International Comity after the Tax Cuts and Jobs Act of 2017 (Part I)

The NY State Bar Association – Tax Section Summer Meeting

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Agenda

- **GILTI**
- **Anti-Hybrid Rules**

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GILTI

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What is the GILTI regime?

The global intangible low-taxed income (GILTI) regime is not a minimum tax on foreign earnings

- GILTI Inclusion
  - Worldwide aggregation of tested income (no per country)
  - Reduced by all tested loss
  - Reduced by net deemed tangible income return with respect to net tested income CFCs (but not tested loss CFCs)
- Deduct (up to) 50% of GILTI inclusion to obtain the taxable income
- For a corporate taxpayer, 80% of the inclusion percentage of aggregate tested foreign income taxes
- Expense allocations will further affect the total tax to which GILTI is subject

The GILTI regime is not an excess earnings regime

- 10% of qualified business asset investment (QBAI) is deducted, but QBAI includes only specified tangible assets, not intangibles
- QBAI is not limited to invested equity, is the reduction for specified interest a proxy?

What does the GILTI regime tax?

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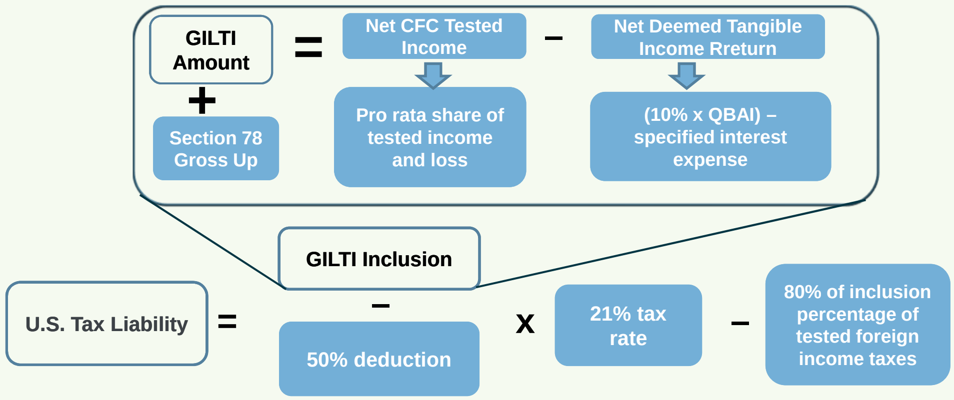
This is the GILTI Regime



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GILTI as a Model in Current OECD Discussion

GILTI as a critical element in the US international tax rules as a backstop against shifting income offshore under an exemption regime for foreign earnings

- GILTI intended as targeting (only) mobile and unusually high returns
- The GILTI regime opted for cross-crediting foreign taxes between high-tax and low-tax CFCs
  - Purported reason: administrative complexity
  - Criticism: cross-crediting does nothing to address the "race to the bottom" among countries looking to attract income
  - Does this allow income from high-tax jurisdiction to subsidize the shifting of income to low-tax jurisdictions?
- In the current OECD debate, country-by-country approach appears favored by some members, e.g., Germany and France)
  - Currently reflected in Pillar 2 proposal
- How does the exclusion of QBAI of tested loss CFC's fit into this debate
  - Would mobile returns in low tax jurisdictions generally result in tested income, but not a tested loss?

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How did we get GILTI? Ways and Means Proposals From 2011 To 2014

Camp 2011: Anti-base-erosion Options for Intangibles

- **Option A**: tax "excess" earnings on intangibles (i.e., in excess of 150% of costs) in low tax jurisdictions as a new category of subpart F income. Inclusion to be phased out between a 10% and 15% rate
- **Option B**: tax gross income (including intangibles income) subject to effective foreign tax rate below 10% unless the gross income qualifies for a "home country exception." The home country exception applies when a firm conducts an active trade or business in the home country, has a fixed place of business, and serves the local market
- **Option C**: new subpart F category for all income of a CFC from intangibles, but allow deduction of 40% of its income from foreign exploitation of intangibles (resulting in an effective tax rate of 15% at a 25% corporate income tax rate)

Camp 2014: New subpart F category for FBC intangible income

- Excess of adjusted gross income over 10% of "QBAI"
  - QBAI is the aggregate of the CFC's adjusted bases in specified tangible property
- Reduced by "applicable percentage" of other subpart F income categories
  - Excess of adjusted gross income over 10% of QBAI, divided by adjusted gross income
- Deduction for foreign intangible income (phased down from 55% (2015) to 40% (2019))
- Income subject to a foreign effective rate at least equal to the US tax rate is excluded (after taking into account the deduction)

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How did we get GILTI? Senate Finance Committee 2013

Baucus 2013: Participation Exemption and Minimum Tax

- **Option Y**: inclusion of all "low-taxed" active income with 20% deduction
  - Low-taxed if subject to less than 80% of the US corporate income tax rate
  - Existing CFC rules are retained
  - Is this GILTI with a 20% Section 250 deduction?
  - Separate FTC category for low-taxed income, but no limitation on carryforwards for excess FTCs and no haircut for related foreign taxes

Option Z: all "active foreign market income" is included and taxed at 60% of the US corporate tax rate

- narrower than "active income": attributable to economically significant activities with respect to a qualified trade or business, and derived from non-US sales or services
- Separate FTC category for subpart F income from active foreign market income, but no limitations on carryforwards for excess FTCs and no haircut for related foreign taxes

Senate Finance Committee, *International Business Tax Reform Discussion Draft in Legislative Language* (Nov. 19, 2013); Joint Committee on Taxation, *Technical Explanation of the Senate Committee on Finance Chairman's Staff Discussion Draft of Provisions to Reform International Business Taxation*, JCX-15-13 (Nov. 19, 2013)

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How did we get GILTI?
Obama Administration 2013-2016

2014/2015 Greenbook

Transactions-Based Excess Return Approach

- Currently tax excess returns associated with transfers of intangibles offshore, as new category of subpart F income:
  - Foreign tax rate of 10% or less: entirely
  - Foreign tax rate of 10-15%: phased in ratably
- Excess income: gross income from transactions connected with/benefitting from intangible over allocated and apportioned cost, increased by a percentage mark-up
- Transactions-based approach

2016/2017 Greenbook

19% minimum tax on foreign earnings of domestic corporations and CFCs

- taxed at 19% less 85% of the per-country effective tax rate (determined as taxes eligible for FTC, for the preceding 60-month period)
- reduced for the allowance for corporate equity (ACE), as a risk-free return on equity invested in active assets
- Per-country determination

See also *Cut Unjustified Tax Loopholes Act* (S. 2075), introduced February 7, 2012 by Sen. Carl Levin, D-Mich.

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OECD 2015
Action 3: Designing Effective CFC Rules

Modify the definition of CFC income in order to capture income that raises BEPS concerns

Excess Profits Analysis for income from intangibles and risk shifting

- Only to apply in situations where the CFC made use of intangible property acquired from or developed by or with assistance of a related party
- Excess Return = Income Earned by CFC − Normal Return
- Normal return is a return that a “normal investor” would expect to make with respect to an eligible equity investment
  - Rate of return: not a risk-free rate of return, but a risk-inclusive rate (estimated at 8% to 10%)
  - Eligible equity: equity invested in assets used in the active conduct of a trade or business (including IP assets)

Foreign tax credit for taxes actually paid in order to eliminate double taxation

- no haircut
- include CFC taxes of “intermediate companies”

OECD (2015), *Designing Effective Controlled Foreign Company Rules, Action 3 - 2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris.

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Are We There Yet? Or Wherever Is GILTI Going? OECD 2019: Global Anti-Base Erosion Proposal

Income Inclusion Rule (Pillar 2)

- Supplement (rather than replace) CFC rules
- Shareholders of a foreign corporation include in income the proportionate share of any foreign corporation's income not subject to tax at a minimum rate
- Foreign tax credits calculated on a country-by-country basis
- Building on "aspects" of GILTI

GILTI vs. Income Inclusion Rule

- Reduction for QBAI (excess earnings feature)
- Haircut for FTCs, and expense allocation (not a minimum tax feature)
- Aggregating of tested losses and tested income across all CFCs, rather than country-by-country determination
- No exclusion for high taxed foreign income
- No exclusion of non-US source ECI

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Tested Income and Loss

Tested income of a CFC = modified gross income – allocable deductions

Modified Gross Income is gross income but excludes:

- US-source effectively connected income (ECI), ie, income described in Section 952(b)
  - Why is non-US source ECI not also excluded?
- Gross income taken into account in determining subpart F income
  - Limited to current year earnings and profits (e&p) under Section 952(c)(1)
  - Because Section 952(c) is disregarded for Section 951A purposes, tested income could exceed current e&p
- High-tax foreign base company income and insurance income
- Related party dividends
- Foreign oil & gas extraction income

Tested income is not limited by e&p, unlike subpart F inclusions, and includes the income of disregarded subsidiaries

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Tested Income and Loss

Tested income of a CFC = modified gross income – allowable deductions

Deductions allocable under § 954(b)(5) principles

- Section 954(b)(5) requires allocating deductions to various income categories
- General depreciation rules apply
  - Depreciation / amortization of stepped up basis resulting from transactions during the GILTI holiday may be disregarded
- Determination of deductions as if the CFC were a domestic corporation under Treas. Reg. § 1.952-2:
  - Sections 163(j) and 267A may apply to disallow/defer deductions
  - Section 267 should apply to accrued but unpaid expenses to related CFC (i.e., deduction allowed if the CFC's accrued but unpaid expense increases a US Shareholder's pro rata share of the payee CFC's tested income, or reduces the pro rata share of payee CFC's tested loss)
- If deductions exceed modified gross income, there is a tested loss
  - Cannot use asset basis for QBAI or foreign taxes paid or accrued for FTC

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Tested Income vs. Tested Loss CFCs

Tested loss companies: CFCs with deductions in excess of tested income

QBAI Impact:

- A US Shareholder's QBAI does not include the asset basis of specified tangible property of a tested loss company
- If a tested income CFC has an interest in a partnership, the qualified business asset investment of the tested income CFC is increased by its partnership QBAI
- A tested loss CFC has no partnership QBAI (but partnership QBAI may turn CFC that is otherwise a tested loss CFC into a tested income CFC, and vice versa)

Foreign Tax Credit Impact:

- Taxes that are attributable to tested loss companies are not taken into account in determining FTCs related to GILTI inclusions
- FTCs of other CFCs are reduced to the extent the tested loss offsets another CFC's tested income

Tested losses may provide favorable expense allocation results

- Creates exempt earnings with expenses allocated under Section 904(b)(4) and not Section 864(e)(3)

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Tested Income and Current E&P

Because tested income is not limited by current year e&p, it is not reduced by expenditures that are not deductible for US federal income tax purposes, but reduce E&P:

- Section 163(j) interest limitation
- Tax-exempt income and related expenses
- Losses disallowed under Section 267
- Income from the discharge of indebtedness (e&p is reduced by COD income to the extent of the amount applied to reduce basis under Section 1017; see Section 312(l))
- Installment sales (e&p is computed as if a corporation did not use the installment method; see Section 312(n)(5); this is expressly excluded form e&p for purposes of determining subpart F income under Section 951(c)(3))

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GILTI Inclusions Through Domestic Partnerships

A domestic partnership is a US Shareholder with respect to a CFC if it owns 10% or more of the vote or value of the CFC stock

Section 951A does not address the determination of a partner's share of tested income/tested loss of CFCs held indirectly through a domestic partnership

- Simple aggregate approach: Each partner calculates its own GILTI inclusion taking into account its pro rata share of CFC items held through the partnership
  - May exempt small partners from any GILTI inclusion
- Simple entity approach: Partnership determines its GILTI inclusion amount and each partner takes its distributive share into income
  - For partners that are otherwise US Shareholders in the indirectly held CFCs, may prevent favorable aggregation of items from indirectly held CFCs with other directly held CFCs

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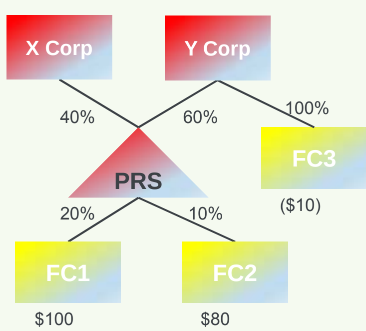
GILTI Inclusions Through Domestic Partnerships

Hybrid approach of the Proposed Regulations

- Entity approach for partners and CFCs where the partner is not a US Shareholder of the CFC held indirectly through a domestic partnership
  - Such partners take into income their distributive share of tested income/tested loss
  - Without regard to tested income/loss attributable to CFCs for which the partner is a US Shareholder
- Aggregate approach for any partner that is a US Shareholder of the CFC held indirectly through a domestic partnership. Such partners
  - Are treated as proportionately owning 958(a) stock in each CFC of the partnership as if the partnership were foreign
  - Take into account their proportionate share of each item of CFC tested income/loss and asset basis whether or not the partnership has a GILTI inclusion for the year
  - Can aggregate these items with other directly held CFC items
  - The application of the aggregate approach gives certainty that domestic corporate partners get Section 960(d) FTCs and Section 250 deductions

Hybrid Partnership Approach: Prop. Reg. § 1.951A-5(g) Ex. 3



- X Corp is not a US Shareholder of FC1 or FC2; Y Corp is a US Shareholder of FC1 and FC3, but not FC2
- PRS has $28 of tested income, and $8 of tested income without regard to FC1
- X Corp takes into account its share of PRS's tested income, or $11.20 ($28 x 40%)
- Y Corp has $12 of tested income from FC1 ($100 x 20% x 60%) and ($10) of tested loss from FC3, for net tested income of $2. In addition, Y Corp must include its proportionate share of PRS's tested income, without regard items from FC1, for an additional $4.8 ($80 x 10% x 60%).

Tested Income, QBAI and NUBILs

Does Section 382 apply in determining tested income and QBAI?

- If a CFC is acquired in a transaction that gives rise to an ownership change, and the CFC has a net unrealized built-in gain (NUBIL), then
  - any recognized built-in loss is subject to limitation (during the 5-year recognition period); and
  - allowable deductions during the 5-year recognition period are limited to the extent attributable to pre-change NUBIL (two methods of Notice 2003-65)
- Increase in tested income as a result of the limitation
- Would it increase QBAI, or is QBAI determined without reducing depreciation?

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Subpart F recapture rule

Modified gross income does not include gross income "taken into account in determining" subpart F income (Section 951A(c)(2)(A)(i)(II) and Prop. Reg. §1.951A-2(c)(1))

- Unlike tested income, subpart F income is limited to current year e&p
- For any tax year when a CFC's subpart F income exceeds e&p, the subpart F inclusion will be limited to such current year e&p (Section 952(c)(1))
- This should not give rise to tested income in the current year, i.e., year the subpart F income is so limited ("taken into account")

While subpart F income in excess of e&p is not included in US taxable income under subpart F or GILTI for the current year, a "section 952(c) recapture account" is established

- Once e&p exceeds subpart F income, items of income of the CFC that are otherwise not subpart F income will be "recharacterized" as subpart F income (Section 952(c)(2))
- The proposed regulations treat the recaptured income as tested income for the same year, as the income is not itself subpart F income.
- NYSBA GILTI Report II agreed, but suggested statutory amendment would be helpful

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Calculating Net DTIR: QBAI

Net DTIR = 10% of QBAI – Specified Interest Expense

QBAI: tested income CFCs' aggregate adjusted bases in specified tangible property used in a trade or business and of a type with respect to which a depreciation deduction under Section 167 is allowable

- Average of quarterly bases
- Specified tangible property is tangible property used in the production of gross tested income
  - Adjusted basis is determined by using the alternative depreciation system (ADS) of Section 168(g)
  - Section 168(g) applies ADS to any tangible property used during the taxable year predominantly outside the United States
- Is the policy reason here two avoid a difference in depreciation for purposes of determining tested income/loss and for QBAI?
  - Substance in foreign jurisdiction?
  - Approaches: people/functions; or mechanical approach (tangible property)
  - Section 7874 "substantial business activities" includes "group" employees, compensation, assets and income for its comparative test

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QBAI Anti-Abuse Rules

<u>Anti-abuse rule for stepped up basis</u> in CFC assets acquired after December 21, 2017 and before GILTI effective date

- For purposes of determining tested income/loss, the benefit of a stepped-up basis is disallowed with respect for "specified property" transferred between related CFCs during the disqualified period
  - Specified property: property of a type for which deduction allowable under Section 167 or 197
- For purposes of determining QBAI, the benefit of a stepped-up basis is similarly disallowed with respect for specified tangible property transferred between related CFCs during the disqualified period

<u>Principal purpose rule</u> disregards for QBAI calculation certain depreciable tangible property acquired by a CFC with "a principal purpose" of reducing GILTI inclusion

- Applies whenever a CFC with tested income holds certain property for less than 12 months but over the close of a quarter, cannot be rebutted
- Not limited to related-party transactions (stock sale with Section 338 election)
- No exception for ordinary course transactions

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Calculating Net DTIR: Specified Interest Expense

Net DTIR = 10% of QBAI – Specified Interest Expense

Specified interest expense is the aggregate of a US Shareholder's share of CFC tested interest expense less tested interest income

- Tested interest expense and tested interest income are amounts reflected in CFC's tested income
- Tested interest expense reduces DTIR only to the extent that related interest income is not also reflected in tested income of another CFC and included by the relevant US Shareholder
  - Interest expense between related CFCs generally will not reduce DTIR
  - Interest expense incurred for third-party loans or loans from the US Shareholder can reduce net DTIR

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Interest Income "Attributable" to Interest Expense

The proposed regulations reject a tracing approach in favor of a netting approach

A US Shareholder's specified interest expense :=

excess of

- aggregate pro rata share of tested interest expense of each CFC taken into account in determining tested income

over

- aggregate pro rata share of tested interest income of each CFC taken into account in determining tested income

Interest expense and income are defined broadly

- Encompasses any amount treated as interest under the Code and regulations, and
- Any other amount incurred or recognized in a transaction (or integrated/related transactions) in which the use or forbearance of funds is secured for a period of time if the expense/loss is predominantly incurred in consideration of the time value of money

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Reducing Net DTIR: Increase QBAI?

Strategies for reducing GILTI

- Increasing QBAI
  - Is the GILTI regime inviting the use of specified assets offshore?
- Locating assets in a tested income CFC (and not a tested loss CFC) in order to maximize available QBAI
  - Use transparent entities as subsidiaries of CFCs, rather than chains of CFCs, which might give rise to trapped losses

Borrow to buy QBAI?

- As long as cost of borrowing is less than 10%, borrowing to acquire QBAI increases net DTIR
  - Additional tested interest expense reduces tested income by the same amount as it reduces net DTIR: no overall effect
- If the cost of borrowing is less than the return on QBAI, and the return on QBAI is less than 10%, debt-financed QBAI reduces tested income
  - Tested income is reduced by 10% of QBAI
  - Result: should low-return QBAI be located offshore?
- QBAI is reduced over time on account of depreciation

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Specified Interest Rules: Example 1

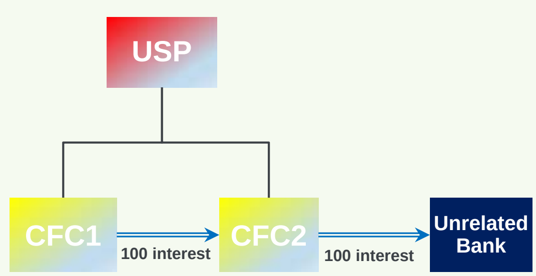
- USP owns 100% of CFC1 and CFC2
- CFC1 pays 100 of interest to CFC 2
- CFC2 pays 100 of interest to an unrelated bank

- Tested Interest Expense
  - 100 from CFC1
  - 100 from CFC2
  - 200 TOTAL

- Tested Interest Income
  - 100 from CFC2
  - 100 TOTAL

- Specified Interest Expense
  - 200 – 100 = 100

Prop. Reg. 1.951A-4(c) – Example 1



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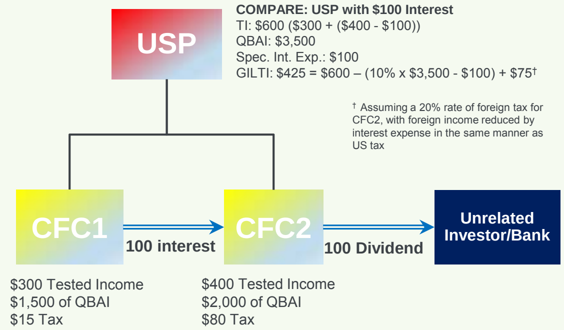
Specified Interest Rules: Example 1 with Preferred Stock

- USP owns 100% of CFC1 and all of the common stock of CFC2
- Unrelated Investor owns preferred stock paying a dividend of 100
- CFC1 pays 100 of interest to CFC 2
- CFC2 pays 100 of dividend to Investor
- Tested Interest Expense
  - 100 from CFC1 to CFC2
  - 100 TOTAL
- Tested Interest Income
  - 100 from CFC2
  - 100 TOTAL
- Specified Interest Expense
  - 100 – 100 = 0
- Tested Income allocated to Investor
  - QBAI also allocated to Investor
  - Reduced specified interest

USP GILTI with $100 Preferred Dividend
TI: $600 ($300 + $300)
QBAI: $3,000 ($1,500 + 3/4 x $2,000)
Spec. Int. Exp.: $0
GILTI: $375 = $600 – (10% x $3,000) + $75

COMPARE: USP with $100 Interest
TI: $600 ($300 + ($400 - $100))
QBAI: $3,500
Spec. Int. Exp.: $100
GILTI: $425 = $600 – (10% x $3,500 - $100) + $75†

† Assuming a 20% rate of foreign tax for CFC2, with foreign income reduced by interest expense in the same manner as US tax



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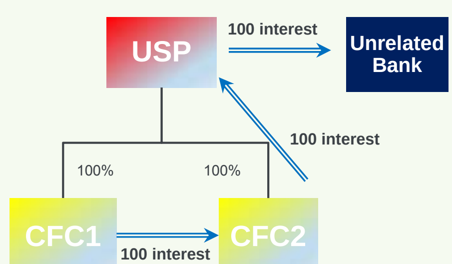
Specified Interest Rules: Borrowing from US Shareholder

- USP owns 100% of CFC1 and CFC2
- CFC1 pays 100 of interest to CFC2
- CFC2 pays 100 of interest to USP
- 200 of Tested Interest Expense
  - 100 from CFC1
  - 100 from CFC2
- 100 Tested Interest Income
  - from CFC2
- Specified Interest Expense
  - 200 – 100 = 100
- Borrowing from USP, with USP borrowing from unrelated Bank, is the same as borrowing directly from unrelated Bank
- Borrowing from USP, without USP borrowing from unrelated Bank, results in same amount of specified interest



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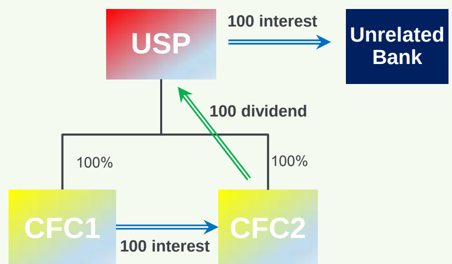
Specified Interest Rules: Equity Capital from US Shareholder

- USP owns 100% of CFC1 and CFC2
- CFC1 pays 100 of interest to CFC 2
- CFC2 pays 100 of dividend to USP
- 100 of Tested Interest Expense (CFC1)
  - 100 from CFC1
- 100 Tested Interest Income (CFC2)
- Specified Interest Expense
  - 100 – 100 = 0
- No reduction of NDTIR by Specified Interest Expense
- Quaere: Could a preferred dividend by treated as "interest" for purposes of Prop. Reg. §1.951A-4(b)(ii)? Is the use of funds secured for a period of time and the expense predominantly incurred in consideration of the time value of money?



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CFC Owned Partnership

Absent special rules, distributive share of items of income, gain, loss and deduction taken into account for purposes of determining GILTI tested income/loss

- Under special rules in Prop. Reg. 1.951A-3, a tested income CFC determines its share of partnership qualified business asset investment (and therefore QBAI):
  - Based on the average partnership basis in specified tangible property for each quarter during the partnership's taxable year; and
  - Based on the "partnership QBAI ratio," which is based on the partners' share of gross income from each specified tangible property
- Does the CFC have to be a tested income CFC without regard to partnership inclusions?
  - "If a tested income CFC holds an interest in a partnership as of the close of the CFC inclusion year, …"
  - "A tested loss CFC has no partnership QBAI," Prop. Reg. § 1.951A-3(g)(1)
  - Examples (1) and (2) presuppose that the relevant CFC is a tested income CFC
- A tested income CFC determines its share of partnership QBAI without regard to partners' share of capital or debt funding the investment in specified tangible property

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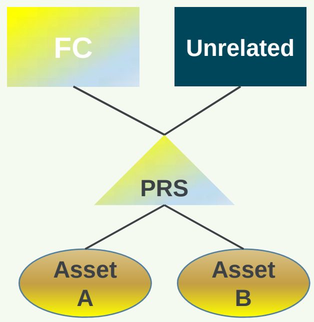
Prop. Reg. § 1.951A-3(g)(4) Ex. 1



- Asset A average basis $100, Asset B average basis $50 – all reflecting qualified business asset investment
- Asset A gross income of $10, $8 allocated to FC; Asset B gross income of $50, $10 allocated to FC
- FC's QBAI ratio for Asset A is 80%, and FC's QBAI ratio for Asset B is $20%
- FC, a tested income CFC, increases its qualified business asset investment by $90 for the year, which equals $80 for Asset A and $10 for Asset B

- If PRS were instead a CFC (and deductions were allocated pro rata), a 100% US Shareholder of FC should be able to include QBAI of only $45 ($150 of aggregate asset basis multiplied by $18 / $60)
- What is the "correct" inclusion?

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Calculating the US Shareholder's Pro Rata Share

A US Shareholder must calculate its pro rata share of each CFC's tested income, loss, and QBAI

- Tested income of a tested income CFC is generally allocated with the pro rata rules under Subpart F
  - Amount that would be received in a hypothetical year-end distribution of all of CFC's current year earnings
  - Amended Subpart F pro rata share rules that apply to both Subpart F and GILTI as part of GILTI regulations package
- A tested loss of a tested loss company is generally allocated pro rata to common stock
- QBAI of a tested income CFC is generally allocated pro rata to its amount of the CFC's tested income
  - Special rule if CFC's QBAI exceeds 10x its tested income (excess allocated only to common stock)
  - This would not apply in the case of a partnership preferred interest, where all partnership QBAI could be allocated to a preferred partnership interest, with no tested income ceiling

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New Pro-Rata Share and Anti-Abuse Rules

Proposed regulations amend section 951 rules on determining a US Shareholder's pro-rata share of Subpart F and GILTI income/items

- In general, the rules maintain a hypothetical liquidation approach and impose a pro-rata rule by class
  - Distribution waterfalls are respected, but other restrictions on distributions generally ignored
  - Generally, disregard any amounts paid in redemption of stock (even if treated as a dividend under section 301)
- Special rules for cumulative preferred stock
  - Allocation is limited to actual distributions plus accruals at AFR
  - Allocations to any prior year dividend arrearages limited to amounts in excess of accumulated e&p
- New anti-abuse rule: pro rata share determined without regard to transactions with a principal purpose of avoiding US federal income taxation, including transactions that reduce a US Shareholder's pro rata share

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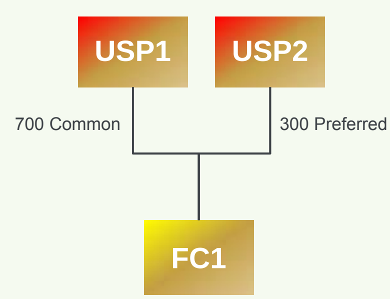
Prop. Reg. § 1.951-1(e)(7) Ex. 6

- FC1: 700 shares of common stock; 300 shares of 4% nonparticipating, voting preferred stock with a par value of $100x per share
  - e&p: $10,000x
  - Subpart F income: $2,000x
  - Tested income: $9,000x
- The current e&p is $11,000x (the greater of e&p or the sum of subpart F income and tested income)
- FC1's current e&p (hypothetically) distributed
  - USP2's preferred shares: $1,200x
    (0.04 x $100x x 300)
  - USP1's common shares: $9,800x
    ($11,000x - $1,200x)
- Pro rata share of Subpart F income:
  - USP1: $1,782x ($2,000x x $9,800x / $11,000x)
  - USP2: $218x ($2,000x x $1,200x / $11,000x)
- Pro rata share of tested income:
  - USP1: $8,018x ($9,000x x $9,800x / $11,000x)
  - USP2: $982x ($9,000x x $1,200x / $11,000x)



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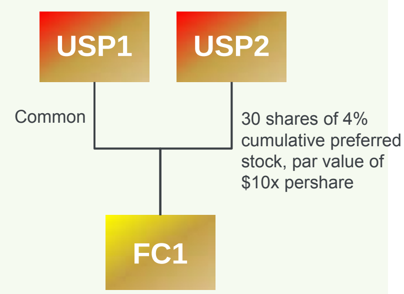
QBAI for Preferred Stock: Prop. Reg. § 1.951-1(d)(3)(iii) Ex. 2

- FC1:
  - Tested income: $120x
  - e&p: $100x
  - QBAI: $1500x
  - No subpart F income
- For purposes of a hypothetical distribution, the greater of e&p and tested income is $120
- Hypothetical distributions:
  - to USP2: $12x (30 x $10x x 4%)
  - to USP1: $108x (remainder)
- QBAI exceeds 10x tested income
  - Allocation of non-excess QBAI ($1,200x, i.e., 10 x tested income):
    - to USP2: $120x ($12x/$120x x $1200x)
    - to USP1: $1080x
  - Allocation of excess QBAI:
    - to USP1: $300 ($108x/108x x ($1500x – $1200x)
- Total QBAI to USP1: $1380x; to USP2: $120x



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Section 961(c) PTEP Basis and GILTI

Does Section 961(c) apply to adjust a higher-tier CFC's basis in the stock of a lower-tier CFC for GILTI purposes

- Section 951A(f): a GILTI inclusion is treated like a Subpart F inclusion for purposes of the PTEP rules
- Section 961(c): the basis adjustment rules for lower-tier CFC stock apply "only for the purposes of determining the amount included under section 951" (and not also Section 951A)

If Section 961(c) did not extend to inclusions of tested income under GILTI, a US Shareholder would be subject to double GILTI inclusions in certain situations

- *E.g.*, on a disposition of lower-tier CFC stock or a distribution of properties of the lower-tier CFC to the upper-tier CFC

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Anti-Hybrid Rules

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International and U.S. Responses to Hybrid Mismatches - History

- The OECD released its first report discussing the issues with hybrid mismatch arrangements in 2012
  - A handful of countries, including the United States, were identified as having rules that – in certain circumstances – address hybrid arrangements
- In the United States:
  - With the exception of the dual consolidated loss rules (section 1503(d)) enacted in 1986, the United States historically did not have rules addressing hybrid arrangements
  - That changed – somewhat – over time:
    - 1997 – Section 894(c)
    - 2008 – Regulations under section 901 addressing foreign tax generator transactions
    - 2010 – Section 901(m)
    - 2010 – Section 909
  - Sections 245A(e) and 267A represent the latest evolution in US policy responses to international developments regarding hybrid mismatch arrangements

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OECD Hybrid Mismatch Report

- The OECD released its final report on "Neutralising the Effects of Hybrid Mismatch Arrangements" in October 2015, which is Action 2 in the 15-point Action Plan to address BEPS.
- The report addresses "**hybrid mismatch arrangements**," which exploit differences in the treatment of an entity or instrument under the laws of two or more tax jurisdictions to achieve double non-taxation, including long-term deferral.
- The targeted mismatches fall into one of three categories:
  - Payments that are deductible under the rules of the payor jurisdiction and re not included in the ordinary income of the payee (a "**D/NI**" outcome)
  - Payments that give rise to two deductions in respect of the same payment (a "**DD**" outcome)
  - Payments that are deductive under the rules of the payor jurisdiction and that are set-off by the payee against a deduction under a deduction under a hybrid mismatch arrangement (an "**indirect D/NI**" outcome)
- The OECD report stated that these arrangements are "widespread" and result in substantial erosion of the tax bases in various countries, and have an overall negative impact on "**competition, efficiency, transparency and fairness**."

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OECD Hybrid Mismatch Report (cont'd.)

- Among other things, Part I of the report makes recommendations for **domestic law rules** to address mismatches that arise in respect of payments made under a "**hybrid financial instrument**" or payments made to or by a hybrid entity.
- The report also makes similar recommendations with respect to **disregarded payments** made by a hybrid entity and payments made to a reverse hybrid entity.
- Differences in timing of the recognition of payments are not treated as giving rise to a D/NI outcome "provided the taxpayer can establish to the satisfaction of the tax authority that the payment will be included as ordinary income within a reasonable period of time."
- The hybrid financial instrument rule is **not intended to give rise to economic double taxation**, e.g., in cases where the payment gives rise to an inclusion in ordinary income by a shareholder of the recipient under a CFC regime.

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OECD Hybrid Mismatch Report (cont'd.)

- The recommended "**primary rule**" with respect to such mismatches, in the case of a D/NI or an indirect D/NI outcome, is for the country of the payor to adopt a "**linking rule**" pursuant to which the country **denies the deduction for a payment** to the extent that 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 apply a "**defensive rule**," requiring the deductible payment to be included in income or denying the duplicate deduction.
  - The rule applies with respect to **payments between related parties** and payments under "**structured arrangements**," except where the taxpayer could not reasonably be expected to be aware of the hybrid mismatch and did not share in the value of the tax benefit from the hybrid mismatch.
  - A "structured arrangement" is any arrangement where a hybrid mismatch is **priced into the terms** of the arrangement or the facts indicate the arrangement is **designed to produce a hybrid mismatch**.
- Part II of the report makes recommendations with respect to the treatment of hybrid instruments and hybrid entities, as well as dual resident entities, under tax treaties.
- The OECD also released a report in 2017 that contains recommendations to neutralize the tax effects of so-called "**branch mismatches**," which are certain arrangements involving branches that result in mismatches similar to hybrid mismatches.

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Overview of ATAD II: Anti-hybrid Rules

ATAD II (2020 and onwards)

- Anti-hybrid rules:
  - Hybrid PE mismatches
  - Hybrid transfers
  - Imported mismatches
  - Reverse hybrid mismatches (2022)
  - Dual resident mismatches

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Local implementation progress

	Austria	Belgium	Bulgaria	Croatia	Cyprus	Czech Republic	Denmark	Estonia	Finland
Anti-hybrid-rules	🟡	🟢	🟡	🔴	🔴	🟢	🟡	🟡	🔴

🟢 Already implemented or embedded in local law
🟡 Existing domestic rule should be amended to meet the ATAD standard
🔴 Not implemented and/or no existing domestic rule

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Local implementation progress

	France	Germany	Greece	Hungary	Ireland	Italy	Latvia	Lithuania	Luxembourg
Anti-hybrid-rules	🟡	🟡	🟡	🟡	🔴	🟢	🟢	🟡	🟡

🟢 Already implemented or embedded in local law
🟡 Existing domestic rule should be amended to meet the ATAD standard
🔴 Not implemented and/or no existing domestic rule

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Local implementation progress

	Malta	Netherlands	Poland	Portugal	Romania	Slovakia	Slovenia	Spain	Sweden	UK*
Anti-hybrid-rules	Yellow	Red	Yellow	Red	Yellow	Green	Red	Yellow	Green	Yellow

Green: Already implemented or embedded in local law

Yellow: Existing domestic rule should be amended to meet the ATAD standard

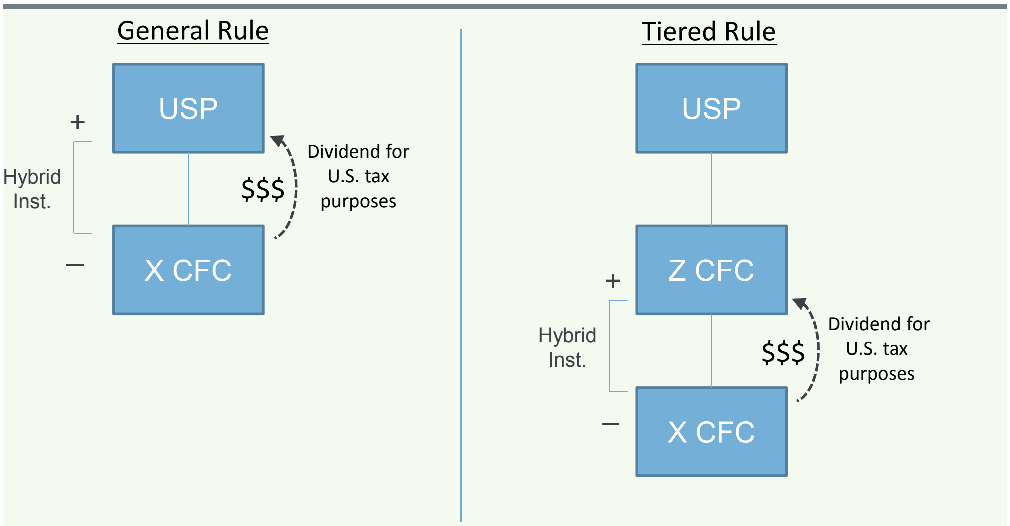
Red: Not implemented and/or no existing domestic rule

* May exit the EU ultimately

Section 245A(e) Overview

- 100% DRD available for the foreign source portion of a dividend received by a 10% US shareholder of a foreign corporation that meets a 1 year holding period
- DRD and FTCs are lost if (i) the payor foreign corporation receives a deduction or other tax benefit with respect to the dividend or (ii) it is a hybrid or tiered hybrid dividend
- Section 245A(e)(4) defines as hybrid dividend as an amount received from a CFC "for which the CFC received a deduction"
- Prop. Reg. §1.245A(e)-1(b)(2) provides that the DRD is denied to the extent of the sum of the US shareholder's "hybrid deduction accounts" with respect to the CFC, irrespective of which class of CFC stock the distribution is made
  - A tiered corporation rule generally requires the US shareholder to include a hybrid dividend from a lower tier CFC to an upper tier CFC in income as subpart F income to the extent of the sum of the latter's hybrid deduction accounts in the former
- Regulations proposed to be effective for distributions after December 31, 2017

§245A(e) – Hybrid Dividends



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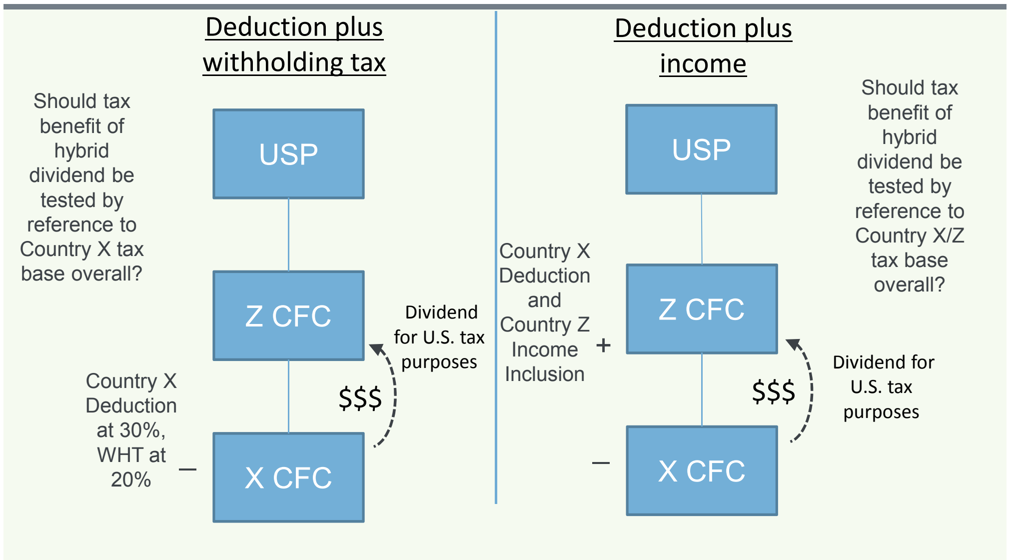
§245A(e) – Hybrid Dividends



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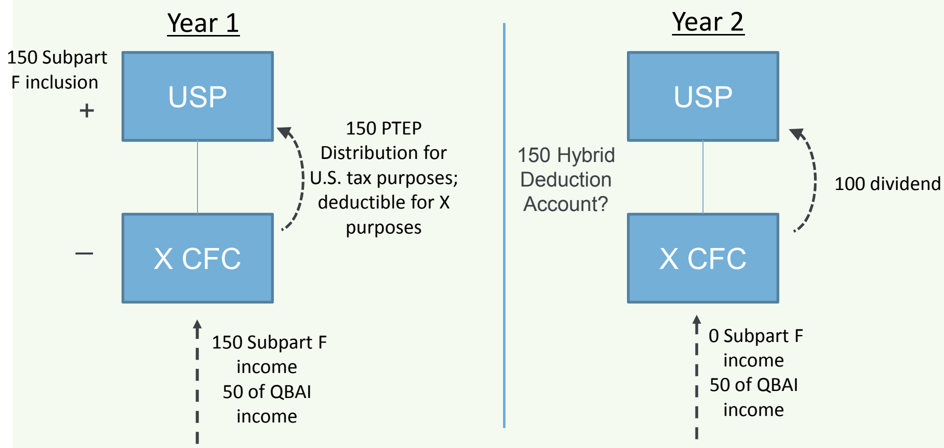
§245A(e) – Hybrid Deduction Accounts



When amounts that benefit from hybrid deduction are currently subject to tax in the US (through subpart F or GILTI), will the hybrid deduction account rules result in too much taxable income (i.e., total US taxable income of 250 in Years 1 and 2 combined)? Should associated foreign tax credits and Section 250 deductions affect the analysis?

Section 267A - General

- Section 267A addresses D/NI outcomes from hybrid arrangements by denying a deduction to the payor.
- The provision applies to a "**disqualified related party amount**" paid or accrued (i) pursuant to a "**hybrid transaction**" or (ii) by or to a "**hybrid entity**" (Section 267A(a)).
  - A **disqualified related party amount** is any **interest or royalty** paid or accrued to a related party to the extent that (i) the amount is not included in the income of the related party under the tax law of the country in which the related party is tax resident or subject to tax or (ii) the related party is allowed a deduction with respect to such amount under the tax law of such country, but does not include any payment to extent such payment is included in the gross income of a U.S. shareholder under section 951(a) (Section 267(b)(1)).
  - A **hybrid transaction** means any (i) transaction or series of transactions, (ii) agreement or (iii) instrument one or more payments on which are treated as interest or royalties for purposes of the Code and which are not so treated under the tax law in the recipient's country (Section 267(c)).
  - A **hybrid entity** mean any entity which is either (i) treated as fiscally transparent for US tax purposes but not so treated in the entity's country of residence, or (ii) vice versa (Section 267(d)).

Section 267A – Grant of Regulatory Authority

- Section 267A contains 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 this section" (Section 267A(e)).
- The grant then lists a number of specific issues on which regulations or other guidance may be issued, including (i) conduit arrangements involving a hybrid transaction or hybrid arrangement, (ii) "certain" structured transactions, (iii) tax residence of a foreign entity, and (iv) exceptions from Section 267A (Section 267A(e)).

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Section 267A – Legislative History

- The House version of the Act did not contain any provision on hybrid transactions or hybrid entities.
- The Senate bill included a version of Section 267A, substantially in the form in which it was enacted.
- The Senate Finance Committee report on the Senate bill stated that the Committee believed that:
  - "these types of arrangements have an overall negative impact on **competition, efficiency, transparency and fairness**"
  - "[Section 267A] 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"

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Proposed Regulations – Overview

- The proposed regulations with respect to section 267A deny a deduction for certain payments of interest or royalties for U.S. tax purposes, as well as certain "structured payments" (referred to as "**specified payments**"), pursuant to hybrid arrangements, or similar arrangements involving branches, that produce D/NI or indirect D/NI outcomes, to the extent of the D/NI outcome.
- The preamble to the proposed regulations refer to the OECD hybrid mismatch and branch mismatch reports, as well as the legislative history discussed above.
- The proposed regulations also provide rules for the application of section 245A(e) to hybrid dividends and rules under sections 1503(d) and 7701 with respect to domestic reverse hybrid entities.
- The regulations do not address DD outcomes, which are addressed through other provisions (e.g., section 1503(d)) or other rules of law, but the preamble states that Treasury is studying disregarded payments made to domestic corporations and requests comments.

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Proposed Regulations – Overview

- The proposed regulations disallow a deduction for interest or a royalty (a "**specified payment**") paid or accrued by a **US tax resident, a CFC or a US taxable branch** (a "specified party") to the extent that the specified payment:
  - (i) is a "**disqualified hybrid amount**,"
  - (ii) is a "**disqualified imported mismatch amount**" or
  - (iii) produces a D/NI outcome and is made pursuant to a transaction a **principal purpose of which is to avoid the purposes** of the regulations under section 267A.
- A specified payment also includes a "**structured payment**" – more on that in a moment.
- The NYSBA Tax Section wrote a report (#1411) on the proposed regulations in February 2019, the more significant comments in which, especially on where the proposed regulations differ from the approach taken in the OECD recommendations, are discussed in more detail below.

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Proposed Regulations – Disqualified Hybrid Amount

- A specified payment is a “disqualified hybrid amount” if it falls into one of five categories:

  1. **Hybrid transaction payment** – a specified payment to a specified recipient as to which the recipient’s country does not treat the payment as interest or a royalty or does not require recognition of the payment within 36 months after the taxable year in which the payor would be allowed a deduction for the payment under U.S. tax law.

  2. **Disregarded payment** – a specified payment which, under the tax law of a tax resident or taxable branch to which a specified payment is made, is not regarded, but the NI outcome is taken into account only to the extent the amount of the deduction otherwise allowable exceeds the specified party’s “dual inclusion income” (net income of the specified party that is subject to dual inclusion in both the U.S. and in the recipient’s jurisdiction).

  3. **Deemed branch payment** – any amount of interest or royalties allowable as a deduction in computing the business profits of a U.S. taxable branch that is a U.S. permanent establishment of a treaty resident, to the extent the amount is deemed paid to the home office (or branch of the home office) and is not regarded (or otherwise taken into account) under the relevant jurisdiction’s tax law.

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Proposed Regulations – Disqualified Hybrid Amount (cont’d.)

4. **Payment to a reverse hybrid** – a specified payment made to a “reverse hybrid” (a domestic or foreign entity that is fiscally transparent under the tax law where it is organized, but not fiscally transparent under the tax law of an investor in the entity) to the extent (i) an investor in the reverse hybrid does not include the payment in income, and (ii) the non-inclusion results from the payment being made to reverse hybrid.

5. **Branch mismatch payment** – a specified payment to a branch that (i) under the home office’s tax law, is treated as income attributable to a branch, and (ii) under the branch’s tax law, the branch is not a taxable branch or the income is not attributable to the branch.

For these purposes, (i) a specified recipient, tax resident or taxable branch to which a specified payment is made, (ii) an investor or (iii) a home office is taken into account only it is **related to the specified party** making the specified payment or is a party to a “**structured arrangement**.”

A “structured arrangement” means an arrangement with respect to which a specified payment would be a disqualified hybrid amount only if (i) the specified payment were analyzed without regard to the relatedness requirement, and (ii) either (x) the hybrid mismatch is **priced into the terms** of the arrangement or (y) based on all of the facts and circumstances, **the hybrid mismatch is a principal purpose** of the arrangement.

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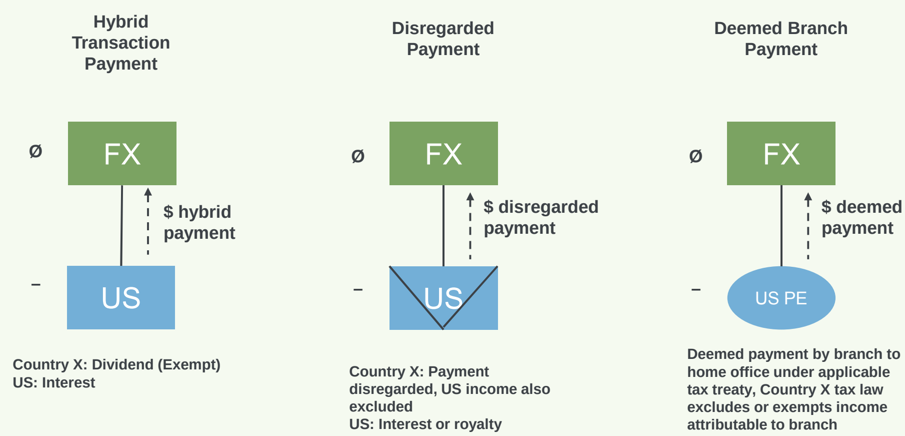
Disqualified Hybrid Amounts - Examples



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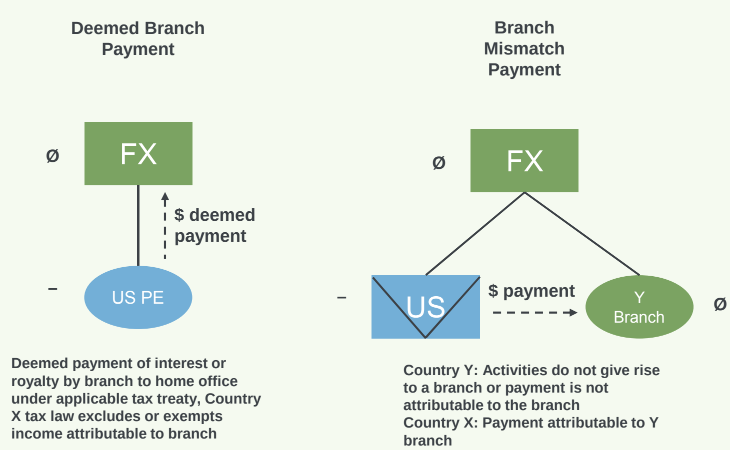
Disqualified Hybrid Amounts - Examples



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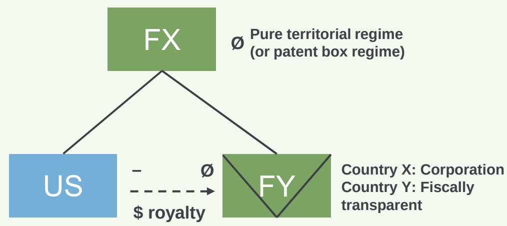
Disqualified Hybrid Amounts – “As a Result of” Hybridity

- The proposed regulations provide that a D/NI outcome gives rise to a disqualified hybrid amount only to the extent that the D/NI outcome is a result of hybridity
- Apply a “counterfactual” test – absent hybridity, would there be non-inclusion?

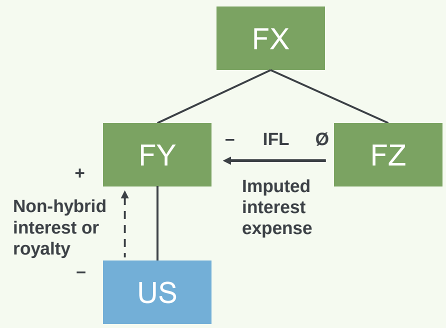


Proposed Regulations – Disqualified Imported Mismatch Amount and Anti-Avoidance Payments

- A “**disqualified imported mismatch amount**” is defined as a specified payment to the extent that the income that is attributable to the payment is directly or indirectly offset by a “**hybrid deduction**” that is (i) incurred by a tax resident or taxable branch that is related to the specified party and (ii) is directly or indirectly funded by the specified payment.
  - A “hybrid deduction” is a deduction allowed for interest or royalties under local tax law to the extent a deduction for such amount would be disallowed if local tax law contained rules similar section 267A, as well as deductions with respect to equity (such as notional interest deductions on equity) and loss carryover attributable to a hybrid deduction.
- Under the **anti-avoidance rules**, the deduction for a specified payment is disallowed to the extent that (i) the payment is not included in the income of a tax resident or a taxable branch, and (ii) a principal purpose of the plan or arrangement is to avoid the purposes of the regulations under section 267A.

Disqualified Imported Mismatch Amount – Example

- Is the imputed interest expense on the IFL a "specified payment" by FY?
- Different result if (i) loan is an interest-bearing loan, but (ii) FZ qualifies for a notional interest deduction on equity?
- In general, how close should the relationship between the non-hybrid payment and the "specified payment" be for there to be an imported mismatch?



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Proposed Regulations – Other Significant Rules

- **Interest** is broadly defined as including any amount that is treated as interest under the Code, and is adjusted for any income, deduction, gain or loss from a derivative that alters the effective cost of borrowing.
  - Even though not interest, **payments related to the time value of money** – substitute interest, commitment fees, debt issuance costs, guaranteed payments for the use of capital and any expense or loss predominantly incurred in consideration of the time value of money in a transaction in which the use of funds is secured – are treated as "**structured payments**" included in the definition of "specified payment."
  - But there are places where the regulations appear to apply differently to interest versus structured payments – is that intended?

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Proposed Regulations – Other Significant Rules

- The proposed regulations expand on the subpart F exception to the disallowance rule in the statute by providing an **exception for payments that are included in the U.S. tax base**, either directly (e.g., where the payment is to a U.S. taxpayer or a U.S. taxable branch) or under GILTI – absent the exception, there would be double taxation.
  - There is no exception, however, for payments that are subject to U.S. withholding tax, because, according to the preamble, withholding tax policies are unrelated to the policies relating to hybrid mismatches. The OECD report takes the same approach.
  - Is this really correct?
    - Withholding taxes are taken into account for purposes of determining the amount of the base erosion tax benefit under section 59A. See Prop. Treas. Reg. § 1.59A-2(e)(3)(iii); Prop. Treas. Reg. § 1.59A-3(c)(2).
    - Withholding taxes were taken into account under old section 163(j)(5)(B), as in effect prior to the TCJA, in determining whether related party interest expense was subject to withholding tax in determining whether interest was subject to section 163(j).
  - Some multilateral coordination may be required if the recipient country would apply a "defensive rule" to require an income inclusion even if the payment was subject to gross basis withholding tax.

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Proposed Regulations – Other Significant Rules

- A specified payment is treated as **included in the income** of a specified recipient to the extent that, under the tax law of the recipient (i) it includes or will include, within **36 months** after the end of the tax specified party's tax year, the payment in its income or tax base at the **full marginal tax rate** imposed on **ordinary income** and (ii) the payment is **not offset or reduced** by any exemption, credit, deduction or similar relief.
  - Whether there is an inclusion is **determined without regard to any "defensive" rules** in the tax law of the recipient.
  - In the case of a reverse hybrid, whether an investor in a reverse hybrid has an inclusion with respect to a specified payment is determined without regard to a distribution (or a right to a distribution) from the reverse hybrid.
- A specified recipient is 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, determined under the principles of Treas. Reg. § 1.894-1(d)(1).

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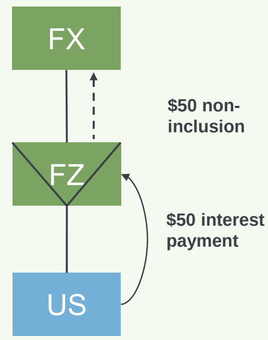
Proposed Regulations – Multiple Specified Recipient Rule

- There may be multiple specified recipients with respect to a specified payment
- For example, assume that FX, a tax resident of Country X, owns FZ, a reverse hybrid organized in Country Z, which owns US
- US makes a $50 interest payment to FZ, which is includible in FZ's income as interest under Country Z tax law
- FX is treated as receiving the payment under Country X law, and has a NI outcome
- Payment is a disqualified hybrid amount because of the NI outcome with respect to FX, even though there is not a NI outcome with respect to FZ (and without regard to whether FZ has a high or low tax rate)
- The OECD Report recommendations would reach the opposite result – to the extent that the payment is included in income in any other jurisdiction where the payment is treated as received, there is not a D/NI outcome



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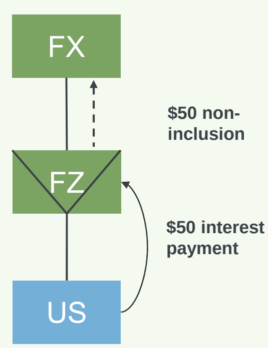
Proposed Regulations – Multiple Specified Recipient Rule (cont'd)

- Compare this result to the result in the situation where FZ is not a hybrid entity as to FX – section 267A does not apply, even if the Country Z tax rate on the interest income is very low or even zero
- Could the anti-avoidance rule apply in this alternative situation?
- Going back to the reverse hybrid example, should the proposed regulations take into account the rate of tax imposed on the interest payment?
  - Data points – 10.5% (nominal GILTI rate); 13.125% (effective minimum US/foreign GILTI rate), 18.1% (subpart F high-tax kick-out rate)?
  - Just in Country Z? Or the total effective tax rate on the interest payment in both Country Z and Country X?
  - Proportionate disallowance based on the difference between the Country X tax rate on interest and the Country Z tax rate on interest?



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Proposed Regulations – Structured Arrangements

	OECD	Proposed Regulations
Pricing test	Yes – is the hybrid mismatch priced into the terms of the arrangement	Same
Facts and circumstances test	Yes – facts and circumstances indicate to an objective observer that the arrangement has been designed to produce a hybrid mismatch	Yes – based on all of the facts and circumstances, the hybrid mismatch a "principal purpose" of the arrangement (i.e., a subjective test)
Taxpayer-specific requirement	Yes – rule applies only if taxpayer or a member of its controlled group "could reasonably have been expected to be aware of the hybrid mismatch" or "shared in the value of the [resulting] tax benefit"	None
List of factors	(1) Arrangement is designed to create a hybrid mismatch (2) Arrangement incorporates a term, step or transaction to produce a hybrid mismatch (3) Arrangement is marketed as tax-advantaged where some or all of the advantage derives from the hybrid mismatch (4) Arrangement is marketed to taxpayers in a jurisdiction where the hybrid mismatch arises; (5) Arrangement contains features that alter the terms of the arrangement in the event the hybrid mismatch is no longer available (6) Arrangement would produce a negative return absent the hybrid mismatch	(1) Marketing the arrangement as tax advantaged where some or all of the advantage derives from the hybrid mismatch (2) Arrangement is primarily marketed to residents of a country which enables the hybrid mismatch (3) Arrangement contains features that alter the terms of the arrangement in the event the hybrid mismatch is no longer available (4) Arrangement would produce a below-market return absent the tax benefits of the hybrid mismatch

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Proposed Regulations – Structured Arrangements Example 1

- OECD – meets pricing test and facts and circumstances test
- Proposed regulations – meets pricing test; facts and circumstances test?

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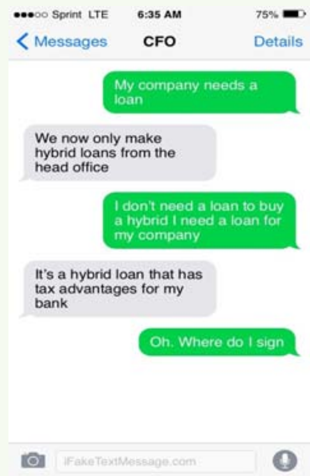
Proposed Regulations – Structured Arrangements Example 2

- OECD – meets facts and circumstances test
- Proposed regulations – probably meets facts and circumstances test



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Proposed Regulations – Structured Arrangements Example 3

- OECD – (probably?) meets facts and circumstances test
- Proposed regulations – ?

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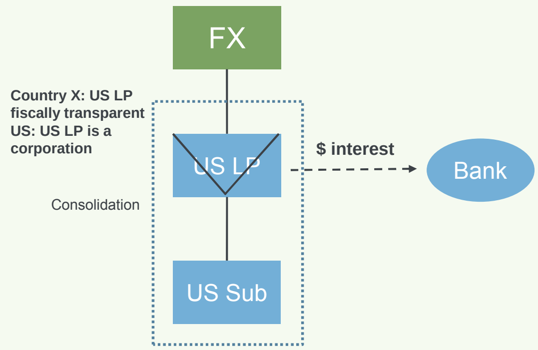
Section 1503(d) and Domestic Reverse Hybrids

- Treasury has determined that these structures are inconsistent with the purposes of section 1503(d) and raise significant policy concerns
- Proposed regulations require, as a condition to US LP's CTB election, that US LP consent to be treated as a dual resident corporation for purposes of section 1503(d)
- If the domestic entity filed a CTB election before 12/20/18, then the entity is deemed to consent to being treated as a dual resident corporation after a 12-month transaction period, unless it elects to be treated as a partnership or DRE



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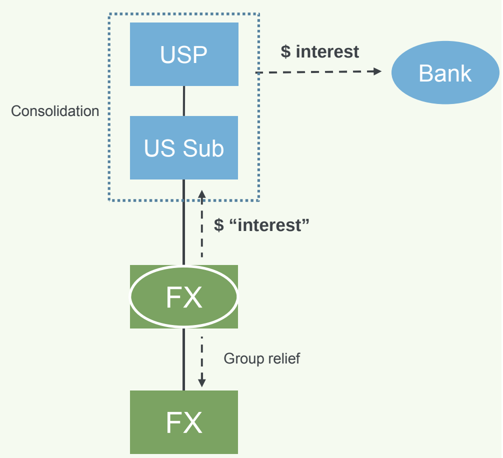
Section 1503(d) and Disregarded Payments

- No DCL because interest payment from FX to US Sub is a disregarded payment
- Treasury has determined that this and similar transactions raise significant policy concerns that are similar to those relating to the D/NI outcomes addressed by sections 245A(e) and 267A, and the D/D outcomes addressed by section 1503(d)



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What's Next?

- Both the OECD report and the preamble to the proposed regulations note that a D/NI outcome can occur even without hybridity – e.g., where a specified recipient's tax law does not have a corporate income tax – but such an outcome is not covered by the hybrid mismatch rules or the proposed regulations
- As part of its work on the tax challenges arising from digitalization, the OECD is considering, in addition to rules relating to nexus and allocation of taxing rights (Pillar 1), two proposals to address ongoing profit shifting that arises due to disparities in tax rates (Pillar 2)
- The second proposal includes a tax on base-eroding payments that would deny a deduction for a payment to related party if that payment was not subject to a (unspecified) minimum tax rate (which would take into account any withholding tax on the payment)

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