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Anti-Hybrid Rules: The IRS Issues Final & Proposed Regulations

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The Tax Cuts and Jobs Actⁱ introduced two “anti-hybrid” rules that generally deny U.S. tax deductions in certain situations involving entities and payments of interest, royalties, or dividends, if such entities or payments are treated differently under U.S. and foreign tax laws and such different treatment results in double non-taxation. These two rules are found in Sections 245A(e) and 267A.ⁱⁱ

Generally, Section 245A provides a participation exemption for certain domestic corporations that are shareholders of a foreign corporation. Specifically, Section 245A(a) provides a 100-percent dividends received deduction to domestic corporate shareholders for foreign-source dividends received from a 10-percent owned foreign corporation. However, in order to prevent double non-taxation, Section 245A(e) denies the dividends received deduction to the extent that the domestic corporate shareholder receives a “hybrid dividend” from the 10-percent owned foreign corporation. A “hybrid dividend” is a payment that is a dividend for U.S. tax purposes but gives rise to a deduction to the payer in its local country. Section 245A(e) also applies to cause a controlled foreign corporation (CFC) to recognize subpart F income if it receives a hybrid dividend from a lower-tier foreign corporation.

Section 267A generally disallows a deduction in cases of outbound deductible interest or royalty payments paid to a related party where the related party recipient does not pay tax in its local country on the payment as a result of a hybrid or branch arrangement. Such cases are generally referred to as a deduction/no inclusion, or “D/NI”. A hybrid or branch arrangement exists where the interest or royalty payment is paid pursuant to a hybrid transaction (e.g., a repurchase agreement) or is paid to a hybrid entity (e.g., an entity that is fiscally transparent for U.S. tax purposes but not for foreign tax purposes, or vice versa). The rules of Sections 245A and 267A generally are intended to be consistent with the recommendations in the two final reports under Action 2 of the OECD Base Erosion and Profit Shifting project.

On December 20, 2018, the IRS issued proposed regulations providing guidance under Section 245A(e) and Section 267A (2018 Proposed Regulations).ⁱⁱⁱ The 2018 Proposed Regulations also addressed certain related rules, such as the dual consolidated loss rules and the “check-the-box” rules. On April 7, 2020, the IRS released final regulations under these rules ([Final Regulations](#)),^{iv} as well as additional proposed regulations ([2020 Proposed Regulations](#)).^v The Final Regulations generally follow the 2018 Proposed Regulations, with some notable changes and clarifications summarized below.

With respect to Section 245(e), the Final Regulations:

- Clarify that whether a deduction or other tax benefit is disallowed or suspended due to foreign “thin capitalization” rules has no impact on the determination of whether such deduction or tax benefit was “allowed” for purposes of the Section 245A(e) analysis.
- Clarify that the determination of whether a foreign tax law allows a deduction or other tax benefit for an amount generally is made without regard to the application of foreign hybrid mismatch rules.
- Revise the definition of “relevant foreign tax law” to include subnational law to the extent addressed in an applicable U.S. tax treaty, and provide that only deductions allowed under a “relevant foreign tax law” to a person related to a CFC may be hybrid deductions (a hybrid deduction is a deduction allowed to a CFC in a foreign jurisdiction for a payment that is characterized as a dividend for U.S. federal tax purposes) of the CFC.
- Clarify that hybrid deductions of a CFC do not include an impairment loss deduction or a mark-to-market deduction allowed to a shareholder with respect to its stock of the CFC.
- Provide rules for allocating a CFC’s hybrid deduction account in connection with a distribution under Section 355 and clarify the effect of a Section 338(g) election on a CFC’s hybrid deduction account.
- Adopt a general anti-duplication rule for hybrid deductions arising in multiple tiers of CFCs.
- Provide that multiple tiers of CFCs are subject to both a general anti-duplication rule for hybrid deductions and specified owner rules for purposes of Sections 951 and 951A, and that the tiered hybrid rule applies only to U.S. corporations who are shareholders of both the upper and lower-tier CFCs.
- Provide that the general anti-avoidance rule does not disregard a restructuring of a hybrid arrangement into a non-hybrid arrangement.

With respect to Section 267A, the Final Regulations:

- Add a reasonable expectation standard to the long-term deferral rules, and clarify that such rules do not apply to specified payments that will never be recognized under the specified recipient’s tax law (because, for example, such tax law does not impose an income tax) to cause the payment to be deemed made pursuant to a hybrid transaction.
- Reduce a specified recipient’s no-inclusion with respect to a specified payment by certain amounts that are repayments of principal for U.S. tax purposes but included in income by the specified recipient.
- Treat a specified payment included in income in a prior taxable as included in income.
- Clarify the treatment of imputed interest arising from interest-free loans under the hybrid transaction rule.

- Provide that a dual inclusion income does not include items of income of a specified party not included in income by reason of a participation exemption or a similar relief, provided that such relief relieves double-taxation rather than creating double non-taxation, even if it is not included in the income of the tax resident or taxable branch to which the disregarded payment is made.
- Create a special rule providing that a specified payment is not a disregarded payment to the extent the payment is otherwise taken into account under the home office's tax law in a manner such that there is no mismatch is added to the disregarded payment rules to create symmetry with the deemed branch payment rule.
- Provide that a U.S. taxable branch must use a direct tracing approach to identify the person to whom interest described in Treas. Reg. § 1.882-5(a)(1)(ii)(B) or -5(e) is payable, and foreign corporations should use U.S. booked liabilities to identify the person to whom an interest expense is payable, without regard to which method the foreign corporation uses to determine its interest expense under Section 882(c)(1).
- Clarify the rules regarding reverse hybrids, including whether an entity is considered fiscally transparent under the tax law of the country where it is established, treatment of certain distributions by a reverse hybrid, and changes to the reverse hybrid rule regarding certain specified payments made to the reverse hybrid.
- Clarify the standard for determining whether amounts qualify as included or includible in income in the United States, including with respect to subpart F income, Section 250 deduction with respect to GILTI, and amounts received by a "qualified electing fund" within the meaning of Section 1295.
- Provide that a specified payment is an imported mismatch payment only to the extent that it is neither a disqualified hybrid amount nor includible in income in the United States.
- Introduce an exclusive list of deductions that constitute hybrid deductions with respect to a tax resident or taxable branch the tax law of which contains hybrid mismatch rules, which includes deductions with respect to equity, interest-free loans and similar arrangements, and amounts that are not included in income in a third foreign country.
- Provide that notional interest deductions are hybrid deductions only to the extent they are produced after December 20, 2018, and the double non-taxation from such production occurs as a result of hybridity.
- Apply the dual inclusion income standard in the imported mismatch context, in cases in which the tax law of the taxable branch permits a loss of the taxable branch to be shared with a tax resident or another taxable branch.
- Clarify that a CFC can incur hybrid deductions and make funded taxable payments.
- Provide that a hybrid deduction or funded taxable payment of a CFC does not include an amount that is a disqualified hybrid amount or includible in income in the United States.
- Provide that for an imported mismatch payment to indirectly fund a hybrid deduction and thus be offset by the deduction, the payee and certain intermediaries must be related to the payer.
- Add new ordering rules and other modifications with respect to the imported mismatch rules.
- Revise the definition of "interest" in certain respects, including by adding a new anti-avoidance rule, and revise the definition of "structured arrangements" to include an objective test.
- Relax the *de minimis* exception such that the \$50,000 threshold applies to the total amount of interest or royalty deductions involving hybrid or branch arrangements.

- Provide a CFC is a “specified party” only if it has an inclusion U.S. shareholder.
- Clarify that Section 267A applies to a specified payment before the application of Section 163(j).
- Modify the general anti-avoidance rule such that it focuses on the terms or structure of an arrangement and requires that the D/NI outcome produced is a result of a hybrid or branch arrangement, and adds a new special anti-avoidance rule pursuant to which, in certain circumstances, a CFC’s earnings and profits are not reduced by a specified payment for which a deduction is disallowed.
- Revise the definition of a country’s “tax law” to include subnational law to the extent addressed in an applicable U.S. tax treaty.
- Provide for additional rules addressing, integration and imputation systems, hybrid sale/license transactions, recovery of basis or principal, the setoff rules, capitalization and recovery provisions.

Importantly for many taxpayers, the Final Regulations delay the application of several provisions, such as with respect to notional interest deductions allowed to CFCs, interest-free loans and similar arrangements, hybrid deduction accounts, or restructurings intended to eliminate or minimize hybridity for structured arrangements. The IRS continues to study disregarded payment structures and noted that it may issue guidance addressing these structures in the future. In addition, the IRS continues to study the comments received regarding the dual consolidated loss regulations.

The 2020 Proposed Regulations address situations where the earnings and profits included in a CFC’s hybrid deduction account are included in income of the CFC’s U.S. shareholder through other means and are not offset by a deduction or credit. Generally, the 2020 Proposed Regulations provide rules for reducing a CFC’s hybrid deduction accounts for subpart F inclusions, including under Section 956, and GILTI inclusions. The 2020 Proposed Regulations also revise the anti-conduit rules to address situations where the use of certain equity interests would allow the issuer a deduction or other tax benefit under foreign tax law, and the GILTI regulations to address mismatches created by payments that generate income during the “disqualified period” and a loss or deduction in a period after the “disqualified period.”

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ENDNOTES

ⁱ Pub. L. No. 115-97, 115 Stat. 2054 (2017).

ⁱⁱ All “Section” references are to the Internal Revenue Code of 1986, as amended, and all “Treas. Reg. §” references are to the regulations promulgated thereunder.

ⁱⁱⁱ REG-104352-18, 83 FR 67612.

^{iv} T.D. 9896.

^v REG-106013-19.

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