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

Cc:

Lafayette "Chip" G. Harter III
Deputy Assistant Secretary (International Tax Affairs)
Department of the Treasury

Douglas L. Poms
International Tax Counsel
Department of the Treasury

Brian Jenn
Deputy International Tax Counsel
Department of the Treasury

Brett York
Associate International Tax Counsel
Department of the Treasury

Brenda Zent
Special Advisor to the International Tax Counsel
Department of the Treasury

Margaret O'Connor
Acting Associate Chief Counsel (International)
Internal Revenue Service

Daniel M. McCall
Deputy Associate Chief Counsel (International)
Internal Revenue Service

John J. Merrick
Senior Level Counsel, Office of Associate Chief Counsel (International)
Internal Revenue Service

Raymond J. Stahl
Special Counsel, Office of Associate Chief Counsel (International)
Internal Revenue Service

Kristine A. Crabtree
Senior Technical Reviewer, Office of Associate Chief Counsel (International)
Internal Revenue Service

Shane McCarrick
Assistant to the Branch Chief (Branch 4)
Internal Revenue Service

Report No. 1411

NEW YORK STATE BAR ASSOCIATION TAX SECTION

REPORT ON PROPOSED REGULATIONS UNDER SECTIONS 267A, 245A(e), AND 1503(d)

February 26, 2019

TABLE OF CONTENTS

Page

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.