule will be treated as satisfying the WC Safe Harbor so long as any deviations or modifications resulted from legitimate commercial considerations and were not effectuated with a principal purpose of avoiding the NQFP limitation. Guidance in this particular area will be important in situations where an identified project or projects are abandoned midstream for bona fide business purposes, requiring the taxpayer to adjust the schedule accordingly.

Finally, as described in Section IV.A.2,[53] we believe that final regulations should more broadly permit QOFs and QOZBs to treat property as QOZBP where improvements to such property are in process. The Proposed Regulations, in our view, unduly limit this concept by tying it to the WC Safe Harbor. We believe that even outside the WC Safe Harbor, such as in the case of a QOF that holds assets directly, property that is being improved <u>must</u> be treated as qualifying property during the pendency of such improvements.

I. QOZB Income Sourcing

Under Section 1400Z-2(d)(3)(A)(ii), a QOZB must satisfy Section 1397C(b)(2), which requires that "at least 50 percent of the total gross income of *such entity* is derived from the active conduct of *such business*." This language does not map neatly onto the definition of QOZB, which provides no antecedent for the phrase "such entity" and does not limit the phrase "such business" to a business conducted in a QOZ. In its original context, however, Section 1397C(b)(2) refers to any corporation or partnership if every trade or business of the corporation or partnership is the active conduct of a qualified business within an empowerment zone. Given the underlying policy of the QOZ provisions and the original meaning of Section 1397C(b)(2), it

[52] For example, in the context of the accumulated earnings tax, a corporation, otherwise subject to such tax, may avoid the tax by showing that its earnings and profits were accumulated for "the reasonable needs of the business". Section 533(a).

[53] *See* fn. 30.

seems clear that Congress intended the gross income requirement to apply to any corporation or partnership seeking status as a QOZB and that only gross income derived within a QOZ could qualify as "good" income.

We recommend that Treasury issue guidance clarifying that a corporation or partnership will satisfy the requirements of Section 1397C(b)(2) if 50 percent of the total gross income of such entity is derived from the active conduct of a trade or business within all QOZs in which such entity conducts such trade or business. Further, we recommend that Treasury adopt rules governing the determination of the source of income as inside or outside a QOZ for purposes of this provision. Any such rules should be designed not only to allow taxpayers to assess with certainty whether the income test is satisfied, but also to ensure that otherwise eligible businesses with operations and service providers within QOZs are not disqualified merely because of income earned with respect to activities occurring or services provided outside QOZs.

In this latter respect, income sourcing rules based on those found in Sections 861 through 865 would not be an appropriate mechanism for implementing Section 1400Z-2's goal of increasing investment and activity in QOZs, as such rules would, among other consequences, deny the benefits of the QOZ provisions to a taxpayer who creates products in the QOZ for sale outside the QOZ. For example, under a traditional delivery-based sourcing rule that treats areas outside a QOZ in the same manner as a foreign country, a manufacturer whose tangible assets are located in a QOZ and whose employees produce items in a facility inside a QOZ would fail to generate "good" income with respect to any such items delivered outside the QOZ. Similarly, an information technology business could not satisfy the gross income requirement with royalties earned for the use of its software outside the QOZ, even if development of the software and any technical support therefor occurs entirely at offices maintained by the business inside the QOZ. In fact, under conventional sourcing rules, businesses that could satisfy the gross income requirement would largely be limited to real estate and on-site service businesses located within QOZs, a result more restrictive than the statutory language would require. In many of the cases posited above, business activity and jobs are created within the QOZs no less than is the case with more "localized" businesses.

A better basis for income-sourcing rules in the QOZ context would be those used to source income for purposes of the New Markets Tax Credit in Section 45D, which, like Section 1400Z-2, was enacted to encourage investment in distressed communities. To satisfy the definition of qualified active low-income community business, a corporation or partnership must derive at least 50 percent of its total gross income from the active conduct of a qualified business within a designated community. The language of this income test requirement is identical to the income test requirement imposed on QOZBs.

Treasury has issued regulations interpreting this gross income requirement for purposes of the New Markets Tax Credit. Under Treasury Regulations Section 1.45D-1(d)(4)(i)(A), an entity is deemed to have satisfied the gross income requirement if either (1) at least 50 percent of the use of the entity's tangible property (whether owned or leased) is within any low-income community[54] or (2) at least 50 percent of the services performed for such entity by its employees

[54] This percentage is determined based on a fraction the numerator of which is the average value of the tangible property owned or leased by the entity and used by the entity during the taxable year in a low-income community

are performed in a low-income community.[55] An entity may also satisfy the gross income requirement based on all the facts and circumstances.[56]

We recommend that Treasury issue guidance adopting comparable, if not identical, income-sourcing rules for purposes of the gross income requirement under Section 1400Z-2. One modification we would recommend is that any component of the gross income requirement that is based on the services performed for the QOZB should take into account both employees as well as independent contractors. Sections 1400Z-2 and 45D are similar statutes with virtually identical underlying policy goals. Importing the same or similar income-sourcing rules into the QOZ context would properly emphasize the statute's policy goals by ensuring that businesses operate and employ personnel substantially within QOZs and create employment opportunities there, regardless of whether, under the standard income-sourcing rules of Sections 861 through 865, the income would have its source within such zone.

J. Single-Tier vs. Two-Tier QOZ Structures

The QOZ rules create a number of critical distinctions between QOZBP held directly by QOFs, and QOZBP held through a subsidiary QOZB entity. As a general matter, holding qualifying property through a QOZB provides more flexibility to taxpayers. These important differences have resulted in tax motivated structuring involving QOZ investments.

The primary benefits to a QOF (and its investors) of investing through a QOZB are as follows:

- A QOF that holds QOZBP directly is subject to the 90% Test,[57] whereas a QOZB must meet the (70%) Sub All Test.[58]

- The Sub All Test to which a QOZB is subject applies only to tangible property held by the QOZB. While a QOZB must also use a "substantial portion" of its intangible assets in its QOZ business, the intangible assets themselves need not be purchased or otherwise satisfy the requirements applicable to QOZBP. Therefore, a QOZB in many cases can hold significant intangibles without impacting

and the denominator of which is the average value of the tangible property owned or leased by the entity and used by the entity during the taxable year. Property owned by the entity is valued at its cost basis as determined under Section 1012. Property leased by the entity is valued at a reasonable amount established by the entity. *See* Treasury Regulations Section 1.45D-1(d)(4)(i)(B)(1).

[55] This percentage is determined based on a fraction the numerator of which is the total amount paid by the entity for employee services performed in a low-income community during the taxable year and the denominator of which is the total amount paid by the entity for employee services during the taxable year. If the entity has no employees, the entity is deemed to satisfy this services performed requirement and the gross income requirement if at least 85 percent of the use of the entity's tangible property (whether owned or leased) is within any low-income community. *See* Treasury Regulations Section 1.45D-1(d)(4)(i)(C).

[56] *See* Treasury Regulations Section 1.45D-1(d)(4)(i)(A).

[57] Section 1400Z-2(d)(1).

[58] Section 1400Z-2(d)(3)(A)(i); Proposed Regulations Section 1.1400Z-2(d)-1(d)(3). Although a QOF that holds assets through a QOZB is still subject to the 90% Test, it may treat all of the interests in a subsidiary entity as qualifying property for these purposes so long as the entity meets the Sub All Test.

qualification. A QOF, in contrast, is subject to a flat 90% Test that takes into account all of its assets. Accordingly, even a small amount of intangible property can cause a loss of QOF status.

- The WC Safe Harbor applies only to QOZBs but not to QOFs that directly own assets. Therefore, in addition to being subject to the less forgiving 90% Test applicable to all its assets, a QOF can fail to qualify as a result of holding cash or other working capital, even if the working capital is governed by a schedule that calls for deployment in a reasonable and prompt manner.

In a narrow set of circumstances, it could be advantageous to hold QOZBP directly instead of through a QOZB. First, the statute does not restrict QOFs from directly operating a Prohibited Business, whereas a QOZB may not engage in such a business.[59] Furthermore, under Section 1400Z-2(d)(3)(A)(ii), a QOZB is subject to certain requirements of Section 1397C(b). These provisions include a prohibition on holding 5% or more of the entity's assets in NQFP. If a QOF will hold NQFP constituting more than 5% but less than 10% of its assets (and cannot otherwise qualify for the WC Safe Harbor), it would be well advised to hold its assets directly instead of through a QOZB. Finally, by cross referencing Section 1397C(b)(2), the rules require that at least 50 percent of the total gross income of a QOZB must be derived from the active conduct of the QOZ business. There is no apparent "active conduct" or similar standard applicable to QOFs holding business assets directly.

The policy justifications for these disparities in treatment are difficult to discern. Yet, the Preamble explicitly acknowledges and tacitly approves of them:

> "The 70 percent requirement for a trade or business will give QOFs an incentive to invest in a qualified opportunity zone business rather than owning qualified opportunity zone business property directly. For example, consider a QOF with $10 million in assets that plans to invest 100 percent of its assets in real property. If it held the real property directly, then at least $9 million (90 percent) of the property must be located within an opportunity zone to satisfy the 90 percent asset test for the QOF. If instead, it invests in a subsidiary that then holds real property, then only $7 million (70 percent) of the property must be located within an opportunity zone. In addition, if the QOF only invested $9 million into the subsidiary, which then held 70 percent of its property within an opportunity zone, the investors in the QOF could receive the statutory tax benefits while investing only $6.3 million (63 percent) of its assets within a qualified opportunity zone."

It is difficult to imagine that Congress intended to afford QOFs less flexibility in holding cash as working capital, and it appears equally unlikely that Congress intended to allow QOFs, but not QOZBs, to operate Prohibited Businesses. Instead, these results seem to be accidents of the statutory framework. We suggest that Treasury consider whether final regulations could reduce the distinctions between single- and double-tier structures by, for example, providing for a safe harbor at the QOF level with a similar effect to the WC Safe Harbor. At the very least, we recommend that property in the process of substantial improvement by a QOF be treated as satisfying the SI Requirement while such work is in process, in precisely the manner in which

[59] Section 1400Z-2(d)(3)(A)(iii); Proposed Regulations Section 1.1400Z-2(d)-1(d)(6).

Proposed Regulations Section 1400Z-2(d)-1(d)(5)(vii) applies at the QOZB level. Alternatively, Congress could consider a statutory amendment that would put single- and double-tier QOFs on equal footing, at least with respect to some of the key elements set forth above. We believe that doing so would obviate unnecessary structuring and administrative complexity, especially for taxpayers compelled to form new entities for the sole purpose of creating tiered structures.

K. Profits Interests and Non Pro-Rata Economic Interests

1. Background

Proposed Regulations Section 1.1400Z-2(a)-1(b)(3)(i) provides that an "eligible interest" in a QOF includes "preferred stock or a partnership interest with special allocations." For QOFs that are partnerships, various issues arise where an investor holds an interest in the QOF that is entitled to special allocations or that has a right to a disproportionate percentage of profits.[60] Indeed, it will not be uncommon for a taxpayer to contribute cash to a QOF and receive both a capital interest and a profits interest ("**Profits Interest**").[61] Section 1400Z-2(c) appears on its face to provide a taxpayer making a Gain Exclusion Election with a basis equal to the full fair market value of the "investment" in the QOF, without distinguishing between the different economic rights that may be encompassed by the unitary "investment" in the QOF.[62] Yet, neither the statute nor the Proposed Regulations specifically address the tax treatment of the appreciation in Profits Interests.

Consider the following examples:

> Example 13. Venture capital firm V invests $10,000 of eligible gains in a QOF partnership, and receives an interest entitling V to a preferred return, as well as a certain minimum equity multiple upon a sale of the investment. The arrangement is arm's length. Section 1400Z-2 appears to permit V to make a Gain Exclusion Election with respect to the entirety of its interest, assuming the various QOZ requirements are satisfied.
>
> Example 14. Individual P is a promoter of investment funds. P raises $10,000 of capital from third party investors and forms a fund classified as a partnership for tax purposes. P is granted a Profits Interest in the fund entitling him to 20% of the profits, after the investors have received a minimum rate of return on their invested capital. P invests no capital in the fund. The fund certifies as a QOF and holds QOZBP for 10 years, at which point P and the limited partners sell their interests, and P receives $1000 in the sale. Clearly P cannot make the Gain Exclusion Election in connection with the sale because P did not acquire its Profits Interest with eligible gains. In fact, P did not acquire the interest in exchange for any investment at all.

[60] Many of the issues discussed in this section could also arise for QOFs formed as C corporations (but not subchapter S corporations).

[61] We note that this discussion is not limited to profits interests as defined under Rev. Proc. 91-32. Profits interests are generally discussed as a proxy for any partnership interest that provides for economics disproportionate to the investor's capital investment.

[62] On the unitary treatment of partnership interests, *see, e.g.,* Rev. Rul. 84-53, 1984-1 C.B. 159 (partner that is both a limited partner and general partner has a unitary outside basis in the partnership).

Example 15. The facts are the same as in Example 14, however P invests $100 of capital in exchange for a 1% interest in the fund and the same 20% of profits.

A question arises under Section 1400Z-2 as to whether P can make the Gain Exclusion Election with respect to all the sales proceeds under the facts of Example 15. Indeed, the proper treatment of P becomes more difficult if one were to imagine investments of smaller amounts of eligible gains, perhaps even de minimis amounts. An equity interest entitling the holder to special (non-pro rata) allocations in a QOF may in fact qualify for the benefits of the statute. Thus, a "carried interest" or "promoted interest" does not appear to be automatically disqualified from being treated as an eligible interest solely on account of the fact that the holder is entitled to economics that are disproportionate to invested capital. The Proposed Regulations and their reference to "special allocations" certainly appear to contemplate this result.

Section 1400Z-2(e) provides for the treatment of Mixed Interests in a QOF to the extent the taxpayer invests eligible capital gains and other capital. The bifurcated treatment of Mixed Interests presents a framework for analyzing the treatment of a taxpayer such as P in the examples above, who receives a Profits Interest combined with another interest in the QOF. The Mixed Fund rule does not, however, provide guidance on how a single investment by a taxpayer is to be divided into its component parts or on whether a stated bifurcation will be respected in all cases. Because such interests are ubiquitous in partnership structures, taxpayers require more specific guidance.

2. Compensatory vs. Non-compensatory Interests

We believe it to be clear under the statute that while a Profits Interest (or any other equity in a QOF) purchased for cash can be an Eligible Interest, an interest issued for services cannot. This is because equity in a QOF received for services cannot be said to have been received in exchange for an "investment," as Section 1400Z-2 requires. We recommend that Treasury consider clarifying this principle in final regulations. Such a rule would also confirm that even a single interest must be treated as two separate interests if received for both capital and services. In these cases, a partial or full disposition of the taxpayer's interest will require a proper allocation of proceeds. In this regard, we recommend that the Treasury adopt a rule that requires a taxpayer to allocate any consideration based on the manner in which the proceeds would be distributed under the governing documents of the QOF.

Any rule governing the bifurcation of compensatory (and thus ineligible) and noncompensatory (and thus eligible) interests in a QOF must also take into account the treatment of the QOF's interest in a subsidiary QOZB. Section 1400Z-2(d)(2)(B) and (C) require that a QOF acquire interests in a QOZB "solely in exchange for cash." In certain scenarios, a QOF may acquire an interest in a QOZB for cash but also may be granted a non pro-rata carried interest in the QOZB, in order to compensate a service provider that holds equity at the QOF level. This may occur, for example, where there are other QOFs that own interests in the QOZB and that do not participate in any such carried interest. In these circumstances, we recommend that such QOZB interest be treated as entirely qualifying, with the bifurcation being applied at the QOF level, since the substance of such an arrangement is a cash investment by a QOF in a QOZB together with a compensatory grant of equity to a service provider at the QOF level. Further, we recommend that final regulations clarify that compensatory interests in a QOF will not cause such QOF to be treated as receiving interests in a QOZB for services, thereby precluding qualification as a QOZB.

3. Anti-Abuse Considerations

The determination of whether a particular QOF interest is an Eligible Interest or an Ineligible Interest becomes more fraught where a taxpayer itself (or through related or affiliated investors) holds both categories of interests. In these cases, taxpayers will be incentivized to shift the economics to the interest received in exchange for eligible capital gains and away from the interest received for other capital. Where these shifts occur between different interests held by the same taxpayer, improper QOZ benefits may be achieved without impacting the relative economic rights as between the partners. Consequently, we believe it is important to consider whether certain arrangements should be subject to scrutiny as to whether the taxpayers has shifted allocations (and thus, value) among the various types of interests in a manner that does not have economic effect apart from maximizing QOZ benefits. In all events, we believe that the general rule should provide that bifurcation is based on relative fair market values of the interests being evaluated.

Determining whether value has been improperly shifted from a compensatory interest to an Eligible Interest may require an analysis of the services provided, which could raise complex valuation issues. However, the difficulty may be mitigated by comparing the rights associated with the purported Eligible Interests to those relating to the interests of other holders who invest only cash in the QOF (whether in exchange for Eligible Interests, Ineligible Interests, or both). This comparison can also help in evaluating the legitimacy of noncompensatory interests that taxpayers seek to treat as Eligible Interests. For example, if an investor contributes $50 of eligible gain to a QOF and $50 of other capital, while there is no requirement that the economic entitlements with respect to the two separate investments be equivalent, a true arm’s length arrangement would presumably result in comparable rights (and value). Needless to say, where these interests are held by separate (and unrelated) investors, market forces will generally ensure that rights to distributions are not tax motivated. Accordingly, we believe that if anti-abuse rules are adopted, they should contain a presumption that special allocations and disproportionate economics will be respected where the arrangement is the result of arm’s length negotiations with unrelated parties and where the economic rights associated with purported Eligible Interests are commensurate with those of Ineligible Interests held by unrelated parties in the same QOF. They should also take into account whether there are tax indifferent parties investing in the QOF, and the QOZ status of the various participants.

We considered recommending specific approaches that could be deployed in ensuring that value is not improperly shifted between related taxpayers or between different interests held by the same taxpayer. We ultimately recommend the adoption of a general anti-abuse rule with certain prescribed “facts and circumstances” and factors that should be taken into account (as illustrated above), as well as presumptions that may apply under certain circumstances.

L. Section 1231 Gains

The Proposed Regulations provide that gain is eligible for deferral if it is treated as a capital gain for U.S. federal income tax purposes. When taxpayers dispose of business property in a taxable transaction, the gain or loss is usually a Section 1231 gain or loss. Whether such gain or loss is treated as ordinary or capital is determined under special rules set forth in Section 1231. When taxpayers dispose of depreciable property (Section 1245 property or Section 1250 property) at a gain, all or part of the gain will first be recognized as ordinary income under the depreciation recapture rules, and any remaining gain will be a Section 1231 gain. To determine the treatment of Section 1231 gains and losses, first the taxpayer will combine all its Section 1231 gains and losses for the year, and if it has a net Section 1231 loss, it is ordinary loss; if it has a net Section 1231 gain, it is ordinary income up to the amount of its Section 1231 losses from the previous five years that have not been recaptured, and the rest, if any, is long-term capital gain.

Therefore, the character of Section 1231 gains can be determined only after cross-netting the transactions for a tax year. Section 1231 gains pose various issues and uncertainties under the QOF rules.

> Example 16. Calendar year taxpayer individual A is in the business of rental real estate. A disposed of an apartment building A had held for longer than one year on April 3, 2018, realizing a $100 gain, of which $30 was treated as depreciation recapture, and the remaining $70 would be treated as Section 1231 gain. A realizes a $40 Section 1231 loss from a separate transaction on August 1, 2018. On November 1, 2018, A realizes another $20 Section 1231 gain. In the previous 5 years, A took ordinary deductions of net Section 1231 loss, of which $35 has not been recaptured.

With respect to the April transaction, the $30 depreciation recapture will always be treated as ordinary income (unless it represents "unrecaptured Section 1250 gain," which is a species of capital gain taxed at a maximum rate of 25%), and therefore, it should not be treated as eligible gain for QOZ purposes. Regarding the Section 1231 items, absent the QOZ rules, Section 1231 gains and losses in the same year will first be netted against each other, and A will have a net $50 Section 1231 gain from 2018 ($70+$20-$40); then $35 will be recognized as ordinary income to recapture prior net Section 1231 loss deductions. The remaining $15 net Section 1231 gain will be treated as long-term capital gain for 2018. It is unclear whether the deferral election is available for (i) both (and either of) the $70 and $20 gross Section 1231 gains from the April and November transaction, or (ii) only the $15 Section 1231 gain after the recapture of prior losses (or perhaps the $50, computed prior to the recapture of unrecaptured Section 1231 losses).

On one hand, the language in the Proposed Regulations seems to only allow deferral of a gain that is "treated as a capital gain," and A cannot treat a particular item of Section 1231 gain as capital gains unless and until it has determined its net $15 amount from its Section 1231 items. On the other hand, Section 1231 items are preferred items, in the sense that net gains enjoy long-term capital gain treatment. It seems a rather harsh result to treat Section 1231 items in a less favorable manner than normal capital gains and losses, where the QOF rules generally allows a taxpayer to defer gross capital gain, and carry forward capital losses. However, allowing deferral elections with respect to gross items of Section 1231 gains will allow taxpayers to use its Section 1231 losses to offset other unrelated ordinary income. We believe that Treasury should consider whether this result is consistent with the intent of the QOZ regime and the Proposed Regulations.

If the deferral election is available with respect to the gross Section 1231 gains of $70 and $20, presumably A can make two investments into QOFs, one of $70 by September 30, 2018, and one of $20 by April 30, 2019 to defer both items of gross Section 1231 gain, and will be able to take an ordinary deduction of $40 with respect to the Section 1231 loss. Under the QOF rules, the attributes of A's deferred gain will be preserved, so if the $70 reinvested Section 1231 gain receives a 15% basis increase (to $10.50) and is then recognized on Dec. 31, 2026, the gain recognized on such date will be $59.50 of Section 1231 gain. But should the $59.50 of gain be subject to recapture of prior net Section 1231 losses? And if so, which five-year window is relevant for this purpose: 2012 through 2017, the five years prior to when the original Section 1231 gain would be recognized had A not made the QOF investment and election, or perhaps 2020 through 2025, the five-year period preceding the recognition of the deferred Section 1231 gains? Should A be required to amend its 2018 return so that its 2018 Section 1231 losses are used to offset the Section 1231 gains now being recognized in 2026?

It seems that a recapture should be required in this situation, because otherwise A would not only have deferred the recognition of its Section 1231 gain, but it also would have converted the recapture portion of such gain from ordinary income to capital gain by investing it in a QOF, and we do not believe that this character conversion effect is an intended benefit under the QOZ rules. Furthermore, even if recapture is required, because A was able to use its gross Section 1231 loss in 2018 to offset its unrelated ordinary income, the election effectively would have enabled A to defer tax on ordinary income, which may also be inconsistent with the statute and the Proposed Regulations. If Treasury were to issue regulations allowing an election with respect to gross Section 1231 gains, rules should also be issued to prevent A from currently using its current deduction of gross Section 1231 losses against ordinary income.

If final regulations only allow a deferral election with respect to the $15 net Section 1231 gain treated as long-term capital gain, a separate issue arises with respect to the appropriate 180-day period with respect to such gain. It appears that there are alternative approaches. First, because A has to recapture prior unrecaptured Section 1231 losses, A can only make deferral elections for gains from transactions that resulted in additional Section 1231 gains after full recapture of prior Section 1231 losses. Under this approach, A can only invest the $15 during the 180-days beginning November 1, 2018. Since A recognized Section 1231 loss in August, after the April transactions that gave rise to the first Section 1231 gain, if A had made a QOF investment immediately after the April transaction, significant uncertainty could result.[63]

The alternative approach would be to start the 180-day clock at the end of the relevant taxable year. At that time, the taxpayer can determine the amount of net Section 1231 gain it will recognize in that year, which will be treated as capital gain under the Code. This approach is similar to the way in which the election operates with respect to capital gains recognized through a non-electing partnership.

We also note that Section 1231 gains give rise to a number of interpretive difficulties when realized at the partnership level. Under Section 702(a)(3), the determination of whether Section 1231 gains are treated as capital gains is made at the partner level. Therefore, it is

[63] The same problem also exists if the net Section 1231 gains are ratably allocated to all Section 1231 gain transactions.

unclear whether a partnership itself can defer that gain through a QOF investment, as the ultimate character determination is done by each partner, and depends on the partner's Section 1231 items from other sources.

M. Treatment of Leases

1. Background

The 90% Test is satisfied by a QOF only if it holds 90 percent of its assets in QOZP, measured as the average of the percentage of such property held on two prescribed semiannual testing dates. As described above, QOZP includes QOZBP and QOZB Interests.[64] As defined in Section 1400Z-2(d)(2)(D), QOZBP comprises any tangible property used in a trade or business of the QOF, but only if the property satisfies the enumerated conditions comprising the Business Property Test.

Under Sections 1400Z-2(d)(2)(B) and (C), stock in a corporation and interests in a partnership will be QOZP in the fund's hands if, among other things, at the time of acquisition and during substantially all of the fund's holding period, the corporation or partnership is a QOZB. Under Section 1400Z-2(d)(3), a QOZB is a trade or business if, among other things, substantially all of the property owned *or leased*[65] by the corporation or partnership is QOZBP, *i.e.*, tangible property that satisfies the Business Property Test applied *mutatis mutandis* at the business level.[66] As described above, the Proposed Regulations establish a 70% standard for the Sub All Test.

The Proposed Regulations also provide that, for purposes of the 90% Test, the value of each asset is the QOF's cost of the asset unless the QOF has an "applicable financial statement," in which case, the value of each asset of the fund is the value of the asset as reported on its applicable financial statement for the relevant reporting period.[67] Similar rules are proposed for purposes of the Sub All Test.[68]

Depending on how they are interpreted, these requirements can lead to absurd results both with respect to property leased by a QOF and with respect to property leased by a QOZB. More specifically, under one potential literal reading, the plain language of the statute would allow a QOF to lease property that is never used in a QOZ while effectively making it impossible for a QOZB to lease property without risking its QOZB status. We offer certain

[64] Section 1400Z-2(d)(2)(A).

[65] We assume that, for purposes of Section 1400Z-2, leased property is property subject to a lease that is respected as such for U.S. federal income tax purposes (a "true" lease) and not a lease that transfers ownership of the property to the nominal lessee. Any other interpretation would render superfluous the language in the statute that distinguishes property leased from property owned. Except as otherwise noted, any references to leases in this Report include only leases that are "true" leases for U.S. federal income tax purposes.

[66] *See* Section 1400Z-2(d)(3)(A)(i).

[67] *See* Proposed Regulations Section 1.1400Z-2(d)-1(b).

[68] Proposed Regulations Section 1.1400Z-2(d)-1(d)(3)(ii).

recommendations below that we believe avoid confusion and abuse and permit the use of leased property in QOZBs, a result we believe is consistent with clear Congressional intent.

2. Treatment of Leased Property at the QOF Level

The 90% Test applies only to property that the QOF "holds." Because the term "hold" connotes ownership, the Business Property Test seems to apply only to that which the QOF owns. Consequently, the Business Property Test appears to have no application to property that the QOF leases.[69] Accordingly, at first blush, leased property does not figure in a QOF's 90% Test percentage irrespective of the nature of the property.[70]

This result is consistent with the policy of Section 1400Z-2 insofar as it is designed to incentivize only new capital investment in property, as there is no such investment in a fair market value lease. At the same time, however, this result allows funds to avoid the "substantially all use in the zone" requirement with respect to leased property, which means that a QOF could use leased property primarily or even exclusively outside the QOZ. It is unlikely that this is what Congress intended, as the statute's objective is to incentivize investment and business activity within QOZs.

The "DC Zone" provisions of former Section 1400B[71] serve as a reasonable guide for the interpretation of Section 1400Z-2. Prior to its repeal in early 2018, Section 1400B provided a similar capital gain exemption for investment in distressed communities and contained asset and business property tests that are in many respects nearly identical to the 90% Test and the Business Property Test in Section 1400Z-2. Prior to its repeal, Section 1400B excluded from gross income "any qualified capital gain from the sale or exchange of any 'DC Zone asset' held for more than 5 years."[72] A "DC Zone asset" was any DC Zone business stock, any DC Zone partnership interest, and any DC Zone business property.[73] The definitions of "DC Zone business stock" and "DC Zone partnership" interest were largely identical to those of the corresponding terms in Section 1400Z-2. For an equity interest in an entity to qualify as a DC Zone asset, the issuing entity had to be a DC Zone business during substantially all of the taxpayer's holding period. The definition of "DC Zone business property," on the other hand, differed in subtle but important ways from its QOZ counterpart. "DC Zone business property," like QOZBP, included any tangible property that satisfies the prescribed "acquired by purchase" and "original use" requirements. But where Section 1400Z-2(d)(2)(D)(i)(III) requires that substantially all of the use of the property be in a QOZ, Section 1400B(b)(4)(A)(iii) required that substantially all of the use of the property be in a "DC Zone *business*" (as opposed to a

69 *McFeely v. Comm'r*, 296 U.S. 102, 107 (1935) ("In common understanding to hold property is to own it. In order to own or hold one must acquire."). *See also United States v. Ninety-Nine Diamonds*, 139 F. 961, 971 (8th Cir. 1905) ("'To own' is defined 'to hold as property; to have a legal or rightful title to; to have; to possess'….").

70 One might argue that, because the fund "holds" the leasehold interest, the leasehold interest should be taken into account as a "bad" intangible asset. But an on-market lease would have no value and zero cost basis and therefore would not alter the fund's 90% Test percentage in any event.

71 Section 1400B was repealed on March 23, 2018 pursuant to Section 401(d)(4)(A), Div. U of P.L. 115-141.

72 See Section 1400B(a) as in effect prior to its repeal pursuant to Section 401(d)(4)(A), Div. U of P.L. 115-141 on March 23, 2018.

73 *See* Section 1400B(b)(1) as in effect prior to its repeal.

"*DC Zone*"). Presumably, this "use in the *business*" requirement was designed to achieve parity between the requirements imposed on businesses conducted directly by the taxpayer and those operated through a subsidiary corporation or partnership in which the taxpayer owned an equity interest.

Unlike a QOZB, which is defined in Section 1400Z-2, the term "DC Zone business" was defined by reference to the definition of "enterprise zone business" in Section 1397C and included both "qualified business entities" and "qualified proprietorships." Sections 1397C(b)(3) and (c)(2) require that "a substantial portion of the use of the tangible property of [the entity or proprietorship, as applicable,] (whether owned *or leased*) is within [a DC Zone]."[74] Accordingly, a taxpayer could not qualify for DC Zone tax benefits with respect to any tangible property unless: (1) in the case of owned tangible property, such property satisfied the "acquired by purchase" and "original use" requirements and substantially all of the use of the property was in the business and (2) *all* tangible property used in the business, *whether owned or leased*, was used in a DC Zone *a substantial portion of the time*. Thus, a taxpayer was free to lease tangible property for use in a purported DC Zone business without regard to whether such property was owned by a related party or previously used in a DC Zone, but its eligibility for DC Zone tax benefits would be jeopardized if the business did not use the leased tangible property within a DC Zone a substantial portion of the time.

Although the legislative history of Section 1400Z-2 does not provide any detail on this point, the differences between the definitions of DC Zone business property and QOZBP appear to be the result of a Congressional desire to impose a more stringent "substantially all use in the zone" requirement for QOZBs instead of the "substantial portion of use in the zone" standard of Section 1400B. Because the 90% Test considers only tangible property "held" by the QOF, however, property leased directly by a QOF escapes the usage requirement altogether.

3. Treatment of Leased Property at the QOZB Level

Section 1400Z-2(d)(3) provides that a trade or business will qualify as a QOZB if, among other things, "substantially all of the tangible property owned *or leased* by the taxpayer is QOZBP (determined by substituting 'qualified opportunity zone business' for 'qualified opportunity fund' each place it appears in [Section 1400Z-2(d)(2)(D))]."[75] Thus, the statute explicitly contemplates that a QOZB may lease tangible property and that, at the QOZB level, QOZBP will include any leased tangible property that, *vis-à-vis* the QOZB, satisfies the Business Property Test.

The plain meaning of the QOZB definition, however, appears to contain an internal inconsistency since tangible property leased by a QOZB cannot, by definition, attain QOZBP status: tangible property will not constitute QOZBP in the hands of a QOZB unless (1) it was acquired by the QOZB by purchase, (2) its original use in the QOZ begins with the QOZB, *and* (3) during substantially all of the QOZB's holding period for the property, substantially all of its use is in a QOZ. Property that fails to satisfy any of these three requirements will not be considered QOZBP. If these requirements are applied literally, it is difficult to conclude that a

[74] *Id*. (emphasis added).
[75] *Id*. (emphasis added).

QOZB can satisfy *any* of these requirements with respect to leased property. Tangible property leased by a QOZB would never be QOZBP because, axiomatically, it will not have been acquired by purchase.[76] In addition, it would be impossible for a QOZB to satisfy the Original Use Requirement except in rare cases. A QOZB would fail the Original Use Requirement with respect to any leased premises in the QOZ previously leased to another tenant and any leased movable property that was previously used in the QOZ. Even if a QOZB is the first tenant to occupy a leased QOZ premises, the "original use" of the premises arguably commences with the lessor in its business of leasing property. Finally, a QOZB does not really have a "holding period" in leased property. Accordingly, notwithstanding that a QOZB's leased tangible property has at all times been used inside the QOZ, it would fail to qualify except in rare circumstances, a result seemingly at odds with the aim of the legislation.

If the value of leased property were treated as a non-qualifying asset, then, an otherwise eligible business that requires indoor space (*e.g.*, office space, retail space, or industrial space) and wishes to lease its plant and equipment would likely find it impossible to qualify as a QOZB and would be forced to purchase and construct its own real estate in the QOZ prior to commencing operations. It does not seem likely that Congress intended to restrict a QOZB's ability to lease property.

We have considered whether it is preferable to interpret the statutory language with respect to a QOZB's leased property by treating the property as QOZBP if it satisfies the Business Property Test in the hands of the landlord.[77] But such a reading would allow the QOZB to bolster its asset test compliance using the landlord's property and, thereby, acquire larger amounts of non-qualifying tangible property than would otherwise be permitted. Such a reading would be directly contrary to the policy of conferring benefits only on those taxpayers that make meaningful investments in a QOZ.

Interpreting Section 1400Z-2 to require leased property of a QOZB to satisfy the Purchase Requirement and Original Use Requirement of the Business Property Test leads only to absurd outcomes or a statute without meaning or effect insofar as leased property is concerned. It is unambiguously clear from the definition of QOZB that Section 1400Z-2 contemplates that a QOZB may lease property and that such property can constitute QOZBP. The only construction that does not render the leased property provisions of the statute a nullity and provides some meaning to the language of Section 1400Z-2(d)(3)(A)(i) is to require leased property of a QOZB to satisfy the "substantially all use in the zone" requirement in Section 1400Z-2(d)(2)(D)(i)(III) but not the Purchase Requirement and Original Use Requirement in Section 1400Z-2(d)(2)(D)(i)(I) and (II). We believe that applying traditional rules of statutory construction in this manner is well within Treasury's authority and would further what we believe are the policy objectives of the QOZ provisions.[78]

[76] One might argue that a QOZB could satisfy the "acquired by purchase" requirement by purchasing a leasehold interest in the property from the original lessee. The leasehold interest itself is an intangible asset, however, and, therefore, not encompassed by the definition of QOZBP.

[77] This would require the QOZB lessee to obtain certifications from the landlord as to the satisfaction of the "original use" requirement and the cost or U.S. GAAP value of the leased property.

[78] As a result of the related party restrictions associated with the Purchase Requirement, we expect many joint ventures between land owners and QOFs to utilize lease structures in lieu of contributions of the land to the joint

4. *Effect of Proposed Regulations*

The Proposed Regulations do not address these issues explicitly, but the proposed rules for asset valuation may affect the treatment of property leased by a QOZB. Under the Proposed Regulations, for purposes of the Sub All Test, tangible property is generally taken into account at the value of the property as reported on the entity's applicable financial statement, which includes a certified audited financial statement that is prepared in accordance with U.S. GAAP, or, in the absence of an applicable financial statement, at cost.

For U.S. federal income tax purposes, a taxpayer entering into an at-market lease has no basis in the leased property. As a result, any leased tangible property that is taken into account at cost will not affect the percentage of a QOZB's tangible property treated as QOZBP. This effectively excludes the leased property from the "substantially all use in the zone" requirement and allows the QOZB to lease non-qualifying tangible property with impunity—the same issue that arises at the QOF level because, under the 90% Test, leased property is (apparently) ignored.

It is not clear how U.S. GAAP would affect the percentage of qualifying assets of a QOZB that values tangible property as reported on its applicable financial statement.[79] If a lease or leased property is assigned any value (other than zero) for purposes of Section 1400Z-2, however, then, as discussed above, under a straightforward application of the statutory language, it would be impossible for it to satisfy the Purchase Requirement and almost impossible for it to satisfy the Original Use Requirement. In such case, neither the lease nor the leased property would generally be characterized as QOZBP, even if all of the use was in the applicable QOZ. Moreover, it is not even clear what the impact is of the inability of leased property to qualify as QOZBP. The Sub All Test only applies to tangible property of a QOZB. While a leasehold interest is an intangible asset, the statute somewhat confusingly refers to "tangible property owned or leased," creating an interpretive dilemma.

5. *Recommendations*

We believe that the QOZ rules are best interpreted as requiring that every QOF and every QOZB use all of its tangible property (whether owned or leased) predominantly in a QOZ. Interpreting the statute to mandate that substantially all of the use of leased tangible property must occur in a QOZ does not create an undue burden on businesses or hinder their ability to use leased property, and it would prevent the use of a lessor's property to shield the lessee's ownership of non-qualifying property. Moreover, such an interpretation would not require an awkward reading of the statute and is consistent with the requirements imposed on businesses attempting to qualify as DC Zone businesses under Section 1400B.

venture. These arrangements are quite common, underscoring the need for clear guidance on the appropriate treatment of leases under the QOZ rules.

[79] We understand that, for U.S. GAAP purposes, a true lease is generally reflected at a value of zero.

Accordingly, we recommend that Treasury clarify that, for purposes of the Sub All Test, all leased property, whether or not leased from a related party,[80] is to be taken into account at cost. As noted above, this would ensure that property leased by a QOZB does not adversely affect the QOZB's satisfaction of the Sub All Test. We further recommend that Treasury exercise the anti-abuse authority granted in Section 1400Z-2(e)(4) to issue guidance requiring substantially all of the use of any tangible property leased by a QOF or a QOZB to be in a QOZ. This recommendation is consistent with the treatment of leased property under former Section 1400B, from which much of the QOZ provisions are derived and, more importantly, with the policy underlying the statute. It would also harmonize treatment of leased property at the QOF level with that of leased property at the QOZB level. Finally, we recommend that Treasury clarify that leased property need not satisfy the Purchase Requirement or the Original Use Requirement in order to qualify under the Business Property Test.

N. Loss Attributable to Section 1400Z-2 Basis

Section 1400Z-2(b)(2)(B)(iii) and (iv) provide for basis increases at year 5 and year 7. The amount of gain taken into account on the Gain Trigger Date is equal to the excess of (1) the lesser of (x) the gain originally excluded and (y) the fair market value of the investment, over (2) the taxpayer's basis. This rule has the effect of permitting an offset against the triggered gain for any depreciation in the value of the investment. Suppose a taxpayer invests $100 of eligible gain in a QOF in 2019 and is credited with a basis increase of $10 in 2024. What is the result if the taxpayer's QOF investment becomes worthless or is otherwise disposed of in a taxable transaction with zero amount realized in 2025? It seems clear from a policy perspective that the taxpayer should not be able to claim a taxable loss in respect of the basis increase under Section 1400Z-2, as those basis adjustments are intended to function solely as a reduction in the amount of deferred gain that must be included in income. However, it is not clear that this result prevails under the statute. Accordingly, we recommend that Treasury address this fact pattern in final regulations.

O. QOZ Basis Issues and Subchapter K

Where a QOF is organized as a partnership for U.S. federal income tax purposes, the determination of inside and outside basis over the life of the QOF investment is subject to significant uncertainties. These questions leave taxpayers unsure about the treatment of income allocations and distributions, nonrecourse deductions, the appropriate computation of gain on the Gain Trigger Date, and the application of the Gain Exclusion Election. In this section we describe some of these uncertainties and request that Treasury provide clarifying guidance. In

[80] There is no sound policy reason to differentiate between leases based on the identity of the lessor. For example, a rule prohibiting leases with related parties would preclude the owner of unimproved real estate from leasing the real estate to a related entity for development by such related entity, but would permit a lease and development of the same property by an unrelated person. The purchase of property from a related person is prohibited by Section 1400Z-2(d) because the policy underlying Section 1400Z-2 is to have taxpayers re-deploy capital to QOZ investments—a sale of opportunity zone property from a taxpayer to a related taxpayer could serve to defeat this policy as no capital is being re-deployed. The same cannot be said of a lease of premises where the capital invested in the QOF is attributable to the sale of an existing non-opportunity zone asset and is being used to build a new business.

many cases we believe that a general anti-duplication concept should be applied in order to ensure that economic income and losses are not taken into account twice.[81]

1. QOF's Basis in its Assets

Nothing in Section 1400Z-2 provides rules regarding a QOF's inside basis in its own assets. If a QOF uses $100 of invested gain to purchase property, under the normal basis rules, the QOF should have an initial basis of $100 in that property. Treasury should confirm this interpretation or alternatively clarify that a QOF must adjust its asset basis to correspond to the holders' bases in the QOF interest under Section 1400Z-2(b)(2)(B).

If final regulations were to require a QOF to adjust its inside basis in this manner, presumably the QOF would also need to increase such basis as investors' outside basis increased pursuant to Sections 1400Z-2(b) and (c). Tracking such increases, especially in tiered partnership situations (which will be the case in many QOF-QOZB structures), would be complex. Permitting the QOF's inside basis to be determined under default tax principles would seem to be consistent with the statute's focus on the investors' investment in the QOF, which arguably is the only asset whose basis is impacted by the QOZ rules.

2. Taxpayer's Basis in its QOF Interest

Section 1400Z-2(b)(2)(B)(i) provides that, except as otherwise provided, the "taxpayer's basis in the investment shall be zero." It does not specify for what purpose the taxpayer's basis in the QOF is zero.[82] Section 1400Z-2(b)(2)(B) provides for increases in outside basis in three circumstances: (1) in the case of an investment held for at least five years, the basis of the investment is increased by ten percent of the deferred gain, (2) in the case of an investment held for at least seven years, the basis is increased by five percent of the deferred gain, and (3) when the deferred gain is included in income (on the earlier of the date on which the investment is sold or exchanged, or December 31, 2026), basis is increased by the amount of gain recognized. Section 1400Z-2(c) provides for an increase in basis, in the case of any investment held by the taxpayer for at least ten years and with respect to which the taxpayer makes a Gain Exclusion Election, to the fair market value of the investment on the date the investment is sold or exchanged. In this section, these QOZ-specific basis rules will be referred to as "**Section 1400Z-2 basis**."

It is not entirely clear how these rules interact with the usual basis rules under subchapter K. ("**Section 705 basis**"). Generally, under Section 722, a partner's basis in its partnership interest includes the basis of property and money contributed to the partnership. Section 752(a) provides that any increase in a partner's share of partnership liabilities is treated as a contribution of money by the partner to the partnership. Under Section 705(a)(1), a partner increases the

[81] In this section, unless otherwise noted, all QOFs and QOZBs are assumed to be partnerships for U.S. federal income tax purposes, although similar issues arise where such entities are Subchapter S corporations or members of consolidated groups.

[82] We note, however, that Section 1016(a)(38) now provides that "[p]roper adjustment in respect of the property shall in all cases be made . . . to the extent provided in subsections (b)(2) and (c) of section 1400Z-2." Treasury should consider the application of this rule.

basis of its partnership interest by his distributive share of the partnership's taxable income and tax-exempt income. A partner's tax basis is likewise generally decreased by the amount of money and the basis of property distributed by the partnership, and by the partner's distributive share of losses from the partnership.

There are a number of possible ways to apply the basis principles of Section 1400Z-2. One reading of Section 1400Z-2(b)(2)(B) is that, for purposes of determining the amount of deferred gain included in income under Section 1400Z-2(b) on the Gain Trigger Date, only Section 1400Z-2 basis is relevant, but that Section 705 basis principles otherwise apply to the taxpayer's interest in the QOF. Under this interpretation, where a sale or exchange of the interest occurs on the Gain Trigger Date the transaction would need to be bifurcated into two pieces: recognition of the original deferred gain under Section 1400Z-2(b)(2)(A), and recognition of additional gain or loss (if any) under Section 1001 with application of Section 705 basis rules. A second reading of Section 1400Z-2(b)(2)(B) is that a taxpayer's Section 705 basis is also treated as being equal to zero, until such basis is increased under the Section 1400Z-2 rules. A third reading is that Section 1400Z-2(b) basis is the only basis calculation for a QOF for all purposes (including for determining the consequences of partnership operations and distributions), which could result in distortions in the amount of deferred gain that is triggered, and even in double taxation.

We recommend that in order to achieve the most sensible results under Section 1400Z-2, Treasury should adopt the following rules in final regulations: (1) in determining the amount of deferred gain included in income under Section 1400Z-2(b) on the Gain Trigger Date, only Section 1400Z-2 basis is taken into account; (2) a taxpayer generally does not have Section 705 basis in its investment in the amount of its deferred gain invested in the QOF, until the times set forth in Section 1400Z-2(b) and (c) (but at such times, the basis increases occur for all purposes); and (3) a taxpayer otherwise computes its Section 705 basis under generally applicable rules. The examples below illustrate these recommendations:

> Example 17. Taxpayer contributes $100 of deferred gain to a QOF in 2019, is allocated no gain or loss, and sells his investment in 2022 for $110. Upon sale, Section 1400Z-2(b)(2) provides that the taxpayer must include in gross income the excess of $100 (the gain originally excluded) over the taxpayer's basis in the investment (which is $0 under Section 1400Z-2(b)(2)(B)(i)). However, the taxpayer has received $110. Consequently, it seems clear that the transaction should be bifurcated, with the taxpayer first recognizing $100 of gain under Section 1400Z-2(b)(2), and an additional $10 of gain under Section 1001.

The technical basis for the additional $10 of gain is that Section 1400Z-2(b)(2)(B)(ii) requires the taxpayer to increase its basis in the QOF investment by the $100. This adjustment should be deemed to happen immediately before the sale. Then, under Section 1001, the taxpayer recognizes additional gain in an amount equal to the excess of the amount realized ($110) over the newly computed basis of $100.

> Example 18. Same facts as Example 17, but taxpayer is allocated $10 of taxable income from the QOF in 2020, and. As above, on sale, the taxpayer must include in gross income the excess of $100 over the taxpayer's basis in the investment. The taxpayer's

Section 1400Z-2 basis is still zero (notwithstanding the fact that the investor was allocated $10 of income), the taxpayer would recognize $100 of gain (the original amount of the gain deferred) under Section 1400Z-2(b). If the sale is bifurcated, the investor's basis for purposes of determining Section 1001 gain (in other words, the Section 705 basis) would include both $100 under Section 1400Z-2(b)(2)(B)(ii) and the basis resulting from the $10 taxable income allocation, such that the investor would recognize no additional gain under Section 1001. In total, the taxpayer would have been taxed on $110, equal to the amount received.

If the taxpayer's Section 1400Z-2 basis included $10 resulting from the taxable income allocation, the taxpayer's gain under Section 1400Z-2(b)(2) would be only $90, with another $10 recognized under Section 1001. While the taxpayer would, in the aggregate, be taxed on the same $110, recognition under Section 1001 could create differences in the character of the gain recognized. Any such differences would arguably contravene the intent of the statute, which is to require the recognition of the entirety of the deferred gain ($100) through the medium of Section 1400Z-2.

If the taxpayer's Section 1400Z-2 basis *and* the taxpayer's Section 705 basis were both zero (that is, if the rule in Section 1400Z-2(b)(2)(B) were read to deny the taxpayer Section 705 basis for the $10 income allocation), the investor could potentially be taxed on a total of $120, notwithstanding that the investor received only $110 from the investment.

Increases in basis attributable to liabilities of a QOF or a lower tier QOZB give rise to similar issues. Under Section 752(a), the partner's increase in a share of partnership liabilities is treated as a contribution of money by the partner to the partnership and generally increases the partner's basis in the partnership. If these increases in basis were not taken into account under Section 1400Z-2, it would lead to distortive results.

Example 19. Taxpayer contributes $100 of deferred gain to a QOF in 2019, is allocated a $10 share of partnership liabilities, and sells his investment in 2022 for $100. On sale, the taxpayer must include in gross income the excess of $100 over his basis in the investment. The taxpayer's Section 1400Z-2 basis is still zero (notwithstanding his share of partnership liabilities), and the taxpayer would recognize $100 of gain (the amount of the gain deferred) under Section 1400Z-2(b)(2). For purposes of Section 1001, however, the investor's amount realized would be $110, including $100 in cash and $10 in relief from his share of partnership liabilities.[83] If the sale is bifurcated, the taxpayer's basis for purposes of determining Section 1001 gain would include the Section 1400Z-2(b)(2) gain recognized and the $10 share of partnership liabilities, such that the investor would recognize no additional gain under Section 1001.

If, instead, the taxpayer's Section 1400Z-2 basis included $10 resulting from the partner's share of liabilities, the taxpayer's gain under Section 1400Z-2(b)(2) would be only $90, perhaps with another $10 of gain recognized under Section 1001. Again, such a reading may result in a different mix of short-term and long-term capital gain, a result that seems contrary to the statute, which presumably is intended to require the recognition of the "full" $100 of deferred gain (with

[83] Section 752(d).

its attendant attributes). Stated differently, the additional $10 of basis under Section 752 should not, in our view, impact the amount of deferred gain to be included in income under Section 1400Z-2(b)(2). Similarly, if the liability allocation were ignored for purposes of both Section 1400Z-2 basis and Section 705 basis, the taxpayer would recognize $110 of gain even though the taxpayer only received $100.

Based on the examples and illustrations above, we recommend that final regulations provide that, for purposes of determining the tax consequences on the Gain Trigger Date, a taxpayer's Section 1400Z-2 basis is determined solely under Section 1400Z-2(b)(2)(A), that any such basis increase is then taken into account for general tax purposes (including Section 1001), and that Section 1400Z-2(b)(2)(A) does not override the Section 705 basis rules that otherwise apply in determining the tax consequences of a sale or exchange of the interest on such date.

3. Impact of Distributions on Basis

The uncertainties regarding basis determinations under Section 1400Z-2 can become even more pronounced where distributions are made to the taxpayer prior to the Gain Trigger Date.

> Example 20. Same facts as Example 18, but the taxpayer receives a distribution of $10 in 2021. Since the taxpayer's Section 705 basis is adjusted for the $10 of income allocated for 2020, the distribution does not result in the recognition of gain or loss and does not terminate any of the taxpayer's QOZ benefits with respect to its QOF interest. As a result of the distribution, the Section 705 basis is reduced by $10 to equal zero. Upon the sale in 2022, the taxpayer must include in gross income the excess of $100 (the gain originally excluded) over the taxpayer's basis in the investment (which is $0 under Section 1400Z-2(b)(2)(B)(i)). No further gain is recognized under Section 1001.

In this example, failing to adjust the Section 705 basis for the $10 of income allocation results directly in the double taxation of that income.

> Example 21. Taxpayer contributes $100 of deferred gain to a QOF in 2019. In 2024, once the QOF has been held for five years, the taxpayer's outside basis in the QOF is increased to $10 under Section 1400Z-2(b)(2)(B)(iii).[84] The taxpayer then receives a distribution of $10 from the QOF.[85] The taxpayer then sells the QOF investment for $100 in 2025.

Assuming the year five basis increase applies for both Section 1400Z-2 basis purposes and Section 705 basis purposes, the taxpayer should not be subject to tax on the $10 distribution (in other words, the taxpayer should not be treated under Section 731 as having sold any portion of the QOF interest), and the taxpayer's Section 705 basis would be reduced to zero. It then must

[84] We assume this basis increase occurs on the five-year anniversary of the investment, though the statute is not explicit on this point.

[85] The distribution may be matched by basis resulting from the investor's share of partnership's liabilities, or by an allocation of taxable income. In many cases, however, a business may have economic income in excess of taxable income (for example, because of bonus depreciation).

be determined whether this reduction of Section 705 basis correspondingly reduces Section 1400Z-2 basis—that is, whether the taxpayer's Section 1400Z-2 basis would be $0 or $10. Upon the sale of the investment for $100 in 2025, if the taxpayer's Section 1400Z-2(b) basis has been reduced to $0 as a result of the distribution, the taxpayer will recognize gain of $100 under Section 1400Z-2(b)(2). If, consistent with our recommendation, the taxpayer's Section 1400Z-2(b) basis remains at $10 even after the distribution, the taxpayer would recognize gain of $90 under Section 1400Z-2(b)(2) and additional gain of $10 under Section 1001. The latter result is arguably more consistent with the statutory language, which appears to mandate that a taxpayer's Section 1400Z-2(b) basis is not affected by any basis adjustments other than those that occur by operation of Sections 1400Z-2(b)(2)(B) and 1400Z-2(c).

4. Suspended Losses and Section 704(d)

Assuming the QOF takes a cost basis in its own property, inside basis will exceed outside basis. Thus, it is possible that the QOF will allocate losses to its partners in excess of their outside basis. Generally, Section 704(d) provides that a partner's distributive share of partnership loss is allowed only to the extent of the adjusted basis of such partner's interest in the partnership at the end of the partnership year in which such loss occurred. Under Treasury Regulations Section 1.704-1(d)(1), such suspended loss is allowed as a deduction at the end of the first succeeding partnership taxable year, and subsequent partnership taxable years, to the extent that the partner's adjusted basis for his partnership interest at the end of any such year exceeds zero.

There are several open questions, again involving the basis rule in Section 1400Z-2(b)(2)(B). As discussed above, Treasury should confirm that this rule does not override Section 705 basis rules generally.

> Example 22. An investor contributes $100 of deferred gain to a QOF in year 1, is allocated $10 in taxable income and year 2, and is allocated $10 of loss in year 3. Presumably the investor's basis for purposes of Section 704(d) at the end of year 2 is at least $10 (as a result of the $10 taxable income allocation), such that the investor is able to use the $10 loss allocated in year 3.

However, we recommend that Treasury clarify that Section 1400Z-2(b)(2) does "override" the Section 705 basis rules for the limited purpose of denying outside basis for the deferred gain until the basis is increased under Sections 1400Z-2(b) and (c). For example, if the investor in Example 22 were not allocated the income in year 2, the $10 of loss in year 3 would be suspended under Section 704(d).

Once the QOF has been held for five years, the taxpayer's outside basis in the QOF would be increased to $10 under Section 1400Z-2(b)(2)(B)(iii). Assuming the year 5 basis increase applies for both Section 1400Z-2 basis purposes and Section 705 basis purposes, $10 of losses should be "freed," bringing the taxpayer's basis back down to $0 under Section 705. However, consistent with our recommendation described above, the taxpayer's Section 1400Z-2 basis is not reduced to $0 by dint of the $10 distribution, and the results of a subsequent sale are as described in Example 25.

5. Basis Increase Under the Gain Exclusion Election

Section 1400Z-2(c) provides that, "[i]n the case of any investment held by the taxpayer for at least ten years and with respect to which the taxpayer makes an election under this clause, the basis of such property shall be equal to the fair market value of such investment on the date that the investment is sold or exchanged." It is not clear how this provision applies in various common situations.

We recommend that the final regulations should provide that (subject to the discussion below regarding depreciation recapture and non-duplication of deductions), the Section 1400Z-2(c) basis step up is to "gross fair market value," to account for partnership liabilities.

> Example 23. Taxpayer contributes $100 of deferred gain to a QOF in year 1, is allocated $10 share of partnership liabilities from the QOF, and sells his investment in year 11 for $150. Immediately before the sale, the investor's basis in the QOF is $110, including the investor's share of liabilities, or $100 without including the partner's share of liabilities. If the Gain Exclusion Election increases the basis to net fair market value (in other words, the net equity value of the QOF interest, which is typically computed net of debt), the outside basis in the QOF will be adjusted to $150. However, the taxpayer's amount realized will include relief from his share of partnership liabilities ($10). Thus, the taxpayer would recognize $10 of gain. If instead the outside basis is increased to gross fair market value ($160), the taxpayer will recognize no gain or loss on sale.

We believe that a basis increase that is gross of liabilities is, as a general matter, the result that is most consistent with the statute and with the principle in the Proposed Regulations to the effect that Section 752 liability allocations do not give rise to Mixed Funds. This rule, which is discussed below, stands for the proposition that appreciation in value that is attributable to the debt financed portion of a QOZ investment will still be eligible for QOZ benefits. We believe that it is important for the Treasury to confirm this result including through examples.[86]

The use of leverage is certainly an important component of the development and substantial repositioning of assets and businesses (whether inside or outside of QOZs). The statute does not offer sufficient guidance regarding the operation of the Gain Exclusion Election in many common scenarios. We believe that clarification is needed, including through examples in the final regulations.

6. Depreciation Recapture and the Gain Exclusion Election

None of the statute, legislative history nor Proposed Regulations address how Section 751 should be applied when a partnership interest in a QOF is held at least ten years and the taxpayer makes a Gain Exclusion Election. The tax policy question is whether Section 1400Z-2(c) should be applied to such sales in a manner that allows taxpayers to avoid recognizing ordinary income under Section 751, in particular in respect of the recapture of depreciation deductions previously taken, for example, on Section 1245 property (as defined in Section

[86] The consequences of these determinations can become rather significant where liabilities are substantial and where such liabilities funded distributions to the investor prior to the Gain Exclusion Election.

1245(a)(3)). These depreciation deductions may be comprised in large part of nonrecourse deductions.

Section 751 is generally intended to prevent taxpayers from avoiding the recognition of ordinary income attributable to unrealized gain on their share of unrealized receivables (including Section 1245 property) or inventory (together with unrealized receivables, "hot assets") held by the partnership when they either sell partnership interest or receive certain distributions. In general, when a partner sells its interest in a partnership that holds hot assets, Section 751(a) requires the partner to recognize ordinary income in respect of its share of the amount of income that would be allocated to the partner on a disposition of such hot assets for their fair market value. This income recognition is required regardless of whether the partner would otherwise recognize gain or loss on the sale of the partnership interest, and to the extent such ordinary income exceeds the gain otherwise recognizable, the partner recognizes a loss on the sale. Section 751(b) generally treats distributions that have the effect of changing a partner's relative interest in the partnership's hot assets (but excluding inventory unless substantially appreciated) in part as a sale or exchange between the partner and partnership of such hot assets for other property (or vice versa).

For example, assume a partnership invests $100 in Section 1245 property and over the depreciation period allocates $50 of depreciation deductions to a partner. When the partner sells its partnership interest, provided that the partner would be allocated $50 of ordinary income on the sale of the Section 1245 property, the partner would be required to recognize $50 of ordinary income, even if the sale would have otherwise resulted in less than $50 of gain. If the partner instead received a distribution of cash that resulted in its having no further interest in the Section 1245 property, the partner would recognize $50 of ordinary income as a result of the distribution.

When a partner's basis in its QOF partnership interest is increased to fair market value by reason of a sale of such interest and a Gain Exclusion Election, we recommend that Treasury confirm that Section 751 requires the partner to recognize ordinary income in an amount that would be allocated to the partner on the partnership's sale of its hot assets. More specifically, in the above example, even if Section 1400Z-2(c) otherwise were to eliminate the recognition of gain from the sale of the partnership interest, the partner would recognize under Section 751(a) $50 of ordinary income (and, presumably, a corresponding $50 of capital loss). In other words, prior depreciation allocated to the partner would be offset by ordinary income, effectively converting those prior ordinary losses into a capital loss. We do not believe that Section 1400Z-2(c) should be applied in a manner that protects the taxpayer from Section 751 and having to recapture prior depreciation deductions.[87]

[87] If Treasury believes that Section 1400Z-2 does not require recapture in these situations, we believe the only clear path for achieving such a result would be through the application of Section 743, perhaps by analogy to the adjustment to a partner's share of basis in partnership-level assets upon the partner's death if the partnership has in place a Section 754 election. Under that approach, the step up in basis to fair market value would result in a corresponding step up to fair market value in the partner's share of the partnership's basis in its assets, just as such adjustment would occur at the partner's death, provided that the partnership has in place a Section 754 election. We are unsure whether this result is supported by the statute or whether it goes beyond the intended benefits of the QOZ rules. On this, we note that the Senate Report only refers to the exclusion of capital gains. *See* S. Rep. No. 115-466, at 537-38 (2017) ("The provision provides for the temporary deferral of inclusion in gross income for *capital gains*

7. Partnership Level Gain Deferral

The uncertainties surrounding tax basis under the QOZ rules are not limited to QOFs or QOZBs, but also extend to partnerships that hold interests in QOFs. The Proposed Regulations provide that a partnership is an "eligible taxpayer" and may elect to defer recognition of some or all of its eligible gains. If a partnership properly makes an election, then the partnership defers recognition of gain under the rules of Section 1400Z-2 and the deferred gain is not included in the distributive shares of the partners under Section 702 and is not subject to Section 705(a)(1). Any amount of deferred gain that an electing partnership subsequently must include in income under Sections 1400Z-2(a)(1)(B) and (b) is recognized by the electing partnership at the time of inclusion and is subject to Sections 702 and 705(a)(1) at that time. The ability for a partnership to elect gain deferral raises a number of questions regarding capital account and basis determinations at the electing partnership level, including in situations where a partner of the electing partnership sells its interest in the partnership.

> Example 24. Assume partnership AB, owned equally by A and B, owns land with outside tax basis of $500 and a fair market value of $1000, reflected on the books of the partnership at $500. Each of A and B has a capital account and outside tax basis of $250. AB sells the land and recognizes a capital gain of $500. AB properly elects to defer the $500 of gain and invests that amount in a QOF, distributing the remaining $500.[88] Under the Proposed Regulations, the $500 of deferred capital gain is not included in the partners' distributive shares and does not increase their outside tax basis. As a result of the book-up and subsequent distribution of cash, each of A and B should have a capital account of $250 and an outside tax basis of $0. AB should own the QOF interest with a book value of $500 and tax basis of $0. Five years after the partnership invests in the QOF, the partnership's basis in the QOF is increased to $50 under Section 1400Z-2(b)(2)(B)(iii).

Treasury should confirm that this basis increase results in a corresponding basis increase for A and B in their partnership interests, under Section 705(a)(1)(B). The purpose of Section 705(a)(1)(B) is to ensure that any event that results in a permanent increase in the partnership's basis in its assets, without a corresponding current or future effect on its taxable income, is also reflected in the partners' outside bases.[89] Without such an outside basis adjustment, the partner could ultimately recognize gain upon liquidation or other disposition of the partner's interest in the partnership interest. In the case of a QOF, if outside basis is not increased when the partnership increases its basis in the QOF, the increase in QOF basis would be temporary rather than permanent. For example, if the partnership sells the QOF after five years for $500, the partnership would recognize gain of $450, which would increase the partners' outside basis

reinvested in a qualified opportunity fund and the permanent exclusion of *capital gains* from the sale or exchange of an investment in the qualified opportunity fund.") (emphasis added).

[88] It is not clear whether, upon sale of the land, the partners' capital accounts are increased to $500 each, or whether the capital accounts continue to reflect the book value of the land before the sale. For purposes of this discussion, we assume the partnership books up its investment at the time of sale, notwithstanding that the gain is deferred.

[89] *See, e.g.*, Rev. Rul. 96-10, 1996-1 C.B. 138. For example, in PLR 9616015, a partner contributed to a partnership land that was subject to special basis provisions under the Alaska Native Claims Settlement Act. The partnership was entitled to increase its basis in the land at some point after the contribution, and the IRS held that the partners' outside basis should be correspondingly increased at that time.

accordingly. If the partners' outside basis had not been increased on the fifth anniversary by $50, the partners would recognize $50 of gain upon distribution of the $500. Furthermore, if instead A were to sell its partnership interest five years after the investment for $250, and did not have a corresponding basis increase, A would recognize $250 of gain, even though A's share of the gain inside the partnership at that point is only $225.

Similarly, Treasury should confirm that the basis increases under Sections 1400Z-2(b)(2)(B)(iv) (seventh anniversary increase), -2(b)(2)(B)(ii) (December 31, 2026, increase), and -2(c) (ten year increase) occur both with respect to the partnership's interest in the QOF and the partners' interests in the partnership.

Another question is whether the partnership's deferred gain is accelerated if one of the partners sells an interest in the partnership. The Proposed Regulations treat the partnership itself as the "eligible taxpayer," so a disposition by a partner generally should not cause a disposition by the partnership. That is, a disposition by a partner has not caused the partnership to "cash out" of the investment. Thus, the better answer is that gain should not be accelerated upon a sale by a partner.

Any rules must also address the treatment of the buyer of an interest in the electing partnership. In the example above, if the QOF increases in value to $1000 and A sells its partnership interest to C for $500 in year 3, A would recognize gain of $500, but the partnership would continue to hold the QOF investment with a tax basis of $0. The buyer (C) would have an initial outside tax basis of $500 and share of inside tax basis of $0. Thus, if the partnership had a Section 754 election in effect in the year of sale between A and C, C should be entitled to a Section 743 adjustment with respect to the QOF investment of $500. Five years after the partnership's original investment in the QOF, when the partnership is now owned by A and C, the partnership would increase its basis in the QOF by $50 (ten percent of the original deferred gain of $500). Assuming that basis increase results in a corresponding outside basis increase to the partners, A would increase its outside tax basis to $25. It is unclear how the basis increase should impact C's outside basis and Section 743 adjustment.

Similar issues arise on the seventh anniversary of the partnership's investment in the QOF and when the remaining original deferred gain is recognized in 2026.

> Example 25. Assume partnership AB, owned equally by A and B, elects to defer $500 of capital gain and invests that amount in a QOF. On the fifth and seventh anniversary, the partnership's tax basis in its QOF interest is increased to $50 and $75, respectively, and presumably the partners' outside basis is increased by a corresponding amount. On December 31, 2026, the partnership recognizes the remaining $425 of gain and increases its basis in the QOF to $500. The partners take into account $425 of gain and their outside bases are adjusted accordingly. After the tenth anniversary of the QOF investment, A sells A's interest to C for $1000. There is no mechanism pursuant to which A can elect to increase its outside basis in the partnership to fair market value, notwithstanding that the partnership could have elected to increase its basis in the QOF to fair market value if the partnership had sold its interest in the QOF. Thus, A recognizes gain of $750. C's outside basis in the partnership interest purchased from A is $1000 (its

cost). In the next year, the partnership sells the QOF for $3000 and makes a Gain Exclusion Election pursuant to Section 1400Z-2(c) for the basis of the QOF at the time of sale to equal $3000. The partnership liquidates, distributing $1500 each to B and C. With respect to B, as discussed above, the partnership's election to increase the basis of the QOF interest should correspondingly increase B's outside basis in the partnership to $1500 (B's share of the basis increase of $1250 plus B's $250 outside basis immediately prior to the increase). If a similar adjustment is made to C's outside basis, C's outside basis in the partnership would increase from $1000 to $2250, and C would recognize a loss of $750. In effect, the sale from A to C would result in A recognizing a gain and C recognizing an offsetting loss.

We recommend that Treasury address these situations in the final regulations, including by adopting more flexible rules when it comes to the application of QOZ basis adjustments through tiers of partnerships.

Treasury should also clarify the treatment of partner-level Section 743(b) adjustments when a partnership elects to defer gain. If a partner has a negative Section 743(b) adjustment in the capital asset sold by the partnership, is that adjustment carried over to the QOF investment? For example, assume a partnership owns a capital asset worth $100 and with zero tax basis. Partner A owns a 50% interest in the partnership and has a negative Section 743(b) adjustment with respect to the property of $50. If the partnership sold the capital asset and did not make a deferral election, partner A would recognize $100 of gain (A's share of the partnership-level gain, plus A's $50 negative Section 743(b) adjustment). If the partnership elects to defer the gain and invests it in a QOF, it is unclear whether A still recognizes the $50 negative Section 743(b) adjustment or whether, instead, that basis adjustment attaches to the QOF interest.[90] In the latter case, presumably the negative Section 743(b) adjustment would be taken into account when the partnership sells or exchanges the QOF interest, or if earlier, on December 31, 2026.

8. Section 752 and Mixed Fund Issues

Section 1400Z-2(e) provides for a bifurcation of an investor's interest in a QOF where a portion (but not all) of the QOF interest is acquired using eligible capital gains. Prior to the enactment of the Proposed Regulations, many commentators had expressed concern that any indebtedness incurred by a QOF taxed as a partnership would be treated as giving rise to a "mixed fund" as a result of the operation of Section 752(a), which generally treats increases in liability allocation as deemed cash contributions. The Proposed Regulations clarify that the deemed contribution is not treated as such for purposes of the QOF rules.[91]

We support the position taken by the Proposed Regulation on this issue, as the alternative would have created significant impediments to financing QOZ projects with construction loans, bank facilities, and even working capital lines of credit.

[90] *Cf.* Treasury Regulations Sections 1.743-1(h)(1), -1(h)(3).

[91] Proposed Regulations Section 1.1400Z-2(e)-1(a)(2). We assume that this rule is broad enough to cover allocations of nonrecourse liabilities under Treasury Regulations Section 1.752-3 as well as allocations of recourse liabilities for which a partner bears the economic risk of loss under Treasury Regulations Section 1.752-2, including personal guarantees of partnership debt.

The Treasury has requested comment on whether there may be circumstances in which not treating the deemed contribution under Section 752(a) as creating a separate QOF investment may be considered abusive or otherwise problematic. We have not identified particularly abusive scenarios, however we have observed that the rule permits a tax-free return funded entirely with debt. Assuming the Gain Exclusion Election takes into account debt inside a partnership (which is addressed in subsection 5 above), a group of taxpayers may contribute equity to a QOF, which then borrows heavily against acquired property on a nonrecourse basis. After the ten year hold period is satisfied (but prior to December 31, 2047), the investors may sell the QOF interest at a large profit and a large realized gain (inclusive of the debt), none of which would be recognized as a result of the election. Because of the changes we are recommending, including with regard to the application of Section 752 and the basis step up to equal gross fair market value, taxpayers would effectively be able to disinvest tax-free from a QOZ far before ten years have expired. We think this may be cause for concern. One way to address this would be to condition access to the beneficial provisions we are describing on not mortgaging-out of the QOZ investment within ten years if the Treasury believes such transactions are abusive. Such mortgaging-out is common in real estate investments, however, and banning them may make leveraged partnership QOFs less attractive investments.

We also note that there are other circumstances in which a taxpayer may be treated as having made a contribution to an entity despite the fact that no cash was contributed. For instance, in the compensation context, Treasury Regulations Section 1.83-6(d) provides that "if a shareholder of a corporation transfers property to an employee of such corporation or to an independent contractor (or to a beneficiary thereof), in consideration of services performed for the corporation, the transaction shall be considered to be a contribution of such property to the capital of such corporation by the shareholder, and immediately thereafter a transfer of such property by the corporation to the employee or independent contractor." We see no policy reason why such a deemed contribution could not be eligible for a gain deferral election under Section 1400Z-2(a). If such deemed contributions are found not to be eligible for a deferral election, then it stands to reason that (similar to Section 752(a) deemed contributions), they should not give rise to Mixed Fund treatment either.

Relatedly, we believe that Treasury should clarify in final regulations whether a taxpayer with eligible gains may contribute a non-cash asset in kind to a QOF and make a deferral election that relies on such in-kind contribution. Both the statute as well as the Proposed Regulations appear to contemplate only cash contributions to QOFs. Any contributed property would not itself be QOZBP, nor would a further contribution of such property to a QOZB result in the receipt of a qualifying interest by the QOF. Permitting in-kind contributions would implicate questions of valuation, as well as complexities relating to tax basis and gain recognition with respect to the transferred property, Section 704(c) consequences where the QOF is taxed as a partnership, and the proper application of the SI Requirement. Yet, nowhere in Section 1400Z-2 is there a technical requirement that the "amount invested" by the shareholder be in the form of cash,[92] and we do not believe there is a compelling policy reason for such a

[92] This is in contrast to the definitions of "qualified opportunity zone stock" and "qualified opportunity zone partnership interest," both of which must be acquired by the QOF "solely in exchange for cash." Sections 1400Z-2(d)(2)(B), (C).

limitation. Consequently, we recommend that Treasury clarify whether an eligible investment in a QOF may be made in property other than cash.

9. Anti-Duplication Rules

In light of the numerous questions and computational uncertainties that we have observed under Section 1400Z-2, we recommend that the final regulations contain a generally applicable anti-duplication rule providing that determinations of basis, income and loss must be carried out in a manner that avoids the double counting of the same economic benefits or losses. We believe that such a rule is primarily necessary for QOFs and QOZBs (and electing taxpayers) taxed as partnerships, but it may also be relevant for corporate entities as well. An anti-abuse rule such as this one seems clearly within the scope of Treasury's authority set forth in Section 1400Z-2(e)(4)(C).

P. Prohibited Businesses

Section 1400Z-2(d)(3)(A)(iii) sets forth the seven Prohibited Businesses for a QOZB. Proposed Regulations Section 1400Z-2(d)-1(d)(6) paraphrases Section 144(c)(6)(B), which include a reference to "any store the principal business of which is the sale of alcoholic beverages for consumption off premises." The legislative history does not shed light on the meaning of these terms. We recommend that Treasury confirm that the "alcoholic beverages" restriction be limited to its clear meaning, *e.g.*, a traditional "liquor store" that sells alcoholic beverages to retail customers for consumption off premises, and not to restaurants and other similar establishments that produce or serve alcoholic beverages on premises primarily for sale to customers consuming the beverages on the premises.

Q. Offsetting-Positions Transactions

Proposed Regulations Section 1.1400Z-2(a) provides that gain is not treated as "eligible gain" (and thus not eligible for deferral under Section 1400Z-2(a)(1)) if such gain is from a position that is or has been part of an "offsetting-positions transaction." For this purpose, an offsetting-positions transaction is a transaction (including a straddle) in which a taxpayer has substantially diminished its risk of loss from holding one position with respect to personal property by holding one or more other positions with respect to personal property (and regardless of whether either of the positions is with respect to actively traded personal property).

The offsetting-positions transaction rule does not appear in the statutory language, and there is no reference to such a concept in the legislative history. As a result, it is not entirely clear why Treasury determined that gain from an offsetting-positions transaction should be excluded from eligible gain treatment. Based on language in the Preamble, however, it appears that the government was concerned that a taxpayer could get the benefits of the QOZ regime with respect to gain realized on one position in an offsetting-positions transaction while the taxpayer was able to take into account a loss in one or more other positions in such transaction.[93]

[93] Specifically, the Preamble states: "The Treasury Department and the IRS considered allowing deferral under Section 1400Z-2(a)(1) for a net amount of capital gain related to a straddle (as defined in section 1092(c)(1)) after

We have considered whether the offsetting-positions transaction rule should be included in final regulations. Specifically, the straddle rules provide generally that any loss with respect to a straddle position may be taken into account for a taxable year only to the extent that the amount of such loss exceeds any unrecognized gain with respect to one or more offsetting positions.[94] For this purpose, the term "unrecognized gain" includes the amount of gain realized but not recognized with respect to a position.[95] Where the amount of unrecognized gain in an offsetting position is realized but not recognized, we believe that the result under current law is that any loss that had been suspended would be recognized when the corresponding gain is ultimately recognized as a result of a subsequent transaction or event (although the straddle rules are silent on this point). The important point here is that, in the straddle context, the deferral of gain from the disposition of a straddle position would not permit the current recognition of an otherwise suspended loss.

> Example 26. Taxpayer owns one share of stock in a publicly-traded company ("Pubco") with a basis of $20. When the stock is trading for $100, taxpayer buys a put option with respect to one share of Pubco stock in exchange for a premium of $10. The put option subsequently lapses unexercised, resulting in taxpayer's realization of a $10 capital loss. Assuming that the put option was not part of an identified straddle, such loss is deferred in its entirety so long as it does not exceed the unrecognized gain in the Pubco share held by taxpayer. If taxpayer subsequently sells the Pubco share for $100, and is permitted to make a gain-deferral election with respect to the $80 of gain realized on the sale, the $10 of deferred loss from the put option would continue to be deferred because there would remain $80 of unrecognized gain (*i.e.*, the Pubco share gain was realized but not recognized). Thus, while the Preamble language suggests that it might be sensible (although complicated) for a taxpayer to be permitted to defer $70 of gain in this case (*i.e.*, its net gain from both positions in the offsetting-positions transaction), the operation of the straddle rules generally would have the same effect by continuing to suspend the $10 put option loss at least until the suspended gain is recognized.

It might be argued, however, that it would be overly-generous for a taxpayer investing in a QOF to eliminate 15% of its deferred gain (assuming that it holds its QOF interest for seven years by December 31, 2026), while permitting the taxpayer ultimately to recognize all of its loss in an offsetting position with respect to the original position giving rise to the invested gain. If this is a concern, the straddle regulations could be amended to provide that any loss suspended under the straddle rules would be eliminated in the same proportion as any elimination of gain in one or more offsetting positions as a result of the QOZ rules. Alternatively, this rule could be adopted in the final QOZ regulations.

With respect to offsetting-positions transactions that do not form part of a straddle (*i.e.*, because such positions are not with respect to actively traded property), it is not clear that the deferral of gains on one of the positions should raise a meaningful tax policy concern. Specifically, because such transactions are not subject to the straddle rules, the tax law currently

the disposition of all positions in the straddle. However, such a rule would pose significant administrative challenges."

94 Section 1092(a)(1)(A).

95 Section 1092(a)(3)(A)(ii).

permits a taxpayer to recognize loss with respect to a loss position while indefinitely deferring gain in an offsetting gain position. If a taxpayer in such a case is generally permitted to recognize tax loss while deferring an offsetting tax gain, it is reasonable to think that such a taxpayer should able to realize such gain but defer its recognition through investment in a QOF (whether such gain is realized before or after recognition of the offsetting loss). In other words, why should the tax law treat the gain realization by such a taxpayer any different than gain realization by a taxpayer not holding its gain position as part of a non-straddle offsetting-positions transaction?

On the other hand, we note the government may indeed have an interest in preventing taxpayers from entering into offsetting positions with the specific purpose of generating gain to be invested in a QOF, whether or not it currently recognizes the loss (which will depend on whether the positions constitute a straddle). There are two similar, yet distinct policies at play when it comes to offsetting-positions transactions. The first is whether taxpayers should be able to "manufacture" gains and thereby access the benefits of the QOZ rules. Second, even if the taxpayer did not enter into offsetting positions for this purpose, there is a question of whether only the net gain for such positions ought to be entitled to QOZ benefits. We believe the first policy issue is of greater concern than the second. Accordingly, we think it would be worth considering a rule that would exclude from eligible gain treatment any gain recognized with respect to a transaction entered into in order to generate eligible gain.

If the offsetting-positions transaction rule is retained, we believe that the government should significantly reduce its scope because, in its current form, the rule could significantly disrupt the ability of taxpayers to invest in QOFs. First, a taxpayer that is a partner in an investment fund, such as a hedge fund, may wish to defer some or all of its share of the capital gain recognized by the fund during a year, but may have significant difficultly ascertaining whether any of the fund's positions giving rise to otherwise eligible gain had ever been part of an offsetting-positions transaction. Second, the rule applies even if all of the other positions in the offsetting-positions transaction have given (or in the future will give) rise to gain (rather than loss). It is difficult to see what tax policy is being achieved by the rule where there was no loss in an offsetting position. Third, the rule applies even if the position was part of an offsetting-positions transaction for only a short period of time and/or it was part of such a transaction years or even decades earlier.[96] If Treasury otherwise determines that the rule is necessary, we recommend excluding from its application offsetting-positions transactions where no offsetting position was in held on or after the date the TCJA was enacted. We note that this might be accomplished by striking the words "or has been" from the Proposed Regulations, and adopting an anti-abuse rule as discussed above to police transactions where hedges are unwound shortly before sale.

[96] We note in this regard that since the rule applies to non-actively traded property, it could potentially disallow entirely non-abusive transactions. For example, if an individual owns a business and entered into a contract to sell the business fifteen years ago, but shortly thereafter terminated the contract with the seller, then *any* gain recognized in the future on the sale of that business would not be eligible for deferral since it is "from a position that is or has been part of an offsetting positions transaction." We are doubtful that this was Treasury's intention in enacting the rule and recommend that Treasury reconsider the breadth of the rule.

R. Failure to Qualify as a QOF and Reasonable Cause

Section 1400Z-2(f) provides that a QOF that fails to meet the 90% Test is subject to a monthly penalty determined based on the Section 6621(a)(2) underpayment rate. Section 1400Z-2(f)(3) states that a QOF is not subject to a penalty if it is shown that such failure is due to reasonable cause. We believe that further guidance is needed in order to assist taxpayers in evaluating the risk of failing to meet the QOF requirements at one or more testing dates. Of particular importance to QOZBs that will conduct tangible property construction and improvement is the manner in which the WC Safe Harbor interacts with the qualification requirement, the determination of penalties and the reasonable cause exception.

The retrospective nature of the WC Safe Harbor creates a number of open questions, as the following example illustrates:

> Example 27. A QOF is properly formed and funded, and acquires a real estate development project in a QOZ through a QOZB. Pre-development costs, due diligence, entitlements and permitting, and other expenses are funded with a combination of debt and equity. Following the acquisition of the property, the construction work begins and the QOZB complies in all respects with the WC Safe Harbor. On one or more testing dates during the construction period, but for the WC Safe Harbor, the amount of cash and other working capital held by the QOZB would exceed 5% of its assets. At the end of the 31-month period beginning with the date on which the QOZB raised its cash, the QOZB determines that it was unable to spend working capital "substantially consistently" with the working capital schedule.

It is not clear under the circumstances described in this example whether (1) the QOF will be treated as never having qualified, (2) the QOF will be treated as having qualified until the date on which the WC Safe Harbor determination was made (that is, the end of the WC Safe Harbor period), and (3) what penalties will apply to the QOF. These questions are critical to the taxpayers that invested eligible capital gains into the QOF, because they need to know whether they will still be entitled to deferral of their gains until the end of the WC Safe Harbor period.

A relief provision based on reasonable cause will likely be an important component of QOZ planning and risk management. Due to the highly technical and periodic nature of many of the QOZ requirements, as well as the fact that a QOF by its nature is a long-life vehicle, taxpayers need additional clarity in this area. Giving content to the reasonable cause standard will be especially critical during the early stages of the QOZ regime, when interpretive questions are likely to be both more numerous and more nettlesome.

Under the REIT rules, a failure to satisfy the various statutory requirements can generally be cured if the failure was due to reasonable cause and not due to willful neglect, although the cure may also require the REIT to pay a penalty tax and to meet other procedural requirements. The REIT rules, most of the penalty provisions in the Code, and various other provisions (40 Code sections in total) grant relief for certain failures that are "due to reasonable cause and not [due] to willful neglect" (the "**Reasonable Cause/Willful Neglect Standard**"). By contrast, four penalty relief provisions apply where there was reasonable cause for the bad conduct and the actor "acted in good faith" (the "**Reasonable Cause/Good Faith Standard**"). A number of regulatory provisions also use each standard. In particular, the Reasonable Cause/Good Faith Standard is used in Section 6664, which provides exceptions to the accuracy-based penalties of Sections 6662, 6662A, and 6663. Part 20.1 of the Internal Revenue Manual (the "**Penalty Handbook**") describes the IRS's policies regarding penalty provisions, including the application of the reasonable cause standards. The Penalty Handbook stresses that the interpretation of reasonable cause is intended to be consistent across the various penalty provisions where the term appears. The Penalty Handbook also notes that:

> The wording used to describe reasonable cause provisions varies. Some IRC penalty Sections also require evidence that the taxpayer acted in good faith or that the taxpayer's failure to comply with the law was not due to willful neglect. See specific [Internal Revenue Manual] sections for the rules that apply to a specific IRC penalty section.

Thus, the Penalty Handbook suggests that the Reasonable Cause/Willful Neglect Standard has two elements: the presence of reasonable cause and the absence of willful neglect.

This interpretation is consistent with other authorities, which have given each of these two prongs a distinct meaning. The regulations governing the failure-to-file and failure-to-pay penalties (relief from which is governed by the Reasonable Cause/Willful Neglect Standard) explain that reasonable cause exists if the taxpayer uses "ordinary business care and prudence"[97] in carrying out the duties imposed by the Code but is nonetheless unable to comply (or, in the case of a failure to pay a tax, would have experienced undue hardship by complying).

In requesting further clarification of the QOZ penalty and relief provisions, we acknowledge that a number of aspects of QOF penalties and decertification have been expressly reserved by the IRS and Treasury until additional guidance is issued. Specifically, the Preamble notes that forthcoming regulations "will address, among other issues, the applicability of the Section 1400Z-2(f)(1) penalty and conduct that may lead to potential decertification of a QOF." Similarly, these forthcoming regulations will also provide guidance on the delegation of authority set forth in Section 1400Z-2(e)(4)(B), which authorizes regulations to ensure that a QOF has "a reasonable period of time to reinvest the return of capital from investments in [QOZBs], and to reinvest proceeds received from the sale or disposition of [QOZBP]." We appreciate the fact that not all the uncertainties surrounding the QOF provisions can be adequately addressed at one time. However, it is important to emphasize that appropriate tax planning requires an understanding of the risks and "downside" scenarios, which is especially true where sponsors assume fiduciary duties to investors in QOFs. Therefore, we respectfully request that Treasury provide more detailed rules regarding the penalty provisions of the QOZ rules (particularly in the WC Safe Harbor context) and the factors that would be taken into account when evaluating whether a failure is due to reasonable cause. As is the case with most factual standards, examples would also be helpful in the QOF penalty context.

[97] Treasury Regulations Section 301.6651-1(c)(1).

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DANIEL Z. ALTMAN is a partner in Sidley Austin's Tax group. Dan represents clients with respect to all tax aspects of domestic and cross-border M&A and corporate restructuring transactions, including tax free and taxable transactions, stock and asset sales, mergers, bankruptcy restructuring, spin-offs, recapitalizations, joint ventures, inbound and outbound investments, and IP structuring and utilization. He provides tax advice in a variety of fields, including life insurance, property and casualty insurance, IP, healthcare, real estate, manufacturing, services, asset management and others. Dan also advises clients on all international aspects of U.S. federal income taxation and assists clients in their international tax planning.

Dan is recommended in Tax: International Tax in *The Legal 500 US* 2017. Most recently, Dan was recognized by *Opportunity Zone Magazine 2019* as a top leading and most influential attorney in the industry.

Dan received his doctoral degree from Harvard Law School and, in addition to other publications, has published a book on Dispute Resolution under Tax Treaties in 2006 and authored the Bloomberg BNA Portfolio on dual consolidated losses in 2018. In 2006, Dan received the prestigious Mitchell B. Carroll Prize from the International Fiscal Association for his dissertation on the resolution of international tax disputes.

Among his deals, Dan has represented:

- Sirius International Insurance Group in its planned merger with Easterly Acquisition Corp., which will result in a combined publicly traded company with a market capitalization of approximately $2.2 billion.
- American International Group in the multi-billion dollar sale of its legacy life settlements portfolio to leading alternative investment management firms.
- Sirius International Insurance Group in the acquisition of International Medical Group.
- Sirius International Insurance Group in the acquisition of ArmadaCorp Capital.
- Harvest Partners and its portfolio company EyeCare Services Partners, a vertically integrated ophthalmologic services platform in numerous acquisitions of clinics and practices.
- Siris Capital Group, LLC acquisition of Premier Global Services, Inc. for $1 billion.
- Nomura acquisition of minority shares American Century Companies, Inc. (a Mutual Fund Manager) for approximately $1 billion.
- Siris Capital Group, LLC acquisition of Polycom, Inc. for $2 billion.
- Kimmeridge Energy sale of Arris Petroleum Corp and other related assets to PDC Energy Inc. for $1.5 billion.
- OMERS Private Equity Inc., in partnership with existing physician owners, acquisition of Forefront Dermatology.

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Kim Blanchard is a partner in Weil's Tax group whose practice encompasses a variety of largely international transactions involving corporate M&A, internal restructurings, business formations and joint ventures. Kim is the immediate past President of the International Tax Institute and a former Chair of the New York State Bar Association Tax Section. She is a "Leading Practitioner Contributor" to the *Tax Management International Journal* and a member of Practical Law Company's U.S. advisory board. In addition, Kim is a member of the Board of Trustees of the American Indian College Fund and of the Board of Directors of the Girl Scouts of Greater New York.

She has consistently been recognized as a leading Tax lawyer by ***Chambers USA***, ***Chambers Global***, ***Legal 500 US***, ***Best Lawyers in America*** and ***The Best of the Best US.***

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Peter Blessing recently joined the Internal Revenue Service as Associate Chief Counsel in the Chief Counsel's Office (International). Prior to this he served as Head of Cross-Border Corporate Transactions in KPMG's Washington National Tax Practice (WNT) and before joining KPMG, Blessing served 25 years as a partner at Shearman & Sterling LLP, a leading international law firm.

Prominent in the area of cross-border taxation, Blessing has received numerous accolades and recognitions from both peers and clients during the course of his career. He is ranked highly in various surveys, including "Best Lawyers of America 2012," Euromoney's "Best of the Best USA 2012" and Chambers and Tax Directors' Handbook. Blessing is the editor of Kluwer's two-volume set, *Tax Planning for International Mergers, Acquisitions, Joint Ventures, and Restructurings*.

Blessing has been a member of the Permanent Scientific Committee of the International Fiscal Association and the Executive Committee of IFA USA Branch. He is active in various other professional organizations as well, having held leadership roles in a number of them (including his position as former chair of the New York State Bar Association Tax Section). He has also taught as an adjunct professor at Columbia Law School.

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Before coming to ITA in 2018, Julie worked for the Wage & Investment Division Counsel as Special Counsel. Julie has done various details in the Commissioner's Office and worked with the Deputy Chief Counsel for Operations.

Prior to joining to the IRS, Julie clerked for the Massachusetts Superior Court. She received her LLM in Taxation from Georgetown University's School of Law; her JD from the New England School of Law; and BA from Boston College.

STEVE EDGE, ESQ.
BIOGRAPHY

Steve, a graduate of Exeter University, qualified with Slaughter and May in 1975. He has been a partner at the firm since 1982 and acts for clients across the full range of the firm's practice.

Steve advises on the tax aspects of private and public mergers, acquisitions, disposals and joint ventures and on business and transaction structuring (including transfer pricing in all its aspects) more generally. He also advises many banks, insurance companies, hedge funds and others in the financial services sector in a wide range of areas.

In recent years, Steve has been heavily involved in several large scale interventions under HMRC's high risk corporates programme and in many in-depth tax investigations of specific domestic or international issues including transfer pricing in particular. He thus has considerable experience of negotiating and dealing with HMRC at all levels.

A large part of Steve's practice involves advising non-UK multinationals (particularly those based elsewhere in Europe and in the US) on cross-border transactions and tax issues of various types. In that area of his practice, he works closely with other leading international tax advisers around the world. He is considered one of the UK's leading authorities on corporate tax law

He is vice-president of the Lancashire Cricket Federation and a member of the Marylebone Cricket Club.

LAWRENCE M. GARRETT, ESQ.
BIOGRAPHY

Larry is a member of the Ernst & Young National Transaction Tax Group of the Transaction Advisory Services service line, and is based in Washington, DC. He has over 28 years of experience in transactional tax planning. Larry's responsibilities include providing firm-wide consultation regarding mergers, acquisitions, dispositions, spin-offs, financings, corporate restructurings, cross-border transactions, and consolidated return issues.

Prior to joining Ernst & Young LLP, Larry was a Participating Principal in another major accounting firm. Before that, Larry was an associate at the Washington office of an international law firm. In both of these capacities, Larry focused on the domestic and international tax aspects of business transactions.

From March 1990 to October 1992, Larry served as an Attorney-Advisor and as Associate Tax Legislative Counsel at the U.S. Treasury Department, where he was responsible for developing and drafting regulations, revenue rulings, and briefing materials on a number of corporate and acquisition-related issues, including limitations on losses and credits following stock ownership changes and the treatment of discharge of indebtedness income.

Larry is currently Co-Chair of the Committee on Spin-Offs, Tax Section, New York State Bar Association. He formerly was Co-Chair of the Committee on Corporations, the Committee on Consolidated Returns and the Committee on Bankruptcy and Net Operating Losses. He also previously served as Chair of the Committee on Corporation Tax, Tax Section, District of Columbia Bar Association.

Larry graduated from Harvard College in 1982 and from Harvard Law School in 1986. He is a member of the New York State and the District of Columbia Bar Associations.

ANDREW HERMAN, ESQ.
BIOGRAPHY

Andrew Herman is a member of Ernst & Young LLP's National Tax Mergers and Acquisitions group, Transaction Advisory Services practice, based in Washington, D.C. He focuses on advising clients on corporate acquisitions, dispositions, spin-offs, reorganizations, consolidated return issues, and cross-border transactions. He is a member of the Executive Committee of the New York State Bar Association Tax Section. Prior to joining EY, Andrew was a tax attorney at the law firm of Debevoise & Plimpton, LLP in New York City. Prior to entering law school, Andrew was a project manager for the NYC Department of Transportation, and an aspiring film score composer.

Andrew obtained a B.A., *magna cum laude*, in Philosophy from the University of Pennsylvania, and a J.D. and LLM in taxation from New York University School of Law.

ELIZABETH T. KESSENIDES, ESQ.
BIOGRAPHY

Liz Kessenides is currently Tax Counsel at the Federal Reserve Bank of New York. Her prior law firm experience includes Covington & Burling, where she was a tax partner focusing on public market mergers and acquisitions. Liz has been an active member of the New York State Bar Association's Tax Section, serving as a member of its Executive Committee since 2006. She holds a B.A. in Political Science from Barnard College and a J.D. from New York University School of Law. Any views expressed at the Summer Meeting are her own, and do not reflect the position of the New York Fed or the Federal Reserve System

ADAM KOOL, ESQ.
BIOGRAPHY

Adam Kool is a tax partner in the New York office of Kirkland & Ellis LLP. Adam has a broad-based practice, and handles a wide range of complex transactions, focusing on the tax aspects of mergers, acquisitions, divestitures, joint ventures and spin-offs, both domestic and cross-border. Adam also advises client on the tax aspects of securities issuances, real estate investments, bankruptcy and restructuring, and investment fund formation.

Prior Experience
Summer Associate, Ivins, Phillips & Barker, Summer 2011
The United States Attorney's Office, Tax Division Summer 2010

Admissions & Qualifications
2012 Illinois
2015 New York

Education
Stanford Law School - J.D. 2012
Managing Editor, ***Stanford Law Review***
Grand Valley State University B.A., International Relations 2009

JOHN J. MERRICK, ESQ.
BIOGRAPHY

John Merrick is a Senior Level Counsel to the Associate Chief Counsel (International) in the Office of Chief Counsel. Prior to joining Chief Counsel, Mr. Merrick practiced international tax in the national offices of two accounting firms in Washington. He also practiced international and corporate tax in Chicago with an accounting firm and a law firm. Mr. Merrick holds a Bachelors in Business Administration in accounting from Loyola University Chicago, *summa cum laude*, where he also earned his J.D., *cum laude*, and was a member of the Loyola Law Journal. He obtained an LL.M. in Taxation from the De Paul College of Law. He also passed the Certified Public Accountant exam.

DAVID S. MILLER, ESQ.
BIOGRAPHY

David Miller is a partner in the Tax Department at Proskauer. David advises clients on a broad range of domestic and international corporate tax issues. His practice covers the taxation of financial instruments and derivatives, cross-border lending transactions and other financings, international and domestic mergers and acquisitions, multinational corporate groups and partnerships, private equity and hedge funds, bankruptcy and workouts, high-net-worth individuals and families, and public charities and private foundations. He advises companies in virtually all major industries, including banking, finance, private equity, health care, life sciences, real estate, technology, consumer products, entertainment and energy.

David is strongly committed to pro bono service, and has represented more than 300 charities. In 2011, he was named as one of thirteen "Lawyers Who Lead by Example" by the *New York Law Journal* for his pro bono service. David has also been recognized for his pro bono work by The Legal Aid Society, Legal Services for New York City and New York Lawyers For The Public Interest.

David has been consistently recognized by leading industry publications, such as *Chambers Global, Chambers USA, Best Lawyers* and *The Legal 500*. Clients surveyed by *Chambers USA* said, "We bring him in on complex matters because he has the experience and the gravitas." David is one of 17 lawyers in the United States in *The Legal 500's* Hall of Fame for US Tax (non-contentious).

David teaches tax policy at the New York University School of Law. He previously taught the taxation of financial instruments at Columbia Law School. He is also a frequent author and has written a number of articles and chapters in various tax publications. David is the former chair of the tax section of the New York State Bar Association.

Prior to joining Proskauer, David was a partner at Cadwalader, Wickersham & Taft LLP.

MICHAEL MOLLERUS, ESQ.
BIOGRAPHY

Mr. Mollerus is a partner in Davis Polk's Tax Department. His practice centers on advice to international and domestic corporate, real estate and private equity fund clients on initial public offerings, mergers, acquisitions, spinoffs and other major transactions, including structured financings. Mr. Mollerus' clients have included many financial institutions and corporate clients, including Uniti Group, Bertelsmann, Delphi Automotive, Emerson, Morgan Stanley Real Estate, PartnerRe, Roche, Reckitt Benckiser and Shire.

Professional History

Partner, 1997-present

Associate, 1990-1997

London office, 1992-1994

Washington DC office, 1990-1992; 1994-1995

Law Clerk, Hon. Anthony M. Kennedy, U.S. Supreme Court, 1989-1990

Law Clerk, Hon. Jerry E. Smith, U.S. Court of Appeals, Fifth Circuit, 1988-1989

Work Highlights

REAL ESTATE

Uniti Group, a communications infrastructure REIT, in connection with numerous matters, including acquisitions, leasing transactions and debt and equity financings

Prime Property Fund, a private institutional REIT advised by Morgan Stanley, in connection with numerous matters, including acquisitions and financings

M&A

Bertelsmann in connection with its announced acquisition of an additional interest in its Penguin Random House joint venture with Pearson

Markit in connection with its merger of equals with IHS

PartnerRe in connection with its acquisition by Exor

Shire in connection with numerous acquisitions, including its proposed transaction with AbbVie

Roche in connection with numerous acquisitions, including its acquisitions of Genentech and InterMune

Warner Chilcott in connection with numerous matters, including its acquisition by Actavis

Emerson in connection with numerous transactions, including its disposition of its Network Power business and its acquisition of Pentair's Valves & Controls business

Morgan Stanley in connection with numerous matters, including its sale of its Global Oil Merchanting business, its disposition of TransMontaigne and its disposition of MSCI

SPINOFFS

Reckitt Benckiser in connection with the tax-free demerger of Indivior

Morgan Stanley in connection with its spinoff of Discover

IPOS AND OTHER FINANCINGS

MSCI in connection with its IPO and various financings

Kosmos Energy in connection with its IPO and various financings

Cobalt International Energy in connection with its IPO and various financings

Delphi Automotive in connection with its IPO and various financings

Recognition

Mr. Mollerus is recognized as a leading tax lawyer in various industry publications:

Chambers USA – Tax: New York, Leading Individual

Chambers Global – Tax: International Tax, Leading Individual

Law360 – "Tax MVP of the Year," 2014

Who's Who Legal: Thought Leaders – Corporate Tax

Practice Focus
Tax

Bar Admissions
State of New York

Education
A.B., Harvard College, 1985
magna cum laude

J.D., Harvard Law School, 1988
magna cum laude

Editor, *Harvard Law Review*

STUART L. ROSOW, ESQ.
BIOGRAPHY

Stuart Rosow is a partner in the Tax Department AT and a leader of the transactional tax team. He concentrates on the taxation of complex business and investment transactions. His practice includes representation of publicly traded and privately held corporations, financial institutions, operating international and domestic joint ventures, and investment partnerships, health care providers, charities and other tax-exempt entities and individuals.

For corporations, Stuart has been involved in both taxable and tax-free mergers and acquisitions. His contributions to the projects include not only structuring the overall transaction to ensure the parties' desired tax results, but also planning for the operation of the business before and after the transaction to maximize the tax savings available. For financial institutions, Stuart has participated in structuring and negotiating loans and equity investments in a wide variety of domestic and international businesses. Often organized as joint ventures, these transactions offer tax opportunities and present pitfalls involving issues related to the nature of the financing, the use of derivations and cross-border complications. In addition, he has advised clients on real estate financing vehicles, including REITs and REMICs, and other structured finance products, including conduits and securitizations.

Stuart's work on joint ventures and partnerships has involved the structuring and negotiating of a wide range of transactions, including deals in the health care field involving both taxable and tax-exempt entities and business combinations between U.S. and foreign companies. He has also advised financial institutions and buyout funds on a variety of investments in partnerships, including operating businesses, as well as office buildings and other real estate. In addition, Stuart has represented large partnerships, including publicly traded entities, on a variety of income tax matters, including insuring retention of tax status as a partnership; structuring public offerings; and the tax aspects of mergers and acquisitions among partnership entities.

Also actively involved in the health care field, Stuart has structured mergers, acquisitions and joint ventures for business corporations, including publicly traded hospital corporations, as well as tax-exempt entities. This work has led to further involvement with tax-exempt entities, both publicly supported entities and private foundations. A significant portion of the representation of these entities has involved representation before the Internal Revenue Service on tax audits and requests for private letter rulings and technical advice.

Stuart also provides regular advice to corporations, a number of families and individuals. This advice consists of helping to structure private tax-advantaged investments; tax planning; and representation before the Internal Revenue Service and local tax authorities on tax examinations.

A frequent lecturer at CLE programs, Stuart is also an adjunct faculty member of the Columbia Law School where he currently teaches Partnership Taxation.

MICHAEL B. SHULMAN, ESQ.
BIOGRAPHY

Michael Shulman has been Tax Team Leader at Shearman & Sterling since 2008. His practice focuses primarily on the taxation of financial instruments, real estate transactions, and the formation and operations of hedge funds, private equity funds and regulated investment companies. He also has wide-ranging experience in domestic and cross-border mergers, acquisitions and restructurings and has advised on numerous debt restructuring transactions.

EDUCATION
NEW YORK UNIVERSITY SCHOOL OF LAW - LL.M.
VANDERBILT UNIVERSITY - J.D.
UNIVERSITY OF CHICAGO - B.A. (WITH HONORS)

ADMISSIONS
New York
District of Columbia

PRACTICES
Tax
Investment Funds
Financial Institutions Advisory & Financial Regulatory
Derivatives & Structured Products

INDUSTRIES
REITs
Financial Services
Technology, Media & Telecommunications
Private Capital

REGIONAL EXPERIENCE
North America

PROFESSIONAL AFFILIATIONS
Executive Committee Member, New York State Bar Association Tax Section
Former Chair of the Financial Transactions Committee of the American Bar Association

PUBLICATIONS
Co-Author (with Nathan Tasso): “Changes to Derivatives ‘Pursuant to Their Terms,” Tax Notes (May 2017)

SPEAKING ENGAGEMENTS
Panelist: “Partnership Issues under the 2017 Tax Act,” Practicing Law Institute 2017 Tax Act Update (March 2019)
Moderator: “Qualified Opportunity Zones,” American Bar Association Tax Section, Winter Meeting (January 2019)
Panelist: “Interest Expense Limitation Under Section 163(j): Tiered Entities,” 2018 USC Tax Institute (January 2019)
Panelist: “Section 163(j) Part Two: Interaction with Other Code Sections,” Practicing Law Institute Taxation of Financial Products and Transactions 2019 (January 2019)

ANSGAR SIMON, ESQ.
BIOGRAPHY

Ansgar Simon is a partner in the tax group of Covington & Burling LLP in its New York office. Ansgar has a broad-based transactional tax practice and regularly advises U.S. and non-U.S. clients on mergers and acquisitions, restructuring transactions, recapitalizations, divestitures (including spin-offs), and the structuring of joint ventures, particularly cross-border transactions. He also regularly advises on the structuring and ongoing tax matters of private equity funds and other alternative investment vehicles. Ansgar is co-author, with Peter Blessing, of the US chapter of *Tax Planning for International Mergers, Acquisitions, Joint Ventures and Restructuring* (Wolters Kluwer). He is a member of the Executive Committee of the Tax Section of the New York State Bar Association.

IRWIN M. SLOMKA, ESQ.
BIOGRAPHY

Irwin M. Slomka is Senior Of Counsel at Morrison & Foerster LLP. His practice focuses on state and local tax controversies before administrative and judicial bodies in New York and throughout the United States. Additionally, he has broad experience in tax planning for the full spectrum of corporate and pass-through entities, as well as individuals, and their related business transactions.

Mr. Slomka is the Co-Chair of the New York City Taxes Committee for the Tax Section of the New York State Bar Association, and is a member of the Tax Section's Executive Committee. He has been the principal author of several reports issued by the New York State Bar Association Tax Section on New York State and City tax issues. Mr. Slomka is a member of the New York City Tax Appeals Tribunal Advisory Committee.

Mr. Slomka speaks on a variety of issues concerning the taxes of New York State, New York City and other jurisdictions. He also regularly speaks before organizations such as the New York State Bar Association Tax Section, the Committee on State Taxation, the Tax Executives Institute, the Institute of International Bankers, and the Committee on Banking Institutions. He has authored numerous articles that have appeared in such publications as *TaxLaw360*, *Forbes.com*, the *Journal of Multistate Taxation and Incentives*, and the *Real Estate Finance Journal*.

JACK TRACHTENBERG, ESQ.
BIOGRAPHY

Jack Trachtenberg is a Principal in Deloitte's Multistate Tax Controversy Services team in New York and a liaison to the Washington National Tax-Multistate practice as a New York controversy and technical lead. Jack focuses on all aspects of state and local tax controversy matters for corporations and pass-throughs, including income/franchise and sales and use tax, and has deep experience serving high-net-worth individuals in personal income tax matters, including residency.

Jack has extensive experience advising clients on New York State and New York City tax matters, having successfully litigated cases before the New York State Division of Tax Appeals, the New York State Tax Appeals Tribunal and the New York State Supreme Courts. Before joining Deloitte, Jack was a partner in the state tax practice at Reed Smith LLP. In 2009, the Governor of New York appointed Jack to serve as the first Deputy Commissioner and Taxpayer Rights Advocate at the New York State Department of Taxation and Finance. In this role, Jack created and implemented the state's Office of the Taxpayer Rights Advocate, which intervenes on behalf of taxpayers facing intractable tax disputes.

Jack is a frequent speaker on state tax issues. Jack is also an author, editor, co-author or publisher of many publications, including the "Multistate Corporate Tax Guide," the "Multistate Guide to Sales and Use Tax," the "New York State Sales and Use Tax Answer Book," and the LexisNexis "Tax Practice Insights: New York." He is also a frequent contributor to tax and accounting publications, such as State Tax Notes and The CPA Journal, and has taught State and Local Tax courses at Albany Law School.

Jack holds a master's and bachelor's degree in political science from Case Western Reserve University and a Juris Doctor from the University at Buffalo School of Law.

KRISHNA P. VALLABHANENI, ESQ.
BIOGRAPHY

Krishna P. Vallabhaneni serves as Deputy Tax Legislative Counsel in the U.S. Department of the Treasury's Office of Tax Policy. In that capacity he leads the Office of Tax Legislative Counsel staff in developing published guidance, proposed legislation, and tax regulations concerning corporations, passthrough entities, and financial institutions and products. Prior to November 2015, he served as the principal corporate tax advisor to the Assistant Secretary for Tax Policy.

Mr. Vallabhaneni was previously a senior manager in the Subchapter C group of Deloitte Tax LLP's Washington National Tax Office, where he advised corporate clients and their shareholders regarding the federal income tax consequences of a wide array of transactions, including taxable and tax-free mergers and acquisitions, reorganizations, and spin-offs.

Between 2001 and 2005, Mr. Vallabhaneni served as an attorney with the Internal Revenue Service's Office of Associate Chief Counsel (Corporate). He earned an LL.M. in Taxation from New York University School of Law, his J.D. from the George Washington University Law School, and a B.A. in Biology from Johns Hopkins University.

Milbank

Andrew R. Walker

Partner

— VCARD — SHARE

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Andrew Walker, a partner in the New York office of Milbank and a member of the firm's Tax Group, has been a partner since 2002.

Primary Focus & Experience

Mr. Walker focuses on international federal income tax matters. His practice focuses on the taxation of complex financing transactions, financial products and derivatives, US and foreign securities offerings, structured finance and asset securitization transactions and investment funds. He has significant experience advising on the tax aspects of cross-border restructurings, refinancing, workouts, strategic investments, mergers and acquisitions.

Mr. Walker has particular expertise in structuring tax efficient solutions that facilitate inbound investment by funds, foreign investors and sovereign investors in a variety of evolving asset classes, including middle market and distressed debt, transportation-related assets and leased assets, life settlements, litigation settlements and real estate.

Mr. Walker is a member of the Executive Committee of the New York State Bar Association Tax Section and serves as co-chair of the Committee on Cross-border Capital Markets. He was previously co-chair of the Committee on US Activities of Foreign Taxpayers and the Committee on Reorganizations. He is also a member of the American Bar Association (Tax Section), the International Fiscal Association, the Tax Forum and the Tax Club.

Recognition & Accomplishments

Mr. Walker has consistently been recognized a leading tax lawyer by *Chambers USA*. Articles by Mr. Walker appear in a number of publications, including the *Tax Lawyer*, the *Journal of Corporate Taxation, Derivatives Magazine* and the *Journal of Tax Exempt Organizations* and he is a regular speaker on federal income tax topics to groups like the American Bar Association, the NYU Institute on Federal Taxation, and the Committee of Banking Institutions on Taxation (CBIT).

CLIFFORD M. WARREN, ESQ.
BIOGRAPHY

Cliff Warren is the Senior Counsel in the Passthroughs division of IRS' Office of Chief Counsel. Cliff was a tax leader at GE Capital, head of tax at a large NYC hedge fund and then head of tax at Kohlberg Kravis Roberts & Co. He was named by *Tax Notes* as a top ten tax lawyer in both 2016 and 2017. Cliff is a graduate of Middlebury College, New York Law School and NYU's LLM program.

DIANA L. WOLLMAN, ESQ.
BIOGRAPHY

Diana L. Wollman's practice focuses on complex international M&A and internal restructuring transactions, tax audits, tax investigations and strategic audit preparation.

She repeatedly has been recognized for her leading role in the profession, including being named the "Lawyer of the Year" for New York tax litigation and controversy by *Best Lawyers* in 2013.

Diana joined Cleary Gottlieb in 2015 after serving as the Internal Revenue Service's first Director of International Strategy for the agency's Large Business & International Division, where she was responsible for developing and managing its international strategic program. Her work included improving how the IRS identifies and addresses significant international tax issues, manages and utilizes its institutional knowledge and data, and trains agents; she also worked to improve the collaboration and coordination between the audit division and the Office of Chief Counsel. She represented the IRS on several Organisation for Economic Co-operation and Development (OECD) working groups, including those focused on BEPS (the OECD's base erosion and profit shifting project), the Forum on Harmful Tax Practices and the Forum on Tax Administration.

Prior to her 2013 appointment to the IRS, Diana was a partner in the tax practice of another major international law firm, where she began her career as an associate in 1993. There she built a diverse practice that included federal and New York State tax controversies, complex cross-border transactions, fund and private equity work, and bankruptcy.

SELECTED ACTIVITIES

- Member, Executive Committee, New York State Bar Association's Tax Section; Former Tax Section Chair (2013)
- Fellow, American College of Tax Counsel
- Member, The Tax Club (Harvard Club of New York)
- Member, The Tax Review
- Member, The Tax Forum
- Former Adjunct Professor, Columbia Law School
- Law Clerk to the Hon. Robert J. Kelleher of the U.S. District Court for the Central District of California, 1991-1992

HONORS AND DISTINCTIONS

- ***Best Lawyers:***
  "Lawyer of the Year for New York City Litigation & Controversy" **-** Tax (2013)
- ***Chambers USA:*** Tax
- ***The Best Lawyers in America***
- ***New York Super Lawyers***
- ***The International Who's Who of Corporate Tax Lawyers***
- ***The Legal 500 U.S.***
- ***Chambers USA: America's Leading Lawyers for Business***
- ***International Tax Review Tax Disputes/Controversy Leaders Guide***
- ***International Tax Review's Women In Tax Leaders Guide***
- ***Who's Who Legal***
  Tax: Controversy

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TAX SECTION
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