

# INTERNAL REVENUE BULLETIN



## HIGHLIGHTS OF THIS ISSUE

These synopses are intended only as aids to the reader in identifying the subject matter covered. They may not be relied upon as authoritative interpretations.

**Bulletin No. 2020-18**  
**April 27, 2020**

## ADMINISTRATIVE

### **Notice 2020-23, page 742.**

This notice amplifies Notice 2020-18 and Notice 2020-20, and provides additional tax relief under section 7508A of the Code for taxpayers affected by the Coronavirus Disease (COVID-19) emergency. Specified Federal tax filings and payments due on or after April 1, 2020, and before July 15, 2020, are postponed to July 15, 2020. Specified time-sensitive actions due to be performed on or after April 1, 2020, and before July 15, 2020, are also postponed to July 15, 2020. This notice also postpones due dates with respect to certain government acts and postpones the application date to participate in the Annual Filing Season Program.

### **Rev. Proc. 2020-23, page 749.**

On March 27, 2020, Congress passed the Coronavirus Aid, Relief, and Economic Security Act (CARES Act), providing broad tax relief for taxable years beginning in 2018 and 2019. By that time, many partnerships had already filed their returns for taxable years 2018 and 2019. The new centralized partnership audit regime under the Bipartisan Budget Act of 2015 (BBA) put in place restrictions under section 6031(b) on amending partnership return information. Accordingly, BBA partnerships are generally prohibited from amending the information on Schedules K-1 and must file an administrative adjustment request (AAR) under section 6227. Partners generally would not receive benefits from AARs until 2021. This revenue procedure allows BBA partnerships to file amended returns, issue amended Schedules K-1, and for partners to receive benefits from the CARES Act this year.

### **Rev. Proc. 2020-24, page 750.**

Rev. Proc. 2020-24 provides guidance under sections 172(b)(1) and 172(b)(3), as amended by the Coronavirus Aid, Relief, and Economic Security Act of 2020 (CARES Act). Section 2303 of the CARES Act amended section

172 to require taxpayers with net operating losses (NOLs) arising in taxable years beginning in 2018, 2019, and 2020 to carry those NOLs back for the 5 preceding taxable years, unless the taxpayer elects to waive or reduce the carryback period. The revenue procedure describes how taxpayers with NOLs arising in taxable years 2018, 2019, or 2020 can elect to either waive the carryback period for those losses entirely or to exclude from the carryback period for those losses any years in which the taxpayer has an inclusion in income as a result of section 965(a).

## ADMINISTRATIVE, INCOME TAX

### **Notice 2020-26, page 744.**

This notice provides relief for certain taxpayers to allow them to take advantage of amendments made to the net operating loss (NOL) provisions set forth in § 172 of the Internal Revenue Code (Code) by section 2303 of the Coronavirus Aid, Relief, and Economic Security Act (CARES Act), Public Law 116-136, 134 Stat. 281 (March 27, 2020). Specifically, this notice extends the deadline for filing an application for a tentative carryback adjustment under § 6411 of the Code with respect to the carryback of an NOL that arose in any taxable year that began during calendar year 2018 and that ended on or before June 30, 2019.

## INCOME TAX

### **T.D. 9896, page 681.**

Final regulations implementing sections 245A(e) and 267A of the Internal Revenue Code regarding hybrid dividends and certain amounts paid or accrued in hybrid transactions or with hybrid entities. This document also contains final regulations under: (1) sections 1503(d) and 7701 to prevent the same deduction from being claimed under the tax laws of both the United States and a foreign country, and (2) sections 6038, 6038A, and 6038C to facilitate administration of these rules.

Finding Lists begin on page ii.

**Rev. Proc. 2020-22, page 745.**

This revenue procedure provides guidance under section 163(j) relating to elections to be an electing real property or farming trade or business. This revenue procedure also provides the time and manner for making three elections under section 2306 of the CARES Act relating to the section 163(j) limitation.

**Rev. Proc. 2020-26, page 753.**

This revenue procedure provides guidance relating to the tax qualification of certain securitization vehicles that hold mortgage loans for which borrowers have participated in forbearance programs arising from the COVID-19 emergency. This revenue procedure also provides guidance for certain real estate mortgage investment conduits (REMICs) that acquire mortgage loans for which borrowers have partici-

pated in forbearance programs arising from the COVID-19 emergency.

**REG-106013-19, page 757.**

Proposed regulations which provide rules for adjusting hybrid deduction accounts under I.R.C. §245A(e) to take into account earnings and profits of a controlled foreign corporation that are included in income under U.S. tax law by reason of provisions other than section 245A(e). This document also contains proposed regulations that address, for purposes of the conduit financing rules under I.R.C. §§881 and 7701(l), multiple-party financing arrangements effected through the use of hybrid arrangements. In addition, this document contains proposed regulations under I.R.C. §951A relating to the treatment of certain payments made during a disqualified period.

# The IRS Mission

Provide America's taxpayers top-quality service by helping them understand and meet their tax responsibilities and enforce the law with integrity and fairness to all.

## Introduction

The Internal Revenue Bulletin is the authoritative instrument of the Commissioner of Internal Revenue for announcing official rulings and procedures of the Internal Revenue Service and for publishing Treasury Decisions, Executive Orders, Tax Conventions, legislation, court decisions, and other items of general interest. It is published weekly.

It is the policy of the Service to publish in the Bulletin all substantive rulings necessary to promote a uniform application of the tax laws, including all rulings that supersede, revoke, modify, or amend any of those previously published in the Bulletin. All published rulings apply retroactively unless otherwise indicated. Procedures relating solely to matters of internal management are not published; however, statements of internal practices and procedures that affect the rights and duties of taxpayers are published.

Revenue rulings represent the conclusions of the Service on the application of the law to the pivotal facts stated in the revenue ruling. In those based on positions taken in rulings to taxpayers or technical advice to Service field offices, identifying details and information of a confidential nature are deleted to prevent unwarranted invasions of privacy and to comply with statutory requirements.

Rulings and procedures reported in the Bulletin do not have the force and effect of Treasury Department Regulations, but they may be used as precedents. Unpublished rulings will not be relied on, used, or cited as precedents by Service personnel in the disposition of other cases. In applying published rulings and procedures, the effect of subsequent legislation, regulations, court decisions, rulings, and procedures must be considered, and Service personnel and others concerned are cautioned

against reaching the same conclusions in other cases unless the facts and circumstances are substantially the same.

The Bulletin is divided into four parts as follows:

### **Part I.—1986 Code.**

This part includes rulings and decisions based on provisions of the Internal Revenue Code of 1986.

### **Part II.—Treaties and Tax Legislation.**

This part is divided into two subparts as follows: Subpart A, Tax Conventions and Other Related Items, and Subpart B, Legislation and Related Committee Reports.

### **Part III.—Administrative, Procedural, and Miscellaneous.**

To the extent practicable, pertinent cross references to these subjects are contained in the other Parts and Subparts. Also included in this part are Bank Secrecy Act Administrative Rulings. Bank Secrecy Act Administrative Rulings are issued by the Department of the Treasury's Office of the Assistant Secretary (Enforcement).

### **Part IV.—Items of General Interest.**

This part includes notices of proposed rulemakings, disbarment and suspension lists, and announcements.

The last Bulletin for each month includes a cumulative index for the matters published during the preceding months. These monthly indexes are cumulated on a semiannual basis, and are published in the last Bulletin of each semiannual period.

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# Part I

26 CFR 1.245A(e)-1, 1.267A-1 through 1.267A-7, 1.1503(d)-1, 1.1503(d)-3, 1.1503(d)-7, 1.1503(d)-8, 1.6038-2, 1.6038-3, 1.6038A-2, 301.7701-3.

## T.D. 9896

### DEPARTMENT OF THE TREASURY Internal Revenue Service 26 CFR Parts 1 and 301

#### Rules Regarding Certain Hybrid Arrangements

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

**SUMMARY:** This document contains final regulations providing guidance regarding hybrid dividends and certain amounts paid or accrued pursuant to hybrid arrangements, which generally involve arrangements whereby U.S. and foreign tax law classify a transaction or entity differently for tax purposes. This document also contains final regulations relating to dual consolidated losses and entity classifications to prevent the same deduction from being claimed under the tax laws of both the United States and a foreign jurisdiction. Finally, this document contains final regulations regarding information reporting to facilitate the administration of certain rules in the final regulations. The final regulations affect taxpayers that would otherwise claim a deduction related to such amounts and certain shareholders of foreign corporations that pay or receive hybrid dividends.

**DATES:** *Effective date:* These regulations are effective on April 8, 2020.

*Applicability dates:* For dates of applicability, see §§1.245A(e)-1(h), 1.267A-7, 1.1503(d)-8(b), 1.6038-2(m), 1.6038-3(l), 1.6038A-2(g), and 301.7701-3(c).

**FOR FURTHER INFORMATION CONTACT:** Tracy Vilecco at (202) 317-6933 or Tianlin (Laura) Shi at (202) 317-6936 (not toll-free numbers).

#### SUPPLEMENTARY INFORMATION:

##### Background

Sections 245A(e) and 267A were added to the Internal Revenue Code (“Code”) by the Tax Cuts and Jobs Act, Pub. L. No. 115-97 (2017) (the “Act”), which was enacted on December 22, 2017. On December 28, 2018, the Department of the Treasury (“Treasury Department”) and the IRS published proposed regulations (REG-104352-18) under sections 245A(e), 267A, 1503(d), 6038, 6038A, 6038C, and 7701 in the **Federal Register** (83 FR 67612) (the “proposed regulations”). Terms used but not defined in this preamble have the meaning provided in the final regulations.

A public hearing on the proposed regulations was scheduled for March 20, 2019, but it was not held because no speaker outlines were submitted to the IRS by the due date for submission, March 15, 2019. The Treasury Department and the IRS received written comments with respect to the proposed regulations. Comments received outside the scope of this rulemaking are generally not addressed but may be considered in connection with future regulations. All written comments received in response to the proposed regulations are available at [www.regulations.gov](http://www.regulations.gov) or upon request.

##### Summary of Comments and Explanation of Revisions

###### I. Overview

The final regulations retain the basic approach and structure of the proposed regulations, with certain revisions. This Summary of Comments and Explanation of Revisions section discusses the revisions as well as comments received in response to the solicitation of comments in the proposed regulations.

###### II. Comments and Revisions to Proposed §1.245A(e)-1 – Special Rules for Hybrid Dividends

###### A. Background

Section 245A(e) and the proposed regulations neutralize the double non-taxa-

tion effects of a hybrid dividend or tiered hybrid dividend through either denying the section 245A(a) dividends received deduction with respect to the dividend or requiring an inclusion under section 951(a)(1)(A) (“subpart F inclusion”) with respect to the dividend, depending on whether the shareholder receiving the dividend is a domestic corporation or a controlled foreign corporation (“CFC”). The proposed regulations require that certain shareholders of a CFC maintain a hybrid deduction account with respect to each share of stock of the CFC that the shareholder owns, and provide that a dividend received by the shareholder from the CFC is a hybrid dividend or tiered hybrid dividend to the extent of the sum of those accounts.

A hybrid deduction account with respect to a share of stock of a CFC reflects the amount of hybrid deductions of the CFC that have been allocated to the share. In general, a hybrid deduction is a deduction or other tax benefit allowed to a CFC (or a related person) under a relevant foreign tax law for an amount paid, accrued, or distributed with respect to an instrument of the CFC that is stock for U.S. tax purposes.

###### B. Hybrid deductions

###### 1. Current Use of Deduction or Other Tax Benefit

One comment requested that for a deduction or other tax benefit allowed under a relevant foreign tax law to be a hybrid deduction, it must be used currently under the relevant foreign tax law and, thus, currently reduce foreign tax liability. The comment noted that a current use might not occur if, for example, the CFC has other deductions or losses under the relevant foreign tax law, or all of a CFC’s income is exempt income (for example, if the CFC is a holding company and all of its income benefits from a 100 percent participation exemption). The comment asserted that absent a current use of a deduction, double non-taxation does not occur.

The Treasury Department and the IRS have determined that it would not be appropriate for a deduction or other tax benefit to be a hybrid deduction only to the

extent it is used currently. Even though a deduction or other tax benefit may not be used currently, it could be used in another taxable period – for example, as a result of a net operating loss carrying over to a subsequent taxable year – and thus could produce double non-taxation. In addition, it could be complex or burdensome to determine whether a deduction or other tax benefit is used currently (because it could, for example, require a factual analysis of how particular deductions offset items of gross income under the relevant foreign tax law) and then, to the extent not used currently, track the deduction or other tax benefit so that it is added to a hybrid deduction account only once it is in fact used. Accordingly, the final regulations do not adopt the comment, and the regulations clarify that a deduction or other tax benefit may be a hybrid deduction regardless of whether it is used currently under the relevant foreign tax law. *See* §1.245A(e)-1(d)(2).

## 2. Coordination with Foreign Disallowance Rules

### i. Thin capitalization and other rules

A comment requested that a deduction or other tax benefit not be a hybrid deduction if under the relevant foreign tax law the deduction or other tax benefit is disallowed under a thin capitalization rule or a rule similar to section 163(j). Similar to the comment discussed in part II.B.1 of this Summary of Comments and Explanation of Revisions section, the comment asserted that such a disallowed deduction or other tax benefit does not produce double non-taxation.

The final regulations do not adopt the comment for reasons similar to those discussed in part II.B.1 of this Summary of Comments and Explanation of Revisions section. For example, a thin capitalization rule or a rule similar to section 163(j) may suspend rather than disallow a deduction, and thus may not prevent eventual double non-taxation. Moreover, because a thin capitalization rule or a rule similar to section 163(j) generally applies to all otherwise allowable deductions, it would be unduly complex and burdensome to determine the extent to which an amount disallowed under such a rule relates to a

particular otherwise allowable deduction. Accordingly, the final regulations do not adopt the comment, and the regulations clarify that the determination of whether a deduction or other tax benefit is allowed is made without regard to a rule that disallows or suspends deductions if a certain ratio or percentage is exceeded. *See* §1.245A(e)-1(d)(2)(ii)(A).

### ii. Foreign hybrid mismatch rules

The proposed regulations do not provide rules to take into account the application of foreign hybrid mismatch rules – that is, hybrid mismatch rules under the relevant foreign tax law. Accordingly, if such hybrid mismatch rules deny a deduction to neutralize a deduction/no-inclusion (“D/NI”) outcome, then, because the deduction is not allowed under the relevant foreign tax law, the deduction cannot be a hybrid deduction under the proposed regulations.

The Treasury Department and the IRS have concluded that, in certain cases, whether a deduction or other tax benefit is a hybrid deduction should be determined without regard to foreign hybrid mismatch rules (and thus without regard to whether such rules disallow the deduction). The determination should be made in this manner in cases in which there is a close temporal connection between the amount giving rise to the deduction or other tax benefit and the payment of the amount as a dividend for U.S. tax purposes. In these cases, in order to prevent a D/NI outcome, the participation exemption under section 245A(a) should not apply to the dividend, as opposed to the participation exemption applying to the dividend to the extent that the foreign hybrid mismatch rules disallow a deduction for the amount in order to neutralize a D/NI outcome.

This approach more closely aligns the rules of section 245A(e) with the approach set forth in the OECD/G20 report, *Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2: 2015 Final Report* (the “Hybrid Mismatch Report”). Such an approach avoids potential circularity or other issues in cases in which the application of foreign hybrid mismatch rules depends on whether an amount will be included in income under U.S. tax law. *See* Hybrid Mismatch Report, para. 35

and Ex. 2.3. In addition, this approach is consistent with an approach suggested in a comment (which was received before the proposed regulations were issued but after the proposed regulations had been substantially developed) with respect to section 245A generally.

Accordingly, the final regulations provide that the determination of whether a relevant foreign tax law allows a deduction or other tax benefit for an amount is made without regard to the application of foreign hybrid mismatch rules, provided that the amount gives rise to a dividend for U.S. tax purposes or is reasonably expected for U.S. tax purposes to give rise to a dividend that will be paid within 12 months after the taxable period in which the deduction or other tax benefit would otherwise be allowed. *See* §1.245A(e)-1(d)(2)(ii)(B).

As an example, assume that but for foreign hybrid mismatch rules, a CFC would be allowed a deduction under the relevant foreign tax law for an amount paid or accrued pursuant to an instrument issued by the CFC and treated as stock for U.S. tax purposes. If the amount is an actual payment that gives rise to a dividend for U.S. tax purposes (or the amount is an accrual but is reasonably expected to give rise to a dividend for U.S. tax purposes that will be paid within 12 months after the taxable period for which the deduction would otherwise be allowed), then the amount generally gives rise to a hybrid deduction regardless of whether the foreign hybrid mismatch rules may disallow a deduction for the amount. If, on the other hand, the amount would give rise to a dividend in a later period, then the amount would not give rise to a hybrid deduction to the extent that the foreign hybrid mismatch rules disallow a deduction for the amount.

## 3. Effect of Withholding Taxes

Under the proposed regulations, the determination of whether a deduction or other tax benefit is a hybrid deduction is generally made without regard to whether the amount is subject to withholding tax under the relevant foreign tax law. *But see* proposed §1.245A(e)-1(g)(2), *Example 2* (illustrating that withholding taxes imposed pursuant to an integration or imputation system may prevent a de-

duction or other tax benefit from being a hybrid deduction). A comment asserted that, to prevent double-taxation, a deduction or other tax benefit under a relevant foreign tax law should not be a hybrid deduction to the extent the amount giving rise to the deduction or other tax benefit is subject to withholding tax under such tax law.

The purpose of withholding taxes generally is not to address mismatches in tax outcomes, but rather to allow the source jurisdiction to retain its right to tax the payment. For example, in many cases withholding taxes are imposed on payments not giving rise to D/NI concerns, such as nondeductible dividends. In addition, had Congress generally intended for withholding taxes to be taken into account for purposes of section 245A(e), it could have included in section 245A(e) a rule similar to the one in section 59A(c)(2)(B), which was enacted at the same time as section 245A(e). Thus, the Treasury Department and the IRS have concluded that withholding taxes generally should not be viewed as neutralizing a D/NI outcome. In addition, generally taking withholding taxes into account for purposes of determining whether a deductible amount gives rise to a hybrid deduction could raise administrability issues if the amount is subject to withholding taxes at the time of payment (with the result that the amount is not added to a hybrid deduction account at that time) but the taxes are refunded in a later period; in these cases it could be difficult or burdensome to retroactively add the amount to the hybrid deduction account and make corresponding adjustments. Accordingly, the final regulations do not adopt this comment. *See also* part II.B.5 of this Summary of Comments and Explanation of Revisions section (deductions or other tax benefits pursuant to imputation systems or other regimes intended to relieve double-taxation).

#### 4. Deductions with Respect to Equity

The proposed regulations provide that a hybrid deduction includes a deduction with respect to equity, such as a notional interest deduction (“NID”). *See* proposed §1.245A(e)-1(d)(2)(i)(B). The preamble to the proposed regulations explains that

NIDs are hybrid deductions because they raise concerns similar to those raised by traditional hybrid instruments.

Several comments asserted that NIDs should not be hybrid deductions because NIDs do not involve sufficient hybridity so as to be within the intended scope of section 245A(e). These comments noted that NIDs are generally available tax concessions that reflect tax policy decisions, and that NIDs are typically allowed without regard to dividend distributions, if any. Another comment asserted that because NIDs are the equivalent of a lower tax rate on profits, any policy concerns with NIDs are appropriately addressed by the global intangible low-taxed income regime (“GILTI”) under section 951A. Other comments raised concerns that treating NIDs as hybrid deductions departs from the Hybrid Mismatch Report (and thus the approaches taken by other countries to implement the Report) and, as a result, could impair the competitiveness of U.S. multinational groups.

As an alternative to not treating NIDs as hybrid deductions, some comments suggested other approaches. For example, a comment suggested that the final regulations reserve on whether NIDs are hybrid deductions so that, to the extent NIDs are viewed as providing inappropriate results, NIDs can be addressed on a multilateral basis. Other comments suggested that only NIDs resulting from an actual payment, accrual, or distribution should constitute hybrid deductions. Lastly, comments suggested that the final regulations treat NIDs as hybrid deductions on a delayed basis, or only if the NIDs are allowed with respect to an instrument issued after a certain date, to allow taxpayers to restructure certain instruments or undertake other restructurings.

The Treasury Department and the IRS have concluded that NIDs should be hybrid deductions, without regard to whether NIDs result from an actual payment, accrual, or distribution. First, because NIDs offset income but generally do not give rise to a corresponding income inclusion, NIDs produce double non-taxation, and such double non-taxation can occur regardless of whether NIDs result from an actual payment, accrual, or distribution. Second, the double non-taxation resulting from NIDs is in general a result of a mis-

match in how different tax laws view an instrument of a CFC; that is, the relevant foreign tax law views the instrument as generating amounts similar to interest – to minimize the disparate treatment of debt and equity – and, were the tax law of the United States (the investor jurisdiction of the CFC) to similarly view the instrument as generating amounts treated as interest, there would generally be a corresponding income inclusion in the United States. Such double non-taxation resulting from the mismatch in the treatment of an instrument is the fundamental policy concern underlying section 245A(e). Moreover, including NIDs in the definition of a hybrid deduction is consistent with the broad language of section 245A(e)(4)(B), which refers to any “deduction (or other tax benefit).”

Thus, the final regulations generally retain the approach of the proposed regulations and treat NIDs as hybrid deductions. However, in response to comments, the final regulations provide that only NIDs allowed to a CFC for taxable years beginning on or after December 20, 2018, are hybrid deductions. *See* §1.245A(e)-1(d)(2)(iv). The Treasury Department and the IRS have determined that this delay (relative to the proposed regulations) is appropriate in order to account for restructurings intended to eliminate or minimize hybridity.

#### 5. Deductions Pursuant to Imputation Systems or Other Regimes Intended to Relieve Double-Taxation

In the case of a deduction or other tax benefit relating to or resulting from a distribution by a CFC with respect to an instrument treated as stock for purposes of a relevant foreign tax law, a special rule under the proposed regulations provides that the deduction or other tax benefit is a hybrid deduction only to the extent that it has the effect of causing the earnings that funded the distribution to not be included in income or otherwise subject to tax under such tax law. *See* proposed §1.245A(e)-1(d)(2)(i)(B). As noted in the preamble to the proposed regulations, this special rule ensures that deductions or other tax benefits allowed pursuant to certain integration or imputation systems, including through systems implemented in part through the

imposition of withholding taxes, do not constitute hybrid deductions.

The final regulations clarify the operation of this special rule. First, the final regulations clarify that the special rule only applies to deductions or other tax benefits relating to or resulting from a distribution by the CFC that is a dividend for purposes of the relevant foreign tax law. *See* §1.245A(e)-1(d)(2)(i)(B). Thus, for example, the special rule does not apply to NIDs as to which withholding tax is imposed under the relevant foreign tax law, because the imposition of withholding tax in these cases is not pursuant to an integration or imputation system (as such systems generally only apply to dividends) and, instead, may be imposed to provide parity between NIDs and an actual interest payment. Second, the final regulations clarify that the imposition of withholding tax pursuant to an integration or imputation system can reduce or eliminate the extent to which dividends paid deductions (as well as other similar tax benefits) give rise to a hybrid deduction. *See id.*; *see also* §1.245A(e)-1(g)(2), *Example 2, alt. facts* (imposition of withholding tax at a rate less than the tax rate at which dividends paid deduction is allowed only prevents a portion of the deduction from being a hybrid deduction). Lastly, the final regulations clarify that, as a result of the special rule, dividends received deductions allowed pursuant to regimes intended to relieve double-taxation within a group do not constitute hybrid deductions. *See* §1.245A(e)-1(d)(2)(i)(B).

#### 6. Deductions or Other Tax Benefits Allowed to a Person Related to the CFC

Under the proposed regulations, a hybrid deduction of a CFC includes certain deductions or other tax benefits allowed under a relevant foreign tax law to a person related to the CFC (such as a shareholder of the CFC). *See* proposed §1.245A(e)-1(d)(2). The proposed regulations provide that relatedness is determined by reference to the rules of section 954(d)(3) (defining

a related person based on ownership of more than 50 percent of interests in entities). *See* proposed §1.245A(e)-1(f)(4).

A comment asserted that, although in certain cases it may be appropriate to treat a deduction or other tax benefit allowed to a related person as a hybrid deduction, the related person rule raises issues, including compliance issues, because it could be burdensome to determine whether any person related to a CFC receives certain deductions or other tax benefits. Accordingly, the comment recommended that the rule be narrowed in certain respects. For example, the comment suggested increasing the threshold for relatedness to 80 percent, including because such a threshold would be consistent with certain other areas of the Code such as the provisions involving consolidated groups. In addition, the comment suggested that a deduction or other tax benefit allowed to a related person be a hybrid deduction only if criteria in addition to those in the proposed regulations are satisfied, such as if (i) treating the deduction or other tax benefit as a hybrid deduction does not result in double-counting, and (ii) the IRS affirmatively demonstrates that, absent treating the deduction or other tax benefit as a hybrid deduction, double non-taxation would occur. Lastly, the comment asserted that the related person rule could inappropriately treat as a hybrid deduction a dividends received deduction, an impairment loss deduction, or a market-to-market deduction allowed to a shareholder.

The Treasury Department and the IRS have determined that, because a deduction or other tax benefit allowed to a person related to a CFC may be economically equivalent to the CFC having been allowed a deduction or other tax benefit, or may otherwise produce a D/NI outcome, the related person rule is necessary to carry out the purpose of section 245A(e). The final regulations therefore retain this rule, including defining relatedness by reference to section 954(d)(3), a well-established standard applicable to controlled foreign corporations and consistent with section 267A, which similarly addresses

hybrid mismatches. *See* section 267A(b)(2) (defining related person by reference to section 954(d)(3)). However, recently-issued final regulations under section 954(d)(3) narrow the definition of relatedness for section 954(d)(3) purposes by providing that relatedness is determined without regard to “downward” attribution. *See* TD 9883, 84 FR 63802. The Treasury Department and the IRS have determined that narrowing the definition of relatedness in this manner addresses the comment’s concerns about potential burdens.

In addition, the final regulations clarify that only deductions allowed under a relevant foreign tax law to a person related to a CFC may be hybrid deductions of the CFC; in general, a relevant foreign tax law is a foreign tax law under which the CFC is subject to tax. *See* §1.245A(e)-1(d)(2)(i) and (f)(5). Thus, for example, in the case of a CFC and a corporate shareholder of the CFC that are tax residents of different foreign countries, a dividends received deduction allowed to the corporate shareholder under its tax law for a dividend received from the CFC is not a hybrid deduction of the CFC.<sup>1</sup>

The final regulations do not adopt the comment’s suggestion to include additional criteria to the related person rule. The Treasury Department and the IRS have concluded that other aspects of the final regulations generally address the comment’s double-counting concerns. *See* part II.B.5 (deductions or other tax benefits pursuant to imputation systems or other regimes intended to relieve double-taxation) and part II.C.3 (discussing an anti-duplication rule) of this Summary of Comments and Explanation of Revisions section. In addition, the Treasury Department and the IRS have concluded that requiring the IRS to affirmatively demonstrate double non-taxation would impose an excessive burden on the IRS and raise significant administrability concerns, particularly because the taxpayer may have better access to information (including information regarding the application of foreign tax law) than the IRS.

<sup>1</sup>As an additional example, in the case of a CFC and a corporate shareholder of the CFC that are tax residents of different foreign countries, an exclusion (similar to the exclusion for previously taxed earnings and profits under section 959) allowed to the corporate shareholder under its tax law upon a distribution by the CFC of earnings and profits previously taxed under such tax law by reason of an anti-deferral regime is not a hybrid deduction of the CFC.

Lastly, the final regulations clarify that a hybrid deduction of a CFC does not include an impairment loss deduction or a mark-to-market deduction allowed to a shareholder of the CFC with respect to its stock of the CFC. This is because such deductions do not relate to or result from an amount paid, accrued, or distributed with respect to an instrument issued by the CFC, and are not deductions allowed to the CFC with respect to equity. *See* §1.245A(e)-1(d)(2)(i)(B).

## 7. Relevant Foreign Tax Law

The proposed regulations define a relevant foreign tax law as, with respect to a CFC, any regime of any foreign country or possession of the United States that imposes an income, war profits, or excess profits tax with respect to income of the CFC, other than a foreign anti-deferral regime under which an owner of the CFC is liable to tax. *See* proposed §1.245A(e)-1(f). In some countries, however, income taxes imposed by a subnational authority of the country (for example, a state, province, or canton of the country) may constitute a significant portion of a tax resident's overall income tax burden in the country. Accordingly, the Treasury Department and the IRS have determined that, in cases in which subnational income taxes of a country are covered taxes under an income tax treaty between the country and the United States (and therefore are likely to represent a significant portion of the overall income tax paid in the country), the tax law of the subnational authority should be treated as a tax law of a foreign country for purposes of section 245A(e). Thus, under the final regulations, a relevant foreign tax law may include a tax law of a political subdivision or other local authority of a foreign country. *See* §1.245A(e)-1(f)(5).

### C. Hybrid deduction accounts

#### 1. Nexus Between Hybrid Dividends and Hybrid Deductions

Under the proposed regulations, a dividend received by a United States shareholder ("U.S. shareholder") from a CFC is generally a hybrid dividend to the ex-

tent of the sum of the U.S. shareholder's hybrid deduction accounts with respect to each share of stock of the CFC, even if the dividend is paid on a share that has not had any hybrid deductions allocated to it. *See* proposed §1.245A(e)-1(b)(2). As explained in the preamble to the proposed regulations, this approach is intended to prevent the avoidance of the purposes of section 245A(e).

One comment noted that the hybrid deduction account approach in the proposed regulations appropriately safeguards against certain abuse. However, the comment and others asserted that, at least in certain cases, the approach is overbroad and could lead to inappropriate results, including causing a dividend to be a hybrid dividend even though a hybrid deduction was not allowed for the amount to which the dividend is attributable but instead was allowed for another amount. The comments recommended alternative approaches.

Under some alternatives, an exception or similar rule would provide that a dividend is not a hybrid dividend to the extent that the distributed earnings and profits are attributable to earnings and profits that did not benefit from a hybrid deduction, or to the extent that the transactions giving rise to the dividend did not give rise to a hybrid deduction. For example, in the case of a dividend paid by a lower-tier CFC to an upper-tier CFC pursuant to a non-hybrid instrument, followed by a dividend paid by the upper-tier CFC to a domestic corporation pursuant to a hybrid instrument, the dividend paid by the upper-tier CFC would not be a hybrid dividend to the extent it is composed of earnings and profits (i) attributable to earnings and profits of the lower-tier CFC, and (ii) not offset under the upper-tier CFC's tax law by the upper-tier CFC's hybrid deductions (which might occur, for example, if, by reason of a participation exemption, the upper-tier CFC excludes from income the dividend paid by the lower-tier CFC). Or, deemed dividends such as a dividend under section 1248(a), or a dividend arising as a result of a compensatory payment for the surrender of a loss pursuant to a foreign group relief or similar regime, generally would not be a hybrid dividend, as the transactions giving rise to such deemed

dividends typically do not give rise to a deduction or other tax benefit under a relevant foreign tax law.

Under another alternative, the hybrid deduction account approach in the proposed regulations would not apply to an amount if there is a legal obligation to pay it within 36 months (and the parties reasonably expect it to be so paid). In these cases, the comment recommended that the amount simply be subject to section 245A(e) once paid, such that it would not affect a hybrid deduction account – that is, the account would neither be increased at the time a deduction for the amount is allowed, nor decreased at the time of payment.

The Treasury Department and the IRS have concluded that the hybrid deduction account approach under the proposed regulations appropriately carries out the purposes of section 245A(e), and prevents the avoidance of section 245A(e), in an administrable manner. Alternative approaches, such as those suggested by the comments, could be difficult to administer or could lead to inappropriate results. For example, the approach under the proposed regulations obviates the need (as would be the case under some of the alternatives) for complex analyses or rules tracking which particular earnings and profits benefited from a hybrid deduction, and how those earnings and profits are distributed to particular shareholders. In addition, excepting certain types of dividends from section 245A(e) could defer, potentially long-term, the application of section 245A(e), as those dividends would reduce (or in some cases eliminate) the CFC's earnings and profits and thereby might cause a subsequent distribution pursuant to a hybrid instrument to be described in section 301(c)(2) or (3) (rather than giving rise to a dividend subject to section 245A(e)). Further, if a 36-month approach like the one suggested in the comment were to apply, then additional rules would be necessary to ensure that, upon certain subsequent transfers of stock of the CFC, the transferee appropriately applies section 245A(e) when an amount to which the hybrid deduction account approach did not apply is paid. Accordingly, the final regulations do not adopt these comments.



## 2. Reduction for Certain Amounts Included in Income by U.S. Shareholders

Under the proposed regulations, a hybrid deduction account is reduced only to the extent that an amount in the account gives rise to a hybrid dividend or a tiered hybrid dividend. *See* proposed §1.245A(e)-1(d). The preamble to the proposed regulations requests comments on whether hybrid deductions attributable to a subpart F inclusion or an amount included in income under section 951A (“GILTI inclusion amount”) should not increase a hybrid deduction account, or, alternatively, on whether a hybrid deduction account should be reduced by distributions of previously taxed earnings and profits, and the effect of any deemed paid foreign tax credits associated with such inclusions.

In response to the comment request, some comments suggested that subpart F inclusions or GILTI inclusion amounts (or a distribution of previously taxed earnings and profits) provide a dollar-for-dollar reduction of a hybrid deduction account. However, another comment noted that a dollar-for-dollar reduction could give rise to inappropriate results because the inclusions may not be fully taxed in the United States, given foreign tax credits associated with the amounts or, in the case of a GILTI inclusion amount, the deduction under section 250. The comment thus suggested that, as part of the end-of-year adjustments to a hybrid deduction account, the account be reduced by certain subpart F inclusions or GILTI inclusion amounts with respect to that year, but only to the extent that such amounts are fully taxed in the United States (determined by accounting for foreign tax credits and the section 250 deduction). Another comment suggested that a hybrid deduction not be added to the hybrid deduction account to the extent that the deduction relates to an amount directly included in U.S. income (for example, under section 882). Finally, comments suggested that, to avoid double-taxation, a hybrid deduction account should also be reduced when an amount is included in a U.S. shareholder’s gross income under sections 951(a)(1)(B) and 956 by reason of the application of section 245A(e) to the hypothetical distribution described in §1.956-1(a)(2).

Section 245A(e) is generally intended to ensure that to the extent earnings and profits of a CFC have not been subject to foreign tax as a result of certain hybrid arrangements, earnings and profits of the CFC of an equal amount will, once distributed as a dividend, be “included in income” in the United States (that is, taken into account in income and not offset by, for example, a deduction or credit particular to the inclusion). To the extent the earnings and profits are so included by other means (for example, as a subpart F inclusion or GILTI inclusion amount), with the result that the double non-taxation effects of the hybrid arrangement are neutralized, section 245A(e) need not apply to a corresponding amount of earnings and profits. Accordingly, in these cases, the Treasury Department and the IRS have determined that hybrid deduction accounts with respect to stock of the CFC – which are generally intended to represent earnings and profits of the CFC that have neither been subject to foreign tax nor yet included in income in the United States – should be reduced. A separate notice of proposed rulemaking published in the Proposed Rules section of this issue of the **Federal Register** (REG-106013-19) provides rules to this effect, which taxpayers may rely on before the regulations described therein are effective. These rules are consistent with the comment recommending that a hybrid deduction account be reduced by amounts included in gross income under sections 951(a)(1)(B) and 956, as well as the comment recommending an account be reduced by certain subpart F inclusions or GILTI inclusion amounts, to the extent fully taxed in the United States. The Treasury Department and the IRS have determined that it would be too complex to adjust hybrid deduction accounts based on the extent to which under a relevant foreign tax law a hybrid deduction offsets certain types of income (such as effectively connected income subject to tax under section 882), and thus the final regulations do not adopt the comment suggesting such an approach.

## 3. Rules Regarding Transfers of Stock

Because hybrid deduction accounts are maintained with respect to stock of a CFC, the proposed regulations provide rules

that take into account transfers of stock of a CFC, including transfers pursuant to certain nonrecognition exchanges and liquidations. *See* proposed §1.245A(e)-1(d)(4). In general, and depending on the type of transaction pursuant to which the transfer occurs, the transferee succeeds to the transferor’s hybrid deduction accounts with respect to the transferred stock, or hybrid deduction accounts with respect to the transferred stock are tacked onto successor or similar interests. However, if the stock is transferred to a person that is not required to maintain a hybrid deduction account, such as an individual or a foreign corporation that is not a CFC, the hybrid deduction account generally terminates.

Although a comment noted that these rules generally provide for appropriate results, the comment (and others) recommended that the rules be modified to address certain issues involving transfers of stock. First, a comment recommended that the rules address certain distributions of stock under section 355. The comment suggested that the balance of a hybrid deduction account with respect to stock of the distributing CFC be allocated to a hybrid deduction account with respect to stock of the controlled CFC in a manner similar to how basis in stock of the distributing CFC is allocated to stock of the controlled CFC under section 358. The Treasury Department and the IRS agree that allocation rules should apply with respect to certain section 355 distributions, but have concluded that the allocation should be consistent with how earnings and profits of the distributing CFC are allocated between the distributing CFC and the controlled CFC. The final regulations thus provide a rule to this effect. *See* §1.245A(e)-1(d)(4)(iii)(B)(4). This rule, like the other rules in §1.245A(e)-1(d)(4)(iii)(B) that adjust hybrid deduction accounts upon certain nonrecognition transactions, is in addition to the general rule of §1.245A(e)-1(d)(4)(iii)(A), pursuant to which an acquirer of stock of a CFC generally succeeds to the transferor’s hybrid deduction accounts with respect to the stock. Accordingly, if the section 355 distribution involves a pre-existing controlled CFC, the shareholder’s hybrid deductions accounts with respect to the controlled CFC immediately after the distribution are generally equal to the sum

of (i) the hybrid deduction accounts with respect to the controlled CFC to which the shareholder succeeds under the rules of §1.245A(e)-1(d)(4)(iii)(A), and (ii) the portions of the hybrid deduction accounts with respect to the distributing CFC that are allocated to hybrid deduction accounts with respect to stock of the controlled CFC under §1.245A(e)-1(d)(4)(iii)(B)(4).

Second, a comment suggested that the final regulations adopt an anti-duplication rule to address cases in which a liquidation of a lower-tier CFC into an upper-tier CFC would in effect result in a duplication of hybrid deductions. For example, the comment noted that if the upper-tier CFC and lower-tier CFC have issued “mirror” hybrid instruments, then hybrid deduction accounts with respect to shares of stock of the upper-tier CFC would already reflect amounts attributable to hybrid deductions of the lower-tier CFC, with the result that, upon the liquidation of the lower-tier CFC, it would not be appropriate to increase hybrid deduction accounts with respect to shares of stock of the upper-tier CFC by the hybrid deductions of the lower-tier CFC. The Treasury Department and the IRS agree with this comment. However, rather than addressing this duplication issue only in the context of transfers of stock of a CFC, the final regulations provide a general anti-duplication rule. *See* §1.245A(e)-1(d)(2)(iii). This rule generally ensures that when deductions or other tax benefits under a relevant foreign tax law are in effect duplicated at different tiers, the deductions or other tax benefits only give rise to a hybrid deduction of the higher-tier CFC. Thus, in the mirror hybrid instrument example, the deduction allowed to the upper-tier CFC, but not the deduction allowed to the lower-tier CFC, would be a hybrid deduction, provided that the deductions arise under the same relevant foreign tax law.

Lastly, a comment requested clarification that, when a section 338(g) election is made with respect to a CFC target, the shareholder of the new target does not succeed to a hybrid deduction account with respect to a share of stock of the old target. The comment asserted that such a result is appropriate because the old target is generally treated as transferring all of its assets to an unrelated person, and the new target is generally treated as acquiring all

of its assets from an unrelated person. The Treasury Department and the IRS agree with this comment because, in general, the new target does not inherit any of the earnings and profits of the old target and, as a result, no distributions by the new target could represent a distribution of earnings and profits of the old target sheltered from foreign tax by reason of hybrid deductions incurred by the old target. Accordingly, the final regulations clarify that, in connection with an election under section 338(g), a hybrid deduction account with respect to stock of the old target generally does not carry over to stock of the new target. *See* §1.245A(e)-1(d)(4)(iii)(B)(5).

#### 4. Mid-Year Transfers of Stock

Under the proposed regulations, if there is a transfer of stock of a CFC during the CFC’s taxable year, then the determinations and adjustments that would otherwise be made at the close of the CFC’s taxable year are generally made at the close of the date of the transfer. *See* proposed §1.245A(e)-1(d)(5). A comment requested clarification regarding how, in such cases, a hybrid deduction account with respect to a share of stock of the CFC is adjusted on the date of transfer, and whether hybrid dividends and tiered hybrid dividends that arise during the post-transfer period affect such adjustments.

In response to this comment, the final regulations provide additional rules that, in general, adjust the hybrid deduction account based on the number of days in the taxable year within the pre-transfer period to the total number of days in the taxable year. *See* §1.245A(e)-1(d)(5). The rules also coordinate the end-of-the year adjustments and the adjustments that must be made on the transfer date. *See Id.*

#### 5. Applicability Date

The proposed regulations provide that proposed §1.245A(e)-1, including the hybrid deduction account rules, applies to distributions made after December 31, 2017. However, the preamble to the proposed regulations explains that if proposed §1.245A(e)-1 is finalized after June 22, 2019, then §1.245A(e)-1 will apply only to distributions made during taxable years ending on or after the date the pro-

posed regulations were issued (December 20, 2018).

Some comments requested that, given that the statutory language of section 245A(e) does not include the concept of an account, the hybrid deduction account rules apply on a prospective basis to provide taxpayers time to comply with the rules and to prevent harsh results. One comment suggested that the rules apply only to distributions made after the proposed regulations were issued, and another suggested that the rules apply only to distributions made after December 31, 2018.

The final regulations provide that the hybrid deduction account rules apply to distributions made after December 31, 2017, provided that such distributions occur during taxable years ending on or after the date the proposed regulations were issued. *See* §1.245A(e)-1(h)(1). The Treasury Department and the IRS have determined that it would not be appropriate to delay the applicability date of the hybrid deduction account rules because the enactment of section 245A(e) provided notice that D/NI outcomes involving instruments that are stock for U.S. tax purposes – including D/NI outcomes involving a deduction or other tax benefit allowed for an amount on a particular date and a payment of a corresponding amount of earnings and profits as a dividend for U.S. tax purposes on a later date – would be neutralized under section 245A(e) (including in conjunction with the regulatory authority under section 245A(g)), and the hybrid deduction account rules are necessary to ensuring such D/NI outcomes are so neutralized.

#### D. Miscellaneous issues

##### 1. Treatment of Amounts under Tax Law of another Foreign Country

Under the proposed regulations, a tiered hybrid dividend means an amount received by a CFC (“receiving CFC”) from another CFC to the extent that the amount would be a hybrid dividend under the proposed regulations if the receiving CFC were a domestic corporation. *See* proposed §1.245A(e)-1(c)(2). As noted in the preamble to the proposed regulations, whether a dividend is a tiered hybrid divi-

dividend is determined without regard to how the amount is treated under the tax law of which the receiving CFC is a tax resident (or under any other foreign tax law). Similarly, whether a deduction or other tax benefit allowed to a CFC (or a related person) under a relevant foreign tax law is a hybrid deduction is determined without regard to how the amount is treated under another foreign tax law.

Comments suggested that the treatment of an amount under another foreign tax law be taken into account in two cases. First, a comment recommended an exception pursuant to which a dividend is not a tiered hybrid dividend to the extent that the receiving CFC includes the dividend in income under its tax law (or is subject to withholding tax under the payer CFC's tax law). The comment suggested that this approach only apply, however, to the extent that the inclusion (or withholding tax) is at a tax rate at least equal to the rate at which the hybrid deduction was allowed. The comment noted that such an approach could prevent double-taxation, though it might also result in additional complexity.

The Treasury Department and the IRS have determined that not taking into account the treatment of an amount under the receiving CFC's tax law (or other foreign tax law), as provided in the proposed regulations, is consistent with the plain language of section 245A(e)(2). In addition, the Treasury Department and the IRS have concluded that such an exception could give rise to inappropriate results in certain cases. For example, if the exception applied without regard to tax rates, then an inclusion by the receiving CFC at a low tax rate applicable to all income would discharge the application of section 245A(e) to a dividend even though the payer CFC deducted the amount at a high tax rate. *See also* part III.C.1 of this Summary of Comments and Explanation of Revisions section (discussing the effect of inclusions in another foreign country). Moreover, and as noted by the comment, a comparative tax rate test would create complexity and administrability issues – for example, it would require that hybrid deduction accounts track the tax rate at which the CFC (or a related person) was

allowed a hybrid deduction. Accordingly, the final regulations do not adopt this comment.

Second, a comment suggested that, in cases involving tiers of CFCs that are tax residents of different foreign countries, a deduction or other tax benefit allowed to the upper-tier CFC under a relevant foreign tax law not be a hybrid deduction to the extent that the deduction or other tax benefit offsets an amount that the upper-tier CFC includes in its income and that is attributable to a hybrid deduction of a lower-tier CFC.<sup>2</sup> For example, the comment noted that, in the case of back-to-back hybrid instruments involving CFCs that are tax residents of different foreign countries (pursuant to which, for U.S. tax purposes, the lower-tier CFC pays a dividend to the upper-tier CFC and the upper-tier CFC pays a dividend to a domestic corporation), in effect only a single D/NI outcome occurs if under its tax law the upper-tier CFC includes in income the amount paid by the lower-tier CFC. The comment asserted that, in such a case, the deduction allowed to the upper-tier CFC should not be treated as a hybrid deduction because, by reason of treating the amount paid by the lower-tier CFC as a tiered hybrid dividend, the D/NI outcome associated with the arrangement is neutralized. The final regulations do not adopt this comment because it would be inconsistent with the statute, which does not take into account the overall effect of a deduction or other tax benefit under the relevant foreign tax law. In addition, the Treasury Department and the IRS have determined that such an exception would be complex and would give rise to administrability issues because it could require, for example, a factual analysis of how particular deductions offset items of gross income under a relevant foreign tax law. Moreover, pursuant to rules described in a separate notice of proposed rulemaking published in the Proposed Rules section of this issue of the **Federal Register** (REG-106013-19), the subpart F inclusion arising by reason of the upper-tier CFC receiving the tiered hybrid dividend will, to an extent, generally reduce the hybrid deduction accounts with respect to stock of the upper-tier CFC.

## 2. Application of Tiered Hybrid Dividend Rule to Non-Corporate U.S. Shareholders

If an upper-tier CFC receives a tiered hybrid dividend from a lower-tier CFC, and a domestic corporation is a U.S. shareholder of both CFCs, then, notwithstanding any other provision of the Code (i) the tiered hybrid dividend is treated for purposes of section 951(a)(1)(A) as subpart F income of the upper-tier CFC, (ii) the U.S. shareholder must include in gross income its pro rata share of the subpart F income, and (iii) the rules of section 245A(d) apply to the amount included in the U.S. shareholder's gross income. *See* proposed §1.245A(e)-1(c)(1). A comment requested that the final regulations address how the tiered hybrid dividend rule applies with respect to a non-corporate U.S. shareholder of the upper-tier CFC.

The final regulations provide that the tiered hybrid dividend rule applies only as to a domestic corporation that is a U.S. shareholder of both the upper-tier CFC and the lower-tier CFC. *See* §1.245A(e)-1(c)(1). Thus, for example, if a domestic corporation and a U.S. individual equally own all of the stock of an upper-tier CFC, and the upper-tier CFC receives a tiered hybrid dividend from a wholly-owned lower-tier CFC, the tiered hybrid dividend rule does not apply to cause a subpart F inclusion to the individual U.S. shareholder (though the dividend may otherwise result in a subpart F inclusion to the individual U.S. shareholder). If the dividend does not give rise to a subpart F inclusion to the individual U.S. shareholder, the earnings associated with the dividend would generally be subject to full U.S. tax when distributed to the individual as a dividend because individuals are not allowed a deduction under section 245A(a) and, as a result, it would be inappropriate for the tiered hybrid dividend rule to have applied to the individual.

## 3. Upper-Tier CFCs Required to Maintain Hybrid Deduction Accounts

Under the proposed regulations, an upper-tier CFC is generally a specified owner of shares of stock of a lower-tier

<sup>2</sup> In these cases, the anti-duplication rule described in part II.C.3 of this Summary of Comments and Explanation of Revisions section, which applies only to certain deductions or tax benefits under the same relevant foreign tax law, would not apply.

CFC, and thus the upper-tier CFC must maintain hybrid deduction accounts with respect to those shares. *See* proposed §1.245A(e)-1(d)(1) and (f)(5). However, in certain cases there may not be a domestic corporation that is a U.S. shareholder of the upper-tier CFC. For example, the only U.S. shareholders of the upper-tier CFC may be individuals, with the result that section 245A(e)(2) would not apply to a dividend received by the upper-tier CFC from the lower-tier CFC. Or, the upper-tier CFC may be a CFC solely by reason of the repeal of the limitation on the “downward” attribution rule under section 958(b)(4), with the result that even if a dividend received by the upper-tier CFC from the lower-tier CFC were a tiered hybrid dividend, there would be no meaningful U.S. tax consequence because no U.S. shareholder would have a subpart F inclusion with respect to the upper-tier CFC.

To obviate the need for hybrid deduction accounts to be maintained in these cases, the final regulations provide that an upper-tier CFC is a specified owner of shares of stock of a lower-tier CFC only if, for purposes of sections 951 and 951A, a domestic corporation that is a U.S. shareholder of the upper-tier CFC owns (within the meaning of section 958(a), but for this purpose treating a domestic partnership as foreign) one or more shares of stock of the upper-tier CFC. *See* §1.245A(e)-1(f)(6). The Treasury Department and the IRS expect that when proposed regulations under section 958 (REG-101828-19, 84 FR 29114) are finalized, the rule described in the preceding sentence treating a domestic partnership as foreign will be removed, as it will no longer be necessary. *See* proposed §1.958-1(d)(1).

#### 4. Anti-Avoidance Rule

The proposed regulations include an anti-avoidance rule that requires appropriate adjustments to be made, including adjustments that would disregard a transaction or arrangement, if a transaction or arrangement is engaged in with a principal purpose of avoiding the purposes of the proposed regulations. As an example, the anti-avoidance rule disregards a transaction or arrangement that is undertaken to affirmatively fail to satisfy the

holding period requirement under section 246, such as the sale of lower-tier CFC stock before satisfying the holding period, if a principal purpose of the transaction or arrangement is to avoid the tiered hybrid dividend rules. A comment suggested that the anti-avoidance rule should not apply to a sale of lower-tier CFC stock before satisfying the holding period if the sale is to an unrelated party, even though the timing of the sale may be driven by tax considerations. Another comment requested clarification that the anti-avoidance rule does not apply to disregard a transaction pursuant to which the hybrid nature of an arrangement is eliminated (for example, a restructuring of a hybrid instrument into a non-hybrid instrument, so as to eliminate the accrual of a hybrid deduction under a relevant foreign tax law).

The Treasury Department and the IRS have determined that the anti-avoidance rule should not be limited to transactions or arrangements with related parties, as otherwise transactions or arrangements with unrelated parties could lead to the avoidance of section 245A(e) and the regulations thereunder. Accordingly, the final regulations retain the anti-avoidance rule in the proposed regulations, and thus whether the anti-avoidance rule applies to a transaction or arrangement depends solely on a principal purpose of the transaction or arrangement for the avoidance of section 245A(e) and the regulations thereunder and does not take into account the status of a counter party. *See* §1.245A(e)-1(e). The Treasury Department and the IRS agree, however, with the comment asserting that the anti-avoidance rule should not apply to disregard a restructuring of a hybrid arrangement into a non-hybrid arrangement and, accordingly, the rule is modified to this effect. *See id.*

### III. Comments and Revisions to Proposed §§1.267A-1 through 1.267A-7 – Certain Payments Involving Hybrid and Branch Mismatches

#### A. Background

The proposed regulations disallow a deduction for any interest or royalty paid or accrued (“specified payment”) to the extent the specified payment produces a

D/NI outcome as a result of a hybrid or branch arrangement. The proposed regulations also disallow a deduction for a specified payment to the extent the specified payment produces an indirect D/NI outcome as a result of the effects of an offshore hybrid or branch arrangement being imported into the U.S. tax system. Finally, the proposed regulations disallow a deduction for a specified payment to the extent the specified payment produces a D/NI outcome and is made pursuant to a transaction a principal purpose of which is to avoid the purposes of the regulations under section 267A.

#### B. Hybrid and branch arrangements

##### 1. Arrangements Giving Rise to Long-Term Deferral

###### i. In general

Several provisions of the proposed regulations address long-term deferral, which results when there is deferral beyond a taxable period ending more than 36 months after the end of the specified party’s taxable year. For example, to address long-term deferral arising as a result of different ordering or other rules under U.S. and foreign tax law, a hybrid transaction includes an instrument a payment with respect to which is interest for U.S. tax purposes but a return of principal for purposes of the tax law of a specified recipient of a payment. *See* proposed §1.267A-2(a)(2). In addition, the proposed regulations deem a specified payment as made pursuant to a hybrid transaction if differences between U.S. tax law and the tax law of a specified recipient of the payment (such as differences in tax accounting treatment) result in more than a 36-month deferral between the time the deduction would be allowed under U.S. tax law and the time the payment is taken into account in income under the specified recipient’s tax law. *See id.* Further, a D/NI outcome is considered to occur with respect to a specified payment if under a relevant foreign tax law the payment is not included in income within the 36-month period. *See* proposed §1.267A-3(a)(1).

One comment supported these provisions, on balance, noting that long-term deferral can create D/NI outcomes that

should be neutralized by section 267A, but recommending certain of the modifications discussed in this part III.B.1 of the Summary of Comments and Explanation of Revisions section. Other comments suggested that the provisions be eliminated, because according to such comments they are potentially burdensome or are not appropriate since a D/NI outcome should not be viewed as occurring if the amount will eventually be included in income; in addition, one comment asserted that the provision dealing with mismatches in tax accounting treatment is neither supported by section 267A nor within the regulatory authority granted under section 267A(e). However, some comments also noted that the burden concerns could be addressed by adopting certain of the comments discussed in this part III.B.1 of the Summary of Comments and Explanation of Revisions section.

The Treasury Department and the IRS have determined that the final regulations should retain the long-term deferral provisions because long-term deferral can in effect create D/NI outcomes and, absent such provisions, hybrid arrangements could be used to achieve results inconsistent with the purposes of section 267A. *See* S. Comm. on the Budget, Reconciliation Recommendations Pursuant to H. Con. Res. 71, S. Print No. 115-20, at 389 (2017) (expressing concern with hybrid arrangements that “achieve double non-taxation, including long-term deferral.”). In addition, the Treasury Department and the IRS have concluded that the provisions are consistent with section 267A and the broad regulatory authority thereunder. In particular, the Treasury Department and the IRS have concluded that deeming mismatches in tax accounting treatment to be hybrid transactions is consistent with section 267A(c) (defining a hybrid transaction), because in these cases a specified payment is deductible interest under U.S. tax law on a particular date whereas it is not includible interest under the foreign tax law until a later date.

Therefore, the final regulations retain the long-term deferral provisions but, in response to comments, modify the provisions as discussed in this part III.B.1 of the Summary of Comments and Explanation of Revisions section.

#### ii. Recovery of basis or principal

One comment requested that, in the case of a specified payment that is treated as a recovery of basis or principal under the tax law of a specified recipient, the final regulations clarify whether the specified recipient is considered to include the payment in income. The comment asserted that basis or principal should be viewed as a “generally applicable” tax attribute such that recovery of basis or principal should not create a D/NI outcome and, therefore, the specified recipient should be considered to include the payment in income.

The Treasury Department and the IRS have determined that basis or principal recovery can give rise to long-term deferral and thus can create a D/NI outcome. For example, consider a specified payment that is made pursuant to an instrument treated as indebtedness for U.S. tax purposes and equity for purposes of the tax law of a specified recipient, and that is treated as interest for U.S. tax purposes and a recovery of basis (under a rule similar to section 301(c)(2)) for purposes of the specified recipient’s tax law. If section 267A were to not apply in such a case, then the specified party would generally be allowed a deduction at the time of the specified payment but the specified recipient would not have a taxable inclusion at that time and, indeed, might not have a taxable inclusion, if any, for an extended period.

Accordingly, the final regulations clarify that a recovery of basis or principal can create a D/NI outcome. *See* §1.267A-3(a)(1)(ii). However, as discussed in parts III.B.1.iii (discussing a rule reducing a no-inclusion by certain amounts that are repayments of principal for U.S. tax purposes but included in income for foreign tax purposes) and III.B.1.iv (discussing hybrid sale/license transactions) of this Summary of Comments and Explanation of Revisions section, the final regulations modify the long-term deferral provisions. The Treasury Department and the IRS expect that these modifications will in many cases prevent a specified payment from being a disqualified hybrid amount when the payment is treated as a recovery of basis or principal under the tax law of a specified recipient.

#### iii. Defining long-term deferral; reduction of no-inclusion by certain amounts

Some comments noted that under the proposed regulations, to determine whether long-term deferral occurs with respect to a specified payment, the specified party must know at the time of the payment if, under the tax law of a specified recipient, the payment will be taken into account and included in income within the 36-month period. The comments stated that in certain cases this could be difficult or burdensome, including because, after the payment is made, the specified party might need to monitor the payment during the 36-month period to ensure that it is in fact taken into account and included in income (and, if it is not so taken into account and included, the specified party might need to amend its tax return to reflect a disallowance of the deduction). The comments suggested addressing these concerns by providing for a reasonable expectation standard, based on whether, at the time of the specified payment, it is reasonable to expect that the payment will be taken into account and included in income within the 36-month period. The Treasury Department and the IRS agree with these comments and, thus, the final regulations provide rules to such effect. *See* §§1.267A-2(a)(2)(ii)(A) and 1.267A-3(a)(1)(i).

Comments also suggested that, to address certain cases in which there are different ordering or other rules under U.S. tax law and the tax law of a specified recipient, certain amounts related to a specified payment be aggregated for purposes of determining whether long-term deferral occurs. For example, under such an approach, if a year 1 \$100x specified payment is interest for U.S. tax purposes and a return of principal for purposes of a specified recipient’s tax law, but a year 2 \$100x payment is a repayment of principal for U.S. tax purposes and interest for purposes of the specified recipient’s tax law (and is included in income by the specified recipient), then there is no long-term deferral with respect to the year 1 payment and, as a result, the payment is not a disqualified hybrid amount. The Treasury Department and the IRS generally agree that the year 1 \$100x specified payment should not be a disqualified hybrid

amount. However, rather than addressing through an aggregation rule, which could give rise to uncertainty in certain cases, the final regulations provide a special rule pursuant to which a specified recipient's no-inclusion with respect to a specified payment is reduced by certain amounts that are repayments of principal for U.S. tax purposes but included in income by the specified recipient. *See* §1.267A-3(a)(4); *see also* §1.267A-6(c)(1)(vi).

#### iv. Hybrid sale/license transactions

Some comments suggested that hybrid sale/license transactions not be subject to the hybrid transaction rule. A hybrid sale/license transaction can occur, for example, when a specified payment is treated as a royalty for U.S. tax purposes, and a contingent payment of consideration for the purchase of intangible property under the tax law of a specified recipient. In such a case, if under the specified recipient's tax law the payment is treated as a recovery of basis, then a D/Ni outcome would occur. Accordingly, if the specified payment is considered made pursuant to a hybrid transaction, then the payment would generally be a disqualified hybrid amount. Comments asserted that these transactions should be excluded because they are common, may be unavoidable, and are not abusive.

The Treasury Department and the IRS have determined that in many cases there might not be a significant difference between the results occurring under a hybrid sale/license transaction and the results that would occur were the specified recipient's tax law to (like U.S. tax law) also view the transaction as a license and the specified payment as a royalty. For example, if the specified recipient's tax law were to view the transaction as a license and the specified payment as a royalty, then the payment could be offset by an amortization deduction attributable to the basis of the intangible property. In such a case, the amortization deduction – a generally available deduction or other tax attribute – would not prevent the specified recipient from being considered to include the payment in income. *See* §1.267A-3(a)(1). Thus, regardless of whether the transaction is a hybrid sale/license or an actual license, the specified payment could under

the specified recipient's tax law be offset by basis or a deduction that is a function of basis. These cases are generally distinguishable from ones in which a transaction is a hybrid debt instrument, because tax laws typically do not provide amortization or similar deductions with respect to indebtedness.

Accordingly, the Treasury Department and the IRS have concluded that it is appropriate to exempt hybrid sale/license transactions from the hybrid transaction rule. The final regulations thus provide a rule to this effect. *See* §1.267A-2(a)(2)(ii)(B).

#### v. Other modifications or clarifications

Comments suggested several other modifications to the long-term deferral provisions. First, although one comment generally supported a bright-line standard for measuring long-term deferral because it provides certainty, other comments suggested modifying the standard for measuring long-term deferral, either by lengthening the period to, for example, 120 months, or defining long-term deferral as an unreasonable period of time based on all the facts and circumstances. The final regulations do not adopt these comments because the Treasury Department and the IRS have concluded that, in general, a bright-line 36-month standard appropriately distinguishes between short-term and long-term deferral and avoids administrability issues that would likely arise if long-term deferral were based on a subjective standard (such as an "unreasonable" period of time). *See also* Hybrid Mismatch Report para. 56 (bright-line safe harbor pursuant to which inclusions within a 12-month period are not considered to give rise to long-term deferral).

Second, a comment suggested that, to balance the benefits of the bright-line standard with the resulting cliff effects, the final regulations provide a rule, similar to section 267(a)(3), that defers a deduction for a specified payment until taken into account under the foreign tax law. The final regulations do not adopt this approach because it would be inconsistent with the plain language of section 267A, which provides for the disallowance of a deduction at the time of the payment, and not a deferral of a deduction. In addition,

the Treasury Department and the IRS have determined that, if such an approach were adopted, tracking rules would be necessary and such rules would create additional complexity and administrative burden.

Third, a comment requested that the final regulations clarify that if a specified payment will never be recognized under the tax law of a specified recipient (because, for example, such tax law does not impose an income tax), then the long-term deferral provision does not apply so as to deem the payment as made pursuant to a hybrid transaction. Finally, a comment requested clarification that a specified payment is treated as included in income if the payment is included in income in a prior taxable period. The Treasury Department and the IRS agree with these comments, and the final regulations thus include these clarifications. *See* §1.267A-2(a)(2)(ii)(A); §1.267A-3(a)(1)(i).

#### 2. Interest-Free Loans

An interest-free loan includes, for example, an instrument that is treated as indebtedness under both U.S. tax law and the tax law of the holder of the instrument but provides no stated interest. If the issuer is allowed an imputed interest deduction, but the holder is not required to impute interest income, the instrument would give rise to a D/Ni outcome. Because the imputed interest deduction is not regarded under the tax law of the holder of the instrument, the disregarded payment rule of the proposed regulations treats the imputed interest as a disregarded payment and, accordingly, a disqualified hybrid amount to the extent it exceeds dual inclusion income.

A comment noted that the Hybrid Mismatch Report generally does not disallow deductions for imputed interest payments, such as interest imputed with respect to interest-free loans, and that imputed interest raises issues that should be further considered on a multilateral basis. The comment thus suggested that the final regulations generally reserve on whether imputed interest is subject to section 267A. The final regulations do not adopt this comment because imputed interest can give rise to D/Ni outcomes that are no different than D/Ni outcomes produced by other hybrid and branch arrangements. However, to

more clearly address these transactions, and because interest-free loans are similar to hybrid transactions and are unlikely to involve dual inclusion income, the final regulations address imputed interest under the hybrid transaction rule, rather than the disregarded payment rule. *See* §1.267A-2(a)(4). The rules in the final regulations addressing interest-free loans and similar arrangements apply for taxable years beginning on or after December 20, 2018. *See* §1.267A-7(b)(1).

### 3. Disregarded Payments

#### i. Dual inclusion income

In general, the proposed regulations provide that a disregarded payment is a disqualified hybrid amount to the extent it exceeds the specified party's dual inclusion income. For this purpose, an item of income of a specified party is dual inclusion income only if it is included in the income of both the specified party and the tax resident or taxable branch to which the disregarded payment is made (as determined under the rules of §1.267A-3(a)). *See* proposed §1.267A-2(b)(3). A comment suggested that the final regulations address whether an item of income is dual inclusion income even though, as a result of a participation exemption, patent box, or other exemption regime, it is not included in the income of the tax resident or taxable branch to which the disregarded payment is made.

The Treasury Department and the IRS have concluded that an item of income of a specified party should be dual inclusion income even though, by reason of a participation exemption or other relief particular to a dividend, it is not included in the income of the tax resident or taxable branch to which the disregarded payment is made, provided that the application of the participation exemption or other relief relieves double-taxation (rather than results in double non-taxation). The final regulations are thus modified to this effect. *See* §1.267A-2(b)(3)(ii); *see also* §1.267A-6(c)(3)(iv). The final regulations provide a similar rule in cases in which an item of income of a specified party is included in the income of the tax resident or taxable branch to which the disregarded payment is made but not included in the

income of the specified party by reason of a dividends received deduction (such as the section 245A(a) deduction). These rules do not apply to items that are excluded from income under a patent box or similar regime because, to the extent the payer of the item is allowed a deduction for the item under its tax law, the deduction and the exclusion, together, result in double non-taxation. *See also* Hybrid Mismatch Report para. 126.

#### ii. Exception for payments otherwise taken into account under foreign law

Under the proposed regulations, a special rule ensures that a specified payment is not a deemed branch payment to the extent the payment is otherwise taken into account under the home office's tax law in such a manner that there is no mismatch. *See* proposed §1.267A-2(c)(2). Absent such a rule, a deduction for a deemed branch payment could be disallowed even though it does not give rise to a D/NI outcome. Thus, for example, if under an applicable treaty a U.S. taxable branch is deemed to pay an amount of interest or royalty to the home office that is not regarded under the home office's tax law, the payment is nevertheless not a deemed branch payment to the extent that under the home office's tax law a corresponding amount of interest or royalties is allocated and attributable to the U.S. taxable branch and therefore is not deductible. *See id.*

However, the proposed regulations do not provide a similar special rule in analogous cases involving disregarded payments. For example, assume FX1, a tax resident of Country X, owns FX2, also a tax resident of Country X, and FX2 has a U.S. taxable branch ("USB"). Further, assume that FX1 borrows from a bank and on-lends the proceeds to FX2, and that pursuant to such transactions FX1 pays \$100x of interest to the bank and FX2 pays \$100x of interest to FX1 but, as a consequence of the Country X consolidation regime, FX2's payment to FX1 is treated as a disregarded transaction between group members. Lastly, assume that the entire \$100x of FX2's payment of interest to FX1 is allocable to USB's effectively connected income under section 882 and thus is a specified payment under proposed §1.267A-5(b)(3). Under

the proposed regulations, USB's specified payment of interest would be a disregarded payment, regardless of whether the payment is otherwise taken into account under Country X tax law. The specified payment would otherwise be taken into account under Country X tax law if, for example, FX1's payment of interest to the bank were allocated and attributed to USB and were therefore not deductible. *Cf.* §1.267A-2(c)(2). To provide symmetry between the disregarded payment rule and the deemed branch payment rule, the final regulations add to the disregarded payment rule a special rule similar to the special rule in the deemed branch payment context. *See* §1.267A-2(b)(2)(ii)(B).

### 4. Payments by U.S. Taxable Branches

#### i. Allocation of interest expense to U.S. taxable branches

The proposed regulations provide that a U.S. taxable branch of a foreign corporation is considered to pay or accrue interest allocable under section 882(c)(1) to effectively connected income of the U.S. taxable branch. *See* proposed §1.267A-5(b)(3). The proposed regulations include rules to identify the manner in which a specified payment of a U.S. taxable branch is considered made. *See id.* For directly allocable interest described in §1.882-5(a)(1)(ii)(A), or a U.S. booked liability described in §1.882-5(d)(2), a direct tracing approach applies; for any excess interest, the U.S. taxable branch is treated as paying or accruing interest to the same persons and pursuant to the same terms that the home office paid or accrued such interest on a pro-rata basis. *See id.* As explained in the preamble to the proposed regulations, these rules are necessary to determine whether a U.S. taxable branch's specified payment is made pursuant to a hybrid or branch arrangement (for example, made pursuant to a hybrid transaction or to a reverse hybrid).

The proposed regulations do not, however, contain rules for tracing a foreign corporation's distributive share of interest expense when the foreign corporation is a partner in a partnership that has a U.S. asset, as described in §1.882-5(a)(1)(ii)(B), or rules for tracing interest that is determined under the separate currency pools

method, as described in §1.882-5(e). The final regulations therefore provide that, like directly allocable interest and U.S. booked liabilities, a U.S. taxable branch must use a direct tracing approach to identify the person to whom interest described in §1.882-5(a)(1)(ii)(B) or §1.882-5(e) is payable. *See* §1.267A-5(b)(3)(ii)(A). In addition, the Treasury Department and the IRS have determined that a consistent approach should apply for purposes of identifying a U.S. branch interest payment in order to avoid treating similarly situated taxpayers differently under section 267A. Accordingly, similar to the tracing rules provided in the final regulations under section 59A, the final regulations provide that 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). *See id.*; *see also* §1.59A-3(b)(4)(i)(B).

#### ii. Interaction with income tax treaties

Under the proposed regulations, the deemed branch payment rule addresses a D/NI outcome when, under an income tax treaty, a deductible payment is deemed to be made by a permanent establishment to its home office (or another branch of the home office) and offsets income not taxable to the home office, but the payment is not taken into account under the tax law of the home office or other branch. *See* proposed §1.267A-2(c)(2). A deemed branch payment is a notional payment that arises from applying Article 7 (Business Profits) of certain U.S. income tax treaties, which takes into account only the profits derived from the assets used, risks assumed and activities performed by the permanent establishment to determine the business profits that may be taxed where the permanent establishment is situated. *See, for example*, the U.S. Treasury Department Technical Explanation to the income tax convention between the United States and Belgium, signed November 27, 2006 (“[T]he OECD Transfer Pricing Guidelines apply, by analogy, in determining the profits attributable to a permanent establishment.”).

A comment questioned whether the deemed branch payment rule is a treaty

override because it creates a new condition on the allowance of a deduction for purposes of computing the business profits of a U.S. permanent establishment based upon an intervening change in U.S. law. The comment noted that the deemed branch payment rule affects the allocation of taxing rights of business profits under the treaty. Another comment raised a similar concern and requested that the deemed branch payment rule be withdrawn because it is inconsistent with U.S. income tax treaty obligations.

The Treasury Department and the IRS have determined that the deemed branch payment rule is not a treaty override and is consistent with U.S. income tax treaty obligations. The treaties that allow notional payments under Article 7 take into account interbranch transactions and value such interbranch transactions using the most appropriate arm’s length methodology. Once expenses are either allocated or determined under arm’s length principles to be taken into account in determining the business profits of the permanent establishment under Article 7, domestic limitations on deductibility of such expenses may apply in the same manner as they would if the amounts were paid by a domestic corporation. In other words, sections 163(j), 267(a)(3), and 267A generally apply to the same extent to the notional payments as they would to actual interest payments by a domestic subsidiary to a foreign parent. The commentary to paragraph 2 of Article 7 of the OECD Model Tax Convention adopts a comparable interpretation. *See* Para. 30 and 31 of the commentary to para. 2 of Article 7 of the OECD Model Tax Convention. Accordingly, the final regulations retain the deemed branch payment rule.

### 5. Reverse Hybrids

#### i. Fiscally transparent

A reverse hybrid is an entity that is fiscally transparent for purposes of the tax law of the country in which it is established but not for purposes of the tax law of an investor of the entity. *See* §1.267A-2(d)(2). Under the proposed regulations, whether an entity is fiscally transparent with respect to an item of income is determined under the principles

of §1.894-1(d)(3)(ii) and (iii). *See* proposed §1.267A-5(a)(8).

The final regulations provide special rules to address certain cases in which, given §1.894-1(d)(3)’s definition of fiscally transparent, an entity might not be considered a reverse hybrid under the proposed regulations with respect to a payment received by the entity, even though neither the entity nor an investor of the entity take the payment into account in income, with the result that the payment gives rise to a D/NI outcome. Pursuant to the special rules, an entity is considered fiscally transparent with respect to the payment under the tax law of the country where it is established if, under such tax law, the entity allocates the payment to an investor, with the result that under such tax law the investor is viewed as deriving the payment through the entity. *See* §1.267A-5(a)(8)(i); *see also* §1.267A-6(c)(5)(vi). A similar rule applies for purposes of determining whether the entity is fiscally transparent with respect to the payment under an investor’s tax law. *See* §1.267A-5(a)(8)(ii). Lastly, to address the fact that under §1.894-1(d)(3)(ii), certain collective investment vehicles and similar arrangements may not be considered fiscally transparent under the tax law of the country where established, a special rule provides that such arrangements are considered fiscally transparent under the tax law of the establishment country if neither the arrangement nor an investor is required to take the payment into account in income. *See* §1.267A-5(a)(8)(iii); *see also* §1.894-1(d)(5), *Example 7*.

#### ii. Current-year distributions from reverse hybrid

Under the proposed regulations, when a specified payment is made to a reverse hybrid, it is generally a disqualified hybrid amount to the extent that an investor does not include the payment in income. *See* proposed §1.267A-2(d)(1). For this purpose, whether an investor includes the specified payment in income is determined without regard to a subsequent distribution by the reverse hybrid. *See* proposed §1.267A-3(a)(3). As explained in the preamble to the proposed regulations, although a subsequent distribution may be included in the investor’s income, the distribution may not occur for an extended



period and, when it does occur, it may be difficult to determine whether the distribution is funded from an amount comprising the specified payment.

A comment noted that if a reverse hybrid distributes all of its income during a taxable year, then current year distributions should be taken into account for purposes of determining whether an investor of the reverse hybrid includes in income a specified payment made to the reverse hybrid. The comment asserted that not doing so would be unduly harsh and could create unwarranted disparities between cases involving current year distributions and anti-deferral inclusions (which are taken into account for purposes of determining whether an investor includes in income a specified payment). The comment also suggested that the final regulations reserve on whether subsequent year distributions are taken into account.

The Treasury Department and the IRS agree with the comment that current year distributions should be taken into account in cases in which the reverse hybrid distributes all of its income during the taxable year. The final regulations thus provide that in these cases a portion of a specified payment made to the reverse hybrid during the taxable year is considered to relate to each of the current year distributions from the reverse hybrid. As a result, to the extent that an investor includes in income a current year distribution, the investor is treated as including in income a corresponding portion of a specified payment made to the reverse hybrid during the year. *See* §1.267A-3(a)(3). The Treasury Department and the IRS have determined that it would be too complex to take into account current year distributions in cases in which the reverse hybrid does not distribute all of its income during the taxable year, as in these cases stacking or similar rules would likely be needed to determine the extent that a specified payment is considered to relate to a distribution. For similar reasons, the Treasury Department and the IRS have determined that it would be too complex to take into account subsequent year distributions.

### iii. Multiple investors

The final regulations clarify the application of the reverse hybrid rule in cases

in which an investor of the reverse hybrid owns only a portion of the interests of the reverse hybrid and does not include in income a specified payment made to the reverse hybrid. In these cases, given the “as a result of” test, only the no-inclusion of the investor that occurs for its portion of the payment may give rise to a disqualified hybrid amount.

For example, consider a case in which a \$100x specified payment is made to a reverse hybrid 60% of the interests of which are owned by a Country X investor (the tax law of which treats the reverse hybrid as not fiscally transparent) and 40% of the interests of which are owned by a Country Y investor (the tax law of which treats the reverse hybrid as fiscally transparent). If the Country X investor does not include any portion of the payment in income, then \$60x of the payment would generally be a disqualified hybrid amount under the reverse hybrid rule, calculated as \$100x (the no-inclusion that actually occurs with respect to the Country X investor) less \$40x (the no-inclusion that would occur with respect to the Country Y investor absent hybridity). *See* §§1.267A-2(d) and 1.267A-6(c)(5)(iv).

### iv. Inclusion by taxable branch in country in which reverse hybrid is established

The final regulations provide an exception pursuant to which the reverse hybrid rule does not apply to a specified payment made to a reverse hybrid to the extent that, under the tax law of the country in which the reverse hybrid is established, a taxable branch the activities of which are carried on by an investor of the reverse hybrid includes the payment in income. *See* §1.267A-2(d)(4). The Treasury Department and the IRS have determined that, in these cases, the inclusion in the establishment country generally prevents a D/NI outcome and thus it is appropriate for an exception to apply.

## C. Exceptions relating to disqualified hybrid amounts

### 1. Effect of Inclusion in another Foreign Country

Under the proposed regulations, a specified payment generally is a disqualified

hybrid amount to the extent that a D/NI outcome occurs with respect to any foreign country as a result of a hybrid or branch arrangement, even if the payment is included in income in another foreign country (a “third country”). *See also* part III.C.2 of this Summary of Comments and Explanation of Revisions section (exceptions for amounts included or includible in income in the United States). Absent such a rule, an inclusion of a specified payment in income in a third country would discharge the application of section 267A even though a D/NI outcome occurs in a foreign country as a result of a hybrid or branch arrangement. The preamble to the proposed regulations expresses particular concern with cases in which the third country imposes a low tax rate.

Comments requested that this rule be eliminated because requiring an income inclusion in multiple jurisdictions is not necessary or appropriate to prevent a D/NI outcome. One of these comments asserted that the rule is unfair and does not effectively prevent rate arbitrage. The comments further asserted that the rule is inconsistent with the policies of section 267A, other provisions of the Code (such as section 894(c) and §1.894-1(d)), and the Hybrid Mismatch Report. One comment stated that the rule is neither included in section 267A nor permissible under the regulatory authority under section 267A(e). Although the comments noted potential concerns associated with an income inclusion in a low-tax third country discharging the application of section 267A, the comments suggested addressing the concerns through the anti-avoidance rule included in the proposed regulations. Alternatively, a comment suggested retaining the general approach of the proposed regulations but permitting an inclusion in a third country to discharge the application of section 267A if the inclusion satisfies a rate test (for example, to the extent the inclusion is at a tax rate at least equal to the U.S. tax rate or the tax rate of the foreign country in which the no-inclusion occurs).

The Treasury Department and the IRS have determined that the approach of the proposed regulations should be retained to prevent the avoidance of section 267A by routing a specified payment through a low-tax third country, and to prevent the use of a hybrid or branch arrangement

from placing a taxpayer in a better position than it would have been in absent the arrangement. In addition, the Treasury Department and the IRS have concluded that the rule is consistent with section 267A and the broad regulatory authority thereunder. Finally, the Treasury Department and the IRS have concluded that relying on the anti-avoidance rule would give rise to uncertainty and be an insufficient remedy, and that a rate test would also be an insufficient remedy because it would give rise to additional complexity and would require taking into account tax rates, which is beyond the scope of hybrid mismatch rules.

## 2. Amounts Included or Includible in Income in the United States

The proposed regulations provide rules that, in general, ensure that a specified payment is not a disqualified hybrid amount to the extent it is included in the income of a tax resident of the United States or a U.S. taxable branch, or is taken into account by a U.S. shareholder under the subpart F or GILTI rules. *See* proposed §1.267A-3(b). Several comments suggested retaining these rules, but revising them in certain respects.

One comment suggested revising the rules relating to amounts taken into account under subpart F so that the determination is made without regard to the earnings and profits limitation under section 952. Another comment noted that the rules relating to amounts taken into account under GILTI could potentially give rise to rate arbitrage (for example, if the rate on the GILTI inclusion amount is in effect reduced by reason of the deduction under section 250(a)(1)(B), and the deduction for the specified payment offsets income that is not eligible for a reduced rate).<sup>3</sup> Finally, a comment suggested an exception for specified payments received by a qualified electing fund (as described in section 1295) and taken into account by a tax resident of the United States under section 1293.

The Treasury Department and the IRS agree with these recommendations, and

thus the final regulations provide rules to such effect. *See* §1.267A-3(b)(3) through (5).

## 3. Effect of Withholding Taxes on a Specified Payment

Under the proposed regulations, the determination of whether a deduction for a specified payment is disallowed under section 267A is made without regard to whether the payment is subject to U.S. source-based tax under section 871 or 881 and such tax has been deducted and withheld under section 1441 or 1442. The preamble to the proposed regulations explains that withholding tax policies are unrelated to the policies underlying hybrid arrangements and, because the approach of the proposed regulations is consistent with the Hybrid Mismatch Report, it may improve the coordination of section 267A with hybrid mismatch rules of other countries.

In response to a request for comments in the proposed regulations, several comments recommended that withholding taxes be taken into account for purposes of section 267A. For example, comments suggested that to the extent the United States imposes withholding tax on a specified payment, section 267A generally should not apply to the payment because, otherwise, the payment may be effectively taxed twice by the United States (once as a result of the withholding tax, and second as a result of the denial of a deduction for the payment). The comments also asserted that such an approach would generally be consistent with the policies underlying the exceptions in §1.267A-3(b) (certain amounts not treated as disqualified hybrid amounts to extent included or includible in income). Although one comment acknowledged that adopting an approach to withholding taxes that is inconsistent from the Hybrid Mismatch Report could raise potential coordination concerns, it recommended further work be undertaken on a multilateral level to avoid such issues and to ensure that economic double taxation does not occur.

The Treasury Department and the IRS have determined that it would not be appro-

priate for withholding taxes to be taken into account for purposes of section 267A. The purpose of withholding taxes is generally not to address mismatches in tax outcomes but, rather, to allow the source jurisdiction to retain its right to tax a payment. In addition, and as explained in the preamble to the proposed regulations, taking withholding taxes into account could create issues regarding how section 267A interacts with foreign hybrid mismatch rules – for example, a foreign country with hybrid mismatch rules may not treat the imposition of U.S. withholding taxes on a specified payment as neutralizing a D/NI outcome and may therefore apply a secondary or defensive rule requiring the payee to include the payment in income. Moreover, had Congress intended for withholding taxes to be taken into account for purposes of section 267A, it could have added a rule similar to the one in section 59A(c)(2)(B), which was enacted at the same time as section 267A. Finally, providing an exception for withholding taxes could raise administrability issues in cases in which a specified payment is subject to U.S. withholding taxes at the time of payment (with the result that a deduction for the payment is not disallowed under section 267A at that time) but the taxes are refunded in a later period; in these cases, it could be difficult or burdensome to retroactively deny the deduction and make corresponding adjustments. Thus, the Treasury Department and the IRS have determined that the exceptions in §1.267A-3(b) should generally be limited to inclusions similar to those described in the flush language of section 267A(b)(1) (inclusions under section 951(a)), which, unlike U.S. source income that is subject to withholding taxes, are included in the U.S. tax base on a net basis. Accordingly, the final regulations do not adopt the comment.

## D. Disqualified imported mismatch amounts

### 1. In General

Under the proposed regulations, an “imported mismatch rule” prevents the effects of an offshore hybrid arrangement

<sup>3</sup>For instance, in the case of a structured arrangement pursuant to which a domestic corporation (US1) makes a specified payment to a CFC of an unrelated domestic corporation (US2), a deduction allowed to US1 for the specified payment would offset income subject to tax at the full U.S. corporate tax rate, whereas US2's GILTI inclusion attributable to the payment would generally be subject to tax at a reduced rate by reason of the deduction under section 250(a)(1)(B).

from being imported into the U.S. taxing jurisdiction through the use of a non-hybrid arrangement. Pursuant to this rule, a specified payment is generally a disqualified imported mismatch amount, and therefore a deduction for the payment is disallowed, to the extent that the payment is (i) an imported mismatch payment, and (ii) income attributable to the payment is directly or indirectly offset by a hybrid deduction of a tax resident or taxable branch. See proposed §1.267A-4(a). The extent that a hybrid deduction directly or indirectly offsets income attributable to an imported mismatch payment is determined pursuant to a series of operating rules, including ordering rules, funding rules, and a pro rata allocation rule. See proposed §1.267A-4(c) and (e). Under these rules, a hybrid deduction is considered to offset income attributable to an imported mismatch payment only if the imported mismatch payment directly or indirectly funds the hybrid deduction. See proposed §1.267A-4(c).

Some comments asserted that the imported mismatch rule is complex and could be difficult to administer. These comments suggested various ways to address these concerns. One comment suggested removing the imported mismatch rule because of the complexity and administrability concerns and also because, according to the comment, the rule exceeds the authority granted under section 267A. Another comment suggested modifying the rule such that an imported mismatch payment is a disqualified imported mismatch amount only if the income attributable to the payment is offset by a hybrid deduction that as a factual matter is connected to the payment; thus, under this approach, the operating rules under the proposed regulations would generally be replaced with a broader facts and circumstances inquiry, possibly supplemented by rebuttable presumptions. Other comments suggested modifications to specific aspects of the imported mismatch rule, such as the operating rules.

The Treasury Department and the IRS have concluded that the general approach of the imported mismatch rule under the proposed regulations should be retained, and that the rule is consistent with the grant of regulatory authority under section 267A(e)(1) (regarding regulations to

address conduit arrangements involving hybrid transactions or hybrid entities). The Treasury Department and the IRS have determined that the operating rules under the proposed regulations provide more certainty than under alternative approaches, such as determining disqualified imported mismatch amounts based on a factual tracing of hybrid deductions to imported mismatch payments. In addition, the Treasury Department and the IRS have determined that the general approach under the proposed regulations promotes parity between similarly situated taxpayers. For example, in the case of one taxpayer with an imported mismatch payment factually linked to a hybrid deduction and another taxpayer with an imported mismatch payment not factually linked to a hybrid deduction, only the first taxpayer's payment would be a disqualified imported mismatch amount under a factual tracing approach, even though as an economic matter (and taking into account the fungibility of money) the income attributable to each taxpayer's payment may be offset by a hybrid deduction. Further, the general approach under the proposed regulations is consistent with the approach recommended under the Hybrid Mismatch and Branch Mismatch reports, which would better align these rules with hybrids mismatch rules of other jurisdictions to ensure that imported mismatches are adequately addressed and do not result in a single hybrid deduction giving rise to a disallowance in more than one jurisdiction. See Hybrid Mismatch Report Recommendation 8; see also OECD/G20, *Neutralising the Effects of Branch Mismatch Arrangements, Action 2: Inclusive Framework on BEPS* (July 2017) Recommendation 5.

However, in response to comments, the final regulations modify certain aspects of the imported mismatch rule in order to reduce complexity and facilitate compliance and administration of the rule. These modifications and others are discussed in parts III.D.2 through 5 of this Summary of Comments and Explanation of Revisions section.

## 2. Imported Mismatch Payments

Several comments suggested that the imported mismatch rule could result in

double U.S. taxation in certain cases. For example, assume US1, a domestic corporation, owns all the interests of each of US2, a domestic corporation, and FX, a tax resident of Country X that is a CFC for U.S. tax purposes. Also assume that FX owns all the interests of FY, a tax resident of Country Y that is a disregarded entity for U.S. tax purposes. Lastly, assume that US2 makes a \$100x non-hybrid specified payment to FY, and that FY incurs a \$100x hybrid deduction. In such a case, according to the comments, treating US2's payment as a disqualified imported mismatch amount could result in double U.S. taxation, as the United States would be disallowing US2 a deduction for the payment even though the entire amount is indirectly included in US1's income as a subpart F inclusion. The comments thus requested modifying the imported mismatch rule such that it does not apply in cases like these.

The Treasury Department and the IRS agree with these comments. As a result, the final regulations revise the definition of an imported mismatch payment, which under the proposed regulations is defined as any specified payment to the extent not a disqualified hybrid amount. Under the final regulations, a specified payment is an imported mismatch payment only to the extent that it is neither a disqualified hybrid amount nor included or includible in income in the United States (as determined under the rules of §1.267A-3(b)). See §1.267A-4(a)(2)(v). Thus, in the example in the previous paragraph, none of US2's payment would be an imported mismatch payment, calculated as \$100x (the amount of the payment) less \$0 (the disqualified hybrid amount with respect to the payment), less \$100x (the amount of the payment that is included or includible in income in the United States). Accordingly, none of the payment would be subject to disallowance under the imported mismatch rule.

## 3. Hybrid Deductions

### i. Deductions constituting hybrid deductions

Under the proposed regulations, for a deduction allowed to a tax resident or taxable branch under its tax law to be a

hybrid deduction, it generally must be one that would be disallowed if such tax law contained rules substantially similar to the rules under §§1.267A-1 through 1.267A-3 and 1.267A-5. *See* proposed §1.267A-4(b). A comment requested guidance on how this standard applies when the tax law of a tax resident or taxable branch contains hybrid mismatch rules. The comment posited several approaches, including (i) not treating deductions allowed to such a tax resident or taxable branch under its tax law as a hybrid deduction, or (ii) treating deductions allowed to such a tax resident or taxable branch under its tax law as a hybrid deduction if the deduction would be disallowed if such tax law contained rules nearly identical to those under section 267A. The comment recommended the first approach.

The Treasury Department and the IRS have determined that the first approach could give rise to inappropriate results. For example, in the case of a deduction allowed to a foreign tax resident under its tax law with respect to an interest-free loan, the deduction would not be a hybrid deduction under the first approach if the tax resident's tax law contains hybrid mismatch rules, even though the deduction would be disallowed under section 267A were section 267A to apply to the deduction. The Treasury Department and the IRS believe that these results could lead to avoidance of the purposes of section 267A. That is, the first approach could incentivize taxpayers to implement certain offshore hybrid arrangements and import the effects of the arrangement into the U.S. taxing jurisdiction, even though a deduction would be disallowed under section 267A were the arrangement to involve the U.S. taxing jurisdiction directly. Accordingly, the final regulations do not adopt this approach.

However, in response to the comment, the final regulations provide 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. *See* §1.267A-4(b)(2)(i). This list, which represents deductions that would be disallowed under section 267A but may be allowed under the hybrid mismatch rules of the foreign country, includes deductions with respect to (i) equity, (ii) interest-free

loans (and similar arrangements), and (iii) amounts that are not included in income in a third foreign country. Thus, in the case of a tax resident or taxable branch the tax law of which contains hybrid mismatch rules, a taxpayer need only consider these three types of arrangements when determining whether the tax resident or taxable branch has hybrid deductions for purposes of the imported mismatch rule. The Treasury Department and the IRS have concluded that this approach increases certainty and improves the administration of the imported mismatch rule.

#### ii. NIDs

Under the proposed regulations, a hybrid deduction includes NIDs allowed to a tax resident under its tax law. *See* proposed §1.267A-4(b). The comments regarding NIDs in the context of section 267A were substantially similar to the comments regarding NIDs in the context of section 245A(e). *See* part II.B.4 of this Summary of Comments and Explanation of Revisions section. Thus, for reasons similar to the reasons discussed in that section, the final regulations generally retain the approach of the proposed regulations regarding NIDs, but provide that only NIDs allowed to a tax resident under its tax law for accounting periods beginning on or after December 20, 2018, are hybrid deductions. *See* §1.267A-4(b)(2)(iii).

In addition, a comment suggested that including NIDs as a hybrid deduction conflicts with nondiscrimination provisions of income tax treaties that require interest and royalties paid by U.S. residents to residents of the other treaty country be deductible under the same conditions as if they had been paid to a resident of the United States. *See, for example*, paragraph (4) of Article 23 (Nondiscrimination) of the income tax convention between the United States and Belgium, signed November 27, 2006. However, the U.S. Treasury Department Technical Explanation of Article 23 of the U.S.-Belgium income tax treaty provides that “. . . the common underlying premise [in each paragraph of the Article] is that if the difference in treatment is directly related to a tax-relevant difference in the situations of the domestic and foreign persons being compared, that difference is not to be treated as discrimi-

natory. . . .” In this case, the disallowance of a deduction is dependent solely on differences in U.S. tax law and the tax law of an imported mismatch payee (or certain other foreign parties), and the tax benefits allowed to the imported mismatch payee (or certain other foreign parties) under foreign tax law. Payments to related domestic persons would always be governed by the same Federal tax laws, and domestic law does not provide hybrid deductions, including NIDs, to domestic persons. Accordingly, the Treasury Department and the IRS have concluded that including NIDs as a hybrid deduction does not conflict with the nondiscrimination provision of applicable U.S. income tax treaties.

The proposed regulations do not provide a rule pursuant to which NIDs are hybrid deductions only to the extent that the double non-taxation produced by the NIDs is a result of hybridity. However, consistent with other aspects of the section 267A regulations, the Treasury Department and the IRS have concluded that such a rule is appropriate and the final regulations therefore provide a rule to this effect. *See* §1.267A-4(b)(1)(ii). Thus, for example, in the case of a tax resident all the interests of which are owned by an investor that is a tax resident of another country, NIDs allowed to the tax resident are not hybrid deductions if the tax law of the investor has a pure territorial regime (that is, only taxes income from domestic sources) or if such tax law does not impose an income tax.

#### iii. Deemed branch payments

Under the proposed regulations, a hybrid deduction of a taxable branch includes a deduction that would be disallowed if the tax law of the taxable branch contained a provision substantially similar to proposed §1.267A-2(c) (regarding deemed branch payments). *See* proposed §1.267A-4(b). Proposed §1.267A-2(c) generally disallows a deduction for a deemed branch payment of a U.S. taxable branch only if the tax law of the home office provides an exclusion or exemption for income attributable to the branch. Proposed §1.267A-2(c) thus provides a simpler standard than the dual inclusion income standard of proposed §1.267A-2(b) (regarding disregarded pay-

ments). The simpler standard applies for deemed branch payments because these payments may arise due to simply operating a U.S. trade or business (as opposed to disregarded payments that typically result from structured tax planning), as well as because, given that U.S. permanent establishments cannot consolidate or otherwise share losses with U.S. taxpayers, there is a more limited opportunity for a deduction for such payments to offset non-dual inclusion income.

A comment noted that under a tax law of a foreign country a taxable branch could be permitted to consolidate or otherwise share losses with a tax resident of that country. The comment thus questioned whether, in the imported mismatch context, it is appropriate for the deemed branch payment rule to apply the branch exemption standard, rather than the dual inclusion income standard.

The Treasury Department and the IRS have concluded that, in the imported mismatch context, the dual inclusion income standard should apply 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, because in these cases the excess of the taxable branch's deemed branch payments over its dual inclusion income could offset non-dual inclusion income. The final regulations therefore provide a rule to this effect. *See* §1.267A-4(b)(2)(ii).

#### iv. Hybrid deductions of CFCs

Under the proposed regulations, only a tax resident or taxable branch that is not a specified party can incur a hybrid deduction. *See* proposed §1.267A-4(b). Similarly, under the proposed regulations, only a tax resident or a taxable branch that is not a specified party can make a funded taxable payment. *See* proposed §1.267A-4(c)(3). This approach was generally intended to ensure that section 267A does not result in double U.S. taxation in cases of specified payments involving CFCs, because payments to CFCs are generally includible in income in the United States and payments by CFCs are generally subject to disallowance as disqualified hybrid amounts.

A comment noted that this approach could lead to inappropriate results in certain cases. For example, it could lead to

the avoidance of the imported mismatch rule through the use CFCs that are not wholly-owned by tax residents of the United States. The comment therefore recommended that the final regulations provide that CFCs can incur hybrid deductions and make funded taxable payments. However, to prevent double U.S. taxation, the comment suggested that a payment by a CFC not give rise to a hybrid deduction or a funded taxable payment to the extent that the payment gives rise to an increase in the U.S. tax base.

The Treasury Department and the IRS agree with the comment and the final regulations therefore provide that CFCs can incur hybrid deductions and make funded taxable payments. *See* §1.267A-4(b)(1) and (c)(3)(v). The final regulations also provide rules to ensure that a hybrid deduction or funded taxable payment of a CFC does not include an amount that is a disqualified hybrid amount or included or includible in income in the United States (as determined under the rules of §1.267A-3(b)). *See* §1.267A-4(b)(2)(iv) and (c)(3)(v)(C). However, in the case of a disqualified hybrid amount of a CFC that is only partially owned by tax residents of the United States (or a disqualified hybrid amount a deduction for which would be allocated and apportioned to income not subject to U.S. tax), only a portion of the disqualified hybrid amount prevents a payment of the CFC from giving rise to a hybrid deduction or a funded taxable payment, as disallowing the CFC a deduction for the disqualified hybrid amount will only partially increase the U.S. tax base (or will not increase the U.S. tax base at all). *See* §1.267A-4(g). A new example illustrates these rules. *See* §1.267A-6(c)(11).

#### 4. Setoff Rules

##### i. Funded taxable payments

Under the proposed regulations, for an imported mismatch payment to indirectly fund a hybrid deduction, the imported mismatch payee must directly or indirectly make a funded taxable payment to the tax resident or taxable branch that incurs the hybrid deduction. *See* proposed §1.267A-4(c)(3). A comment requested that the final regulations clarify that, for

a payment to be a funded taxable payment, it must be included in income of a tax resident or taxable branch. The Treasury Department and the IRS agree with the comment and the final regulations thus provide a clarification to this effect. *See* §1.267A-4(c)(3)(v)(B).

##### ii. Hybrid deduction first offsets imported mismatch payment with closest nexus to deduction

Under the proposed regulations, when there are multiple imported mismatch payments, a hybrid deduction is first considered to offset income attributable to the imported mismatch payment that has the closest nexus to the hybrid deduction. *See* proposed §§1.267A-4(c)(2) and 1.267A-6(c)(10). For example, in the case of two imported mismatch payments, one of which is made pursuant to a transaction entered into pursuant to the same plan pursuant to which the hybrid deduction is incurred (a “factually-related imported mismatch payment”) and the other of which is not a factually-related imported mismatch payment, the hybrid deduction is first considered to offset income attributable to the factually-related imported mismatch payment. As an additional example, in the case of two imported mismatch payments, one of which is directly connected to a hybrid deduction (because the imported mismatch payee with respect to the payment is the tax resident or taxable branch that incurs the hybrid deduction) and the other of which is indirectly connected to the hybrid deduction (because the imported mismatch payee with respect to the payment makes a funded taxable payment to the tax resident or taxable branch that incurs the hybrid deduction), the hybrid deduction is first considered to offset income attributable to the imported mismatch payment that is directly connected to the hybrid deduction.

The final regulations retain this approach and provide two clarifications. First, the final regulations clarify that an imported mismatch payment is a factually-related imported mismatch payment – and therefore is given priority in terms of funding the hybrid deduction over other imported mismatch payments – only if a design of the plan or series of related transactions pursuant to which the hybrid

deduction is incurred was for the hybrid deduction to offset income attributable to the payment. *See* §1.267A-4(c)(2)(i).

Second, the final regulations clarify that when there are multiple imported mismatch payments that are indirectly connected to the tax resident or taxable branch that incurs the hybrid deduction, the hybrid deduction is first considered to offset income attributable to an imported mismatch payment that is connected, through the fewest number of funded taxable payments, to the tax resident or taxable branch that incurs the hybrid deduction. *See* §1.267A-4(c)(3)(vii) and (viii). For example, in the case of back-to-back imported mismatch payments, the first such payment is given priority over more removed imported mismatch payments.

### iii. Relatedness requirement

Under the proposed regulations, a hybrid deduction offsets income attributable to an imported mismatch payment only if the tax resident or taxable branch that incurs the hybrid deduction is related to the imported mismatch payer (or is a party to a structured arrangement pursuant to which the payment is made). *See* proposed §1.267A-4(a). A comment requested that, for an imported mismatch payment to indirectly fund a hybrid deduction and thus be offset by the deduction, the imported mismatch payee (and, if applicable, each intermediary tax resident or taxable branch in the chain of funded taxable payments) must be related to the imported mismatch payer (or a party to a structured arrangement pursuant to which the payment is made). The Treasury Department and the IRS agree with the comment and the final regulations therefore provide rules to this effect. *See* §1.267A-4(c)(3)(ii) and (iv).

## 5. Coordination with Foreign Imported Mismatch Rules

### i. Certain payments deemed to be imported mismatch payments

The proposed regulations coordinate the U.S. imported mismatch rule with foreign imported mismatch rules, in order to prevent the same hybrid deduction from resulting in deductions for non-hybrid payments being disallowed under

imported mismatch rules in more than one jurisdiction. In general, the proposed regulations do so through a special rule pursuant to which certain payments by non-specified parties are deemed to be imported mismatch payments (the “Deemed IMP Rule”). *See* proposed §1.267A-4(f). In certain cases, the effect of the Deemed IMP Rule is that the rule reduces the extent to which a payment of a specified party is considered to fund a hybrid deduction (and therefore reduces the extent to which the hybrid deduction is considered to offset the income attributable to the imported mismatch payment). For example, a hybrid deduction may be considered directly funded by a payment of a non-specified party, rather than indirectly funded by a payment of a specified party; or, a hybrid deduction may be considered pro rata funded by a payment of a specified party and a payment of a non-specified party, rather than solely funded by the payment of the specified party. Under the proposed regulations, the Deemed IMP Rule applies only to payments by a tax resident or taxable branch the tax law of which contains hybrid mismatch rules, and only to the extent that pursuant to an imported mismatch rule under such tax law, the tax resident or taxable branch is denied a deduction for all or a portion of the payment.

Comments recommended modifying the Deemed IMP Rule so that it takes into account payments subject to disallowance under a foreign imported mismatch rule, rather than payments a deduction for which is actually denied under the foreign imported mismatch rule. According to a comment, this would obviate the need for taxpayers to apply all foreign imported mismatch rules before the U.S. imported mismatch rule, determine which payments are ones for which a deduction is disallowed under the foreign rules, and then treat those payments as imported mismatch payments for purposes of the U.S. imported mismatch rule.

The Treasury Department and the IRS generally agree with these comments and the final regulations therefore modify the Deemed IMP Rule to this effect. *See* §1.267A-4(f)(2). However, as discussed in part III.D.5.ii of this Summary of Comments and Explanation of Revisions section, the final regulations adjust the application of the imported mismatch

rule in certain cases, in order to prevent the Deemed IMP Rule from giving rise to inappropriate results.

### ii. Special rules for applying imported mismatch rule

In cases in which the U.S. imported mismatch rule treats a deduction as a hybrid deduction but a foreign imported mismatch rule does not, the Deemed IMP Rule could give rise to inappropriate results. For example, consider a case in which FW, a tax resident of Country W, owns all the interests of FX, a tax resident of Country X, which owns all the interests of FZ, a tax resident of Country Z (the tax law of which contains hybrid mismatch rules), and FZ owns all the interests of US1, a domestic corporation. Assume that US1 makes a non-hybrid interest payment to FZ (which FZ includes in income), FZ makes a non-hybrid interest payment to FX (which FX includes in income), FX makes a payment to FW that is considered a hybrid deduction for purposes of the U.S. imported mismatch rule, and no other payments are made during the accounting period. Further, assume that FZ’s payment is subject to disallowance under the Country Z imported mismatch rule, but that the Country Z imported mismatch rule does not treat FX’s deduction as a hybrid deduction (for example, because it is with respect to an interest-free loan). If pursuant to the Deemed IMP Rule FZ’s payment were deemed to be an imported mismatch payment, then, given that FZ’s payment has a closer nexus to FX’s hybrid deduction than US1’s payment, the hybrid deduction would, for purposes of the U.S. imported mismatch rule, offset only the income attributable to FZ’s payment. The Deemed IMP Rule would thus lead to neither the United States nor Country Z neutralizing the D/NI outcome produced by the hybrid arrangement, thereby creating a result contrary to the purpose of the rule.

To address this concern, the final regulations provide that the U.S. imported mismatch rule is first applied by taking into account only certain hybrid deductions – that is, deductions that are unlikely to be treated as hybrid deductions for purposes of a foreign hybrid mismatch rule. *See* §1.267A-4(f)(1). The final regulations provide an exclusive list of such hybrid

deductions, which covers the hybrid deductions similar to those on the list discussed in part III.D.3.i of this Summary of Comments and Explanation of Revisions section. *See id.* In addition, for purposes of applying the imported mismatch rule in this manner, the Deemed IMP Rule does not apply. Consequently, such hybrid deductions are considered to offset only income attributable to imported mismatch payments of specified parties. This approach generally ensures that a foreign imported mismatch rule does not turn off the U.S. imported mismatch rule in cases in which the foreign imported mismatch rule is unlikely to neutralize the D/NI outcome produced by the hybrid arrangement.

For all other hybrid deductions, the imported mismatch rule is applied by taking into account the Deemed IMP Rule. *See* §1.267A-4(f)(2). This generally ensures that, for deductions that are likely to be treated as hybrid deductions for both the U.S. and a foreign imported mismatch rule, there is a coordination mechanism to mitigate the likelihood of double-tax.

iii. Payments to a country the tax law of which contains hybrid mismatch rules

Several comments suggested a special rule pursuant to which an imported mismatch payment is exempt from the U.S. imported mismatch rule if the tax law of the imported mismatch payee contains hybrid mismatch rules. According to the comments, such an approach would generally rely on an imported mismatch rule of the imported mismatch payee to neutralize the effects of offshore hybrid arrangements that have a closer nexus to the country of the imported mismatch payee than the United States.

The final regulations do not incorporate a special rule to this effect because the Treasury Department and the IRS have determined that such a rule could give rise to inappropriate results similar to those discussed in part III.D.5.ii of this Summary of Comments and Explanation of Revisions section. In addition, the Treasury Department and the IRS have concluded that when the U.S. imported mismatch rule is applied by taking into account the Deemed IMP Rule, the Deemed IMP Rule – in conjunction with other portions

of the imported mismatch rule, such as the ordering and funding rules (including the waterfall approach) – generally obviates the need for the special rule. That is, when a hybrid deduction has a closer nexus to the country of the imported mismatch payee than the United States, the hybrid deduction is generally considered to offset income attributable to the imported mismatch payee's payment, rather than income attributable to the specified party's payment. As a result, the U.S. imported mismatch rule in effect relies on an imported mismatch rule of the imported mismatch payee to neutralize the effect of the offshore hybrid arrangement. *See* §1.267A-6(c)(10)(iv) and (c)(12).

iv. Priority for certain amounts disallowed under foreign imported mismatch rule

One comment suggested a new coordination rule pursuant to which, to the extent that a foreign tax resident or taxable branch is disallowed a deduction for a payment under a foreign imported mismatch rule, the U.S. imported mismatch rule generally considers a hybrid deduction to offset income attributable to that payment before offsetting income attributable to other payments. Such an approach would in effect provide as a credit against the U.S. imported mismatch rule amounts disallowed under a foreign imported mismatch rule. According to the comment, such an approach would mitigate the chance of double tax and would be appropriate if the main purpose of the U.S. imported mismatch rule is to participate with the international community in neutralizing the effects of hybrid arrangements (as opposed to protecting the integrity of the U.S. tax base).

The final regulations do not adopt this comment. The Treasury Department and the IRS have concluded that when a hybrid deduction has a closer nexus to the United States than a foreign country, the U.S. imported mismatch rule – rather than the foreign imported mismatch rule – should apply to neutralize the effects of the offshore hybrid arrangement. In addition, the Treasury Department and the IRS have determined that, for purposes of administrability, the U.S. imported mismatch rule should not require an analysis

of amounts actually disallowed under a foreign imported mismatch rule. *See also* part III.D.5.i of this Summary of Comments and Explanation of Revisions section.

E. Other issues

1. Definition of Interest

As explained in the preamble to the proposed regulations, the definition of interest in proposed §1.267A-5(a)(12) is based on, and is similar in scope as, the definition of interest contained in the proposed regulations under section 163(j); no comments were received on this definition. However, the Treasury Department and IRS received numerous comments on the definition of interest in the proposed regulations under section 163(j). Taking into account those comments, the final regulations modify the definition of interest for section 267A purposes in certain respects. For example, in view of comments recommending modification of the hedging rules, the final regulations under section 267A do not include rules requiring adjustments to the amount of interest expense to reflect the impact of derivatives that alter a taxpayer's effective cost of borrowing. *See* §1.267A-5(a)(12). As another example, in view of comments regarding the treatment of swaps with non-periodic payments, the final regulations provide exceptions for cleared swaps and for non-cleared swaps subject to margin or collateral requirements. *See* §1.267A-5(a)(12)(ii).

2. Structured Payments Treated as Interest

In order to address certain structured transactions, the proposed regulations provide that structured payments are treated as specified payments and therefore are subject to section 267A. *See* proposed §1.267A-5(b)(5)(i). Under the proposed regulations, structured payments include certain payments related to, or predominantly associated with, the time value of money, and adjustments for amounts affecting the effective cost of funds. *See* proposed §1.267A-5(b)(5)(ii). A comment noted that under the proposed regulations it is unclear in certain cases whether struc-

tured payments are treated as identical to interest for purposes of section 267A. The comment suggested that the final regulations address this ambiguity, including by providing that structured payments are treated as identical to interest or including structured payments within the definition of interest. The Treasury Department and the IRS agree with the comment, and thus the final regulations clarify that structured payments are treated as identical to interest for purposes of section 267A. *See* §1.267A-5(b)(5)(i).

In addition, the final regulations modify the definition of a structured payment in light of comments that the Treasury Department and the IRS received regarding the definition of interest in the proposed regulations under section 163(j). Under proposed §1.267A-5(b)(5)(ii), certain amounts that are closely related to interest and that affect the economic cost of funds, such as commitment fees, debt issuance costs, and guaranteed payments, are treated as structured payments. The final regulations do not specifically include these items as part of the definition of structured payments; instead, the final regulations provide an anti-avoidance rule under which any expense or loss that is economically equivalent to interest is treated as a structured payment for purposes of section 267A if a principal purpose of structuring the transaction is to reduce an amount incurred by the taxpayer that otherwise would have been treated as interest or as a structured payment under §1.267A-5(a)(12) or (b)(5)(ii). *See* §1.267A-5(b)(5)(ii)(B).

### 3. Coordination with Capitalization and Recovery Provisions

A comment noted that in certain cases a structured payment may not be deductible under the Code and, instead, the payment may be capitalized and give rise to amortization or depreciation deductions. The comment suggested that the final regulations clarify how section 267A applies to such payments, including whether the payments are treated as “paid or accrued” for purposes of the regulations and whether amortization or depreciation deductions for the payments are subject to disallowance under section 267A. The comment asserted that the disallowance of deduc-

tions relating to capitalized costs should be limited to structured payments.

The final regulations provide that section 267A applies to a structured payment, including a capitalized cost, in the same manner as if it were an amount of interest paid or accrued. *See* §1.267A-5(b)(5)(i). In addition, the final regulations coordinate section 267A with the capitalization and recovery provisions of the Code. *See* §1.267A-5(b)(1)(iii). Pursuant to this rule, to the extent a specified payment is described in §1.267A-1(b) (that is, a disqualified hybrid amount, a disqualified imported mismatch amount, or one to which the section 267A anti-avoidance rule applies), a deduction for the payment is considered permanently disallowed for all purposes of the Code and, therefore, the payment is not taken into account for purposes of any capitalization and recovery provision. *See id.* *But see* §1.267A-5(b)(4) (a payment for which a deduction is disallowed may still reduce the corporation’s earnings and profits). This rule is not limited to structured payments because the Treasury Department and the IRS have determined that, if the rule were so limited, deductions for other specified payments could inappropriately give rise to D/NI outcomes through, for example, depreciation or amortization deductions.

## 4. Structured Arrangements

### i. Definition

Under the proposed regulations, an arrangement is a structured arrangement if either (i) a pricing test is satisfied, meaning that a hybrid mismatch is priced into the terms of the arrangement, or (ii) a principal purpose test is satisfied, meaning that, based on all the facts and circumstances, a hybrid mismatch is a principal purpose of the arrangement. *See* proposed §1.267A-5(a)(20).

A comment suggested that the principal purpose test could be difficult to apply, as it requires a subjective analysis of actual motivation or intent. In addition, the comment noted that in certain cases it might not be clear whose actual motivation or intent controls for purposes of the test. Thus, the comment suggested replacing the principal purpose test with an objective test, such as a test that analyzes

whether the arrangement was designed to produce the hybrid mismatch. Further, the comment suggested incorporating a “reason to know” standard into the structured arrangement rules, such that a tax resident or taxable branch would not be considered a party to a structured arrangement if the tax resident or taxable branch (or a related party) could not reasonably have been expected to be aware of the hybrid mismatch. Lastly, the comment noted that having a pricing test as an independent test could potentially lead to confusion if the other test (that is, the principal purpose test or the design test) also takes into account pricing considerations.

The Treasury Department and the IRS agree with this comment. Thus, the final regulations provide for an objective design test, incorporate a reason to know standard, and incorporate the pricing test into the design test. *See* §1.267A-5(a)(20).

### ii. Applicability date

A comment asserted that it may be difficult or costly to unwind a structured arrangement between unrelated parties. In order to facilitate restructuring of these arrangements, the comment suggested transitional relief for specified payments made pursuant to structured arrangements entered into on or before December 20, 2018 (or, alternatively, before December 22, 2017, the date of the Act). For example, the comment suggested that specified payments made pursuant to such arrangements be subject to section 267A beginning January 1, 2021.

The Treasury Department and the IRS have determined that, to facilitate restructurings intended to eliminate or minimize hybridity for structured arrangements entered into before December 22, 2017, the final regulations should apply to specified payments made pursuant to such an arrangement only for taxable years beginning after December 31, 2020. The final regulations therefore provide a rule to this effect. *See* §1.267A-7(b)(2).

## 5. De Minimis Exception

The proposed regulations include a de minimis exception that exempts a specified party from the application of section 267A for any taxable year for which the



sum of the specified party's interest and royalty deductions (plus interest and royalty deductions of any related specified parties) is below \$50,000. *See* proposed §1.267A-1(c). This \$50,000 threshold takes into account a specified party's interest or royalty deductions without regard to whether the deductions involve hybrid arrangements and therefore, absent the de minimis exception, would be disallowed under section 267A. *See id.*

A comment suggested that the \$50,000 threshold instead should apply to the total amount of interest or royalty deductions involving hybrid or branch arrangements. The comment suggested that such an approach would produce more equitable results between similarly situated taxpayers. The Treasury Department and the IRS agree with the comment, and the final regulations thus modify the de minimis exception to this effect. *See* §1.267A-1(c). In addition, for purposes of clarity, and because certain specified payments may not be deductible under the Code (but, instead, may be capitalized and give rise to other deductions, such as amortization or depreciation, or loss), the final regulations replace the reference in the de minimis exception to interest or royalty deductions with a reference to specified payments.

#### 6. Tax Law of a Country

The proposed regulations define a tax law of a country to include statutes, regulations, administrative or judicial rulings, and treaties of the country. *See* proposed §1.267A-5(a)(21). However, as discussed in part II.B.7 of this Summary of Comments and Explanation of Revisions section, the Treasury Department and the IRS have determined that it is appropriate to take into account a country's subnational tax laws when such laws impose income taxes that are covered taxes under an income tax treaty with the United States (and therefore are likely to comprise a significant amount of a taxpayer's overall tax burden in that country). The final regulations therefore provide that the tax law of a country includes the tax law of a political subdivision or other local authority of a country, provided that income taxes imposed under such a subnational tax law are covered by an income tax treaty be-

tween that country and the United States. *See* §1.267A-5(a)(21).

#### 7. Specified Parties

Under the proposed regulations, a specified party includes a CFC for which there are one or more U.S. shareholders that own (within the meaning of section 958(a)) at least ten percent of the stock of the CFC. *See* proposed §1.267A-5(a)(17). However, the Treasury Department and the IRS have determined that in certain cases involving CFCs the definition of specified party could be overbroad. For example, under the proposed regulations, a CFC wholly owned by a domestic partnership is a specified party, even if all the partners of the partnership are foreign persons.

The final regulations thus provide that a CFC is a specified party only if there is a tax resident of the United States that, for purposes of sections 951 and 951A, owns (within the meaning of section 958(a), but for this purpose treating a domestic partnership as foreign) at least ten percent of the stock of the CFC. The Treasury Department and the IRS expect that when proposed regulations under section 958 (REG-101828-19, 84 FR 29114) are finalized, the rule described in the preceding sentence treating a domestic partnership as foreign will be removed, as it will no longer be necessary. *See* proposed §1.958-1(d)(1).

#### 8. Coordination with Section 163(j)

The proposed regulations provide a rule to coordinate section 267A with other provisions of the Code. *See* proposed §1.267A-5(b)(1). A comment requested that the final regulations clarify that section 267A applies to a specified payment before section 163(j) applies to the payment.

The final regulations provide a clarification to this effect. *See* §1.267A-5(b)(1)(ii). In addition, the final regulations clarify that to the extent a specified payment is not described in §1.267A-1(b) at the time it is subject to section 267A, the payment is not again subject to section 267A at a subsequent time. *See* §1.267A-5(b)(1)(i). For example, if for the taxable year in which a specified pay-

ment is paid the payment is not described in §1.267A-1(b) but under section 163(j) a deduction for the payment is deferred, the payment is not again subject to section 267A in the taxable year for which section 163(j) no longer defers the deduction.

#### 9. Anti-Avoidance Rule

The proposed regulations include an anti-avoidance rule, which provides that a specified party's deduction for a specified payment is disallowed to the extent it gives rise to a D/NI outcome, and a principal purpose of the plan or arrangement is to avoid the purposes of the regulations under section 267A. *See* proposed §1.267A-5(b)(6).

One comment supported a purpose-based anti-avoidance rule, in general, but questioned whether the rule was appropriate in the context of the section 267A regulations – which sets forth detailed rules regarding the hybrid or branch arrangements addressed by section 267A – and whether the rule appropriately balances fairness and administrability. The comment also raised concerns that the anti-avoidance rule may be overly broad because it neither requires hybridity nor that the D/NI outcome be the cause of hybridity. Finally, the comment requested a clearer distinction between the structured arrangement rule and the anti-avoidance rule, and recommended that the anti-avoidance rule focus on the use of a specific structure or terms in order to accomplish a D/NI outcome while avoiding the application of the regulations.

The Treasury Department and the IRS have determined that it is appropriate for the final regulations to retain a general anti-avoidance rule because, even in the context of specific rules that target hybrid and branch arrangements, such rules might be circumvented in a manner that is contrary to the purposes of the section 267A regulations. However, the Treasury Department and the IRS agree with the comment that the anti-avoidance rule should focus on the terms or structure of an arrangement and require that the D/NI outcome produced is a result of a hybrid or branch arrangement. The final regulations thus provide rules to this effect. *See* §1.267A-5(b)(6).

## 10. Effect of Disallowance on Earnings and Profits

The proposed regulations provide that the disallowance of a deduction under section 267A does not affect a corporation's earnings and profits. *See* proposed §1.267A-5(b)(4). Thus, a corporation's earnings and profits may be reduced as a result of a specified payment for which a deduction is disallowed under section 267A. One comment stated that this rule is generally appropriate. However, the comment questioned whether the rule is appropriate in the context of a CFC, as the reduction of the CFC's earnings and profits may, because of the limit in section 952(c)(1), limit or prevent a subpart F inclusion with respect to the CFC, thereby negating the effect of disallowing the CFC's deduction.

The Treasury Department and the IRS agree with the comment and, accordingly, the final regulations adopt an anti-avoidance rule. *See* §1.267A-5(b)(4). Pursuant to this rule, for purposes of section 952(c)(1) or §1.952-1(c), a CFC's earnings and profits are not reduced by a specified payment for which a deduction is disallowed if a principal purpose of the transaction giving rise to the specified payment is to reduce or limit the CFC's subpart F income. *See id.*

### IV. Comments and Revisions to Dual Consolidated Loss Rules and Entity Classification Rules

#### A. Domestic reverse hybrids

To address double-deduction outcomes that result from domestic reverse hybrid structures, the proposed regulations require, as a condition to a domestic entity electing to be treated as a corporation under §301.7701-3(c), that the domestic entity agree to be treated as a dual resident corporation for purposes of section 1503(d) for taxable years in which certain requirements are satisfied. *See* proposed §301.7701-3(c)(3).

A comment agreed with the policy rationale for subjecting domestic reverse hybrids to the section 1503(d) regulations, and recommended that losses of domestic reverse hybrids be treated as dual consolidated losses. However, the comment

expressed concern that the approach of the proposed regulations might establish a precedent allowing for a check-the-box election to be conditioned on consenting to any rule, which the comment asserted would be contrary to sound tax policy. Nonetheless, the comment stated that the section 1503(d) regulations are closely connected to the check-the-box regime, and acknowledged that a consent approach had been noted in a comment on regulations under section 1503(d) that were proposed in 2005. *See* TD 9315, 74 FR 12902. The comment recommended that, rather than the approach of the proposed regulations, the Treasury Department and the IRS directly subject domestic reverse hybrids to section 1503(d) or, if the Treasury Department and the IRS were to determine that there is not sufficient authority to do so, seek a legislative amendment.

The Treasury Department and the IRS have determined that it is appropriate to condition a check-the-box election on consenting to be subject to the section 1503(d) regulations because the double-deduction concerns that result from domestic reverse hybrid structures are closely connected to the check-the-box regime. Moreover, as explained in the preamble to the proposed regulations, the approach of the proposed regulations is narrowly tailored such that the consent applies only for taxable years in which it is likely that losses of the domestic consenting corporation could result in a double-deduction outcome. The Treasury Department and the IRS have therefore determined that the approach of the proposed regulations is appropriate and consistent with ensuring that the check-the-box regime does not result in double-deduction outcomes. Accordingly, the final regulations retain the approach of the proposed regulations regarding domestic reverse hybrids.

#### B. Disregarded payments made to domestic corporations

The preamble to the proposed regulations describes certain structures involving payments from foreign disregarded entities to their domestic corporate owners that are regarded for foreign tax purposes but disregarded for U.S. tax purposes. The preamble notes that these disregarded payment structures are not addressed un-

der the current section 1503(d) regulations but give rise to significant policy concerns that are similar to those arising under sections 245A(e), 267A, and 1503(d). In addition, the preamble states that the Treasury Department and the IRS are studying these structures and request comments. In response to this request, one comment was received.

The Treasury Department and the IRS continue to study disregarded payment structures and the comment, and may in the future issue guidance addressing these structures. In addition, the Treasury Department and the IRS are studying other issues and comments received regarding the section 1503(d) regulations, such as an issue involving the interaction of the section 1503(d) regulations and the matching rule under §1.1502-13(c).

### Special Analyses

#### I. Regulatory Planning and Review – Economic Analysis

Executive Orders 13771, 13563, and 12866 direct agencies to assess costs and benefits of available regulatory alternatives and, if regulation is necessary, to select regulatory approaches that maximize net benefits (including potential economic, environmental, public health and safety effects, distributive impacts, and equity). Executive Order 13563 emphasizes the importance of quantifying both costs and benefits, of reducing costs, of harmonizing rules, and of promoting flexibility. For purposes of Executive Order 13771, this rule is regulatory.

The Office of Information and Regulatory Affairs has designated the proposed regulations as significant under section 1(b) of the Memorandum of Agreement between the Treasury Department and the Office of Management and Budget (OMB) regarding review of tax regulations (April 11, 2018). Accordingly, the OMB has reviewed the final regulations.

#### A. Background

Multinational corporations (MNCs) that have operations in both the U.S. and foreign countries can engage in so-called "hybrid arrangements." In some instances, the MNC structures its U.S. and foreign

operations in a way that exploits differences between foreign tax rules and U.S. tax rules. By using particular organizational structures or financial instruments, the MNC can avoid paying taxes in one or both jurisdictions. Hybrid arrangements refer to particular strategies for achieving this type of tax outcome.

Hybrid arrangements may be “hybrid entities” or “hybrid instruments.” A hybrid entity is a business that is treated as a flow-through or so-called disregarded entity for U.S. tax purposes and as a corporation for foreign tax purposes. A “reverse hybrid entity” is a business that is treated as a corporation for U.S. tax purposes, but as a flow-through entity for foreign tax purposes. For example, a foreign parent could own a domestic limited liability partnership that elects to be treated as a corporation under U.S. tax law<sup>4</sup> but is viewed as a partnership under foreign tax law. In this situation, the domestic subsidiary could be entitled to a deduction for U.S. tax purposes for interest payments it makes to the foreign parent, but the foreign country would not tax the interest income of the foreign parent because it treats it as payment between a partnership and a partner. In plain language, the result is that this portion of income would not be taxed in either country. This outcome is possible because of both the difference in the recognized business structure across countries (for the same business) and differences in the tax treatment applied to different business structures.

A similar result is possible under a hybrid instrument. A hybrid instrument is a financial instrument with characteristics of both debt and equity. Because the instrument has a mix of characteristics, one country may treat the instrument as debt while another country may treat it as equity. An example is “perpetual debt,” which the United States generally treats as equity and which many other countries treat as debt. If a foreign affiliate of a U.S.-based MNC issues perpetual debt to a U.S. holder, the interest payments made to the U.S. holder would be tax deductible in the foreign jurisdiction (if the foreign country treats perpetual debt as debt) and could potentially be eligi-

ble for a dividends received deduction (DRD) in the United States, which treats perpetual debt as equity. Again, the result is that this portion of income would not be taxed in either country. The double non-taxation produced by hybrid instruments or deductible payments made by or to a hybrid entity is often referred to as a “deduction/no-inclusion outcome” (D/NI outcome).

The Act introduced two new provisions that affect the treatment of these hybrid arrangements. New section 245A(e) disallows the DRD for any dividend received by a U.S. shareholder from a controlled foreign corporation if the dividend is a hybrid dividend. In addition, section 245A(e) treats hybrid dividends between controlled foreign corporations with a common U.S. shareholder as subpart F income. The statute defines a hybrid dividend as an amount received from a controlled foreign corporation for which a deduction would be allowed under section 245A(a) and for which the controlled foreign corporation received a deduction or other tax benefit in a foreign country. The disallowance of the DRD for hybrid dividends and the treatment of hybrid dividends as subpart F income neutralize the D/NI outcome produced by hybrid dividends.

The Act also added section 267A of the Code, which denies a deduction for any disqualified related party amount paid or accrued as a result of a hybrid transaction or by, or to, a hybrid entity. The statute defines a disqualified related party amount as any interest or royalty paid or accrued to a related party where there is no corresponding inclusion to the related party in the foreign tax jurisdiction or where the related party is allowed a deduction with respect to such amount in the foreign tax jurisdiction. The statute’s definition of a hybrid transaction is any transaction where there is a mismatch in tax treatment between the U.S. and the other foreign jurisdiction. Similarly, a hybrid entity is any entity which is treated as fiscally transparent (that is, a flow-through or disregarded entity) for U.S. tax purposes but not for purposes of the foreign tax jurisdiction, or vice versa. The statute provides regulatory authority to address overly broad

or under-inclusive applications of section 267A.

The Treasury Department and the IRS previously issued proposed regulations under sections 245A(e), 267A, 1503(d), 6038, 6038A, 6038C, and 7701 on December 20, 2018.

## B. Overview of the final regulations

These final regulations provide clarity to taxpayers regarding the determination and tracking of hybrid dividends. They also provide clarity and guidance on the disallowance of deductions for interest or royalties paid as a result of hybrid or branch arrangements.

### 1. Section 245A(e)

Section 245A(e) applies in certain cases in which a CFC pays a hybrid dividend, which is a dividend paid by the CFC for which the CFC received a deduction or other tax benefit under foreign tax law (a hybrid deduction). The proposed regulations provide rules for identifying hybrid deductions and hybrid dividends. They further require taxpayers to maintain “hybrid deduction accounts” by which taxpayers would track those hybrid deductions. These accounts would allow for CFCs to track the amounts of hybrid deductions across sources and years and properly reduce the amounts when they are considered to give rise to inclusions under U.S. tax law. The final regulations largely retain the decisions made in the proposed regulations and provide additional clarity on what is a hybrid deduction and how the hybrid deduction account rules operate.

### 2. Section 267A

Section 267A disallows a deduction for interest or royalties paid or accrued in certain transactions involving a hybrid arrangement. Congress intended this provision to address cases in which the taxpayer is provided a deduction under U.S. tax law, but the payee does not have a corresponding income inclusion under foreign tax law (the D/NI outcome). See S. Comm. on the Budget, Reconciliation Recommenda-

<sup>4</sup>Treasury and IRS regulations contain a so-called “check-the-box” provision under which certain taxpayers can choose whether they are treated as a corporation or as a partnership or disregarded entity. It is this election that facilitates the creation of hybrid entities.

tions Pursuant to H. Con. Res. 71, S. Print No. 115-20, at 389 (2017).

The proposed regulations disallow a deduction under section 267A only to the extent that the D/NI outcome is a result of a hybrid arrangement. Consistent with the grant of regulatory authority to address overly broad applications of section 267A, the proposed regulations provide several exceptions to section 267A in order to refine the scope of the provision and minimize burdens on taxpayers, and further provide de minimis rules that exempt small taxpayers from section 267A. Finally, the proposed regulations address the treatment of a comprehensive set of arrangements that give rise to D/NI outcomes to close off potential avenues for additional tax avoidance by applying the rules of section 267A to branch mismatches, reverse hybrids, certain transactions with unrelated parties that are structured to achieve D/NI outcomes, certain structured transactions involving amounts similar to interest, and imported mismatches. The final regulations largely retain these decisions while providing additional clarity for taxpayers.

### C. Need for the final regulations

Because the Act introduced new sections to the Code to address hybrid entities and hybrid instruments, a number of the relevant terms and necessary calculations that taxpayers are currently required to apply under the statute can benefit from greater specificity. The final regulations provide taxpayers with interpretive guidance and clarifications on which types of arrangements are subject to the statute and the effect of the application of the statute to such arrangements.

### D. Economic analysis

#### 1. Baseline

The Treasury Department and the IRS have assessed the benefits and costs of the final regulations relative to a no-action baseline reflecting anticipated Federal in-

come tax-related behavior in the absence of these regulations.

#### 2. Summary of Economic Effects

These final regulations provide certainty and clarity to taxpayers regarding (i) the determination and tracking of hybrid dividends; and (ii) the deductibility of interest or royalties paid as a result of hybrid or branch arrangements. In the absence of this clarity, the likelihood that different taxpayers would interpret the rules regarding hybrid payments differently would be exacerbated. In general, overall economic performance is enhanced when businesses face more uniform signals about tax treatment. Certainty and clarity over tax treatment generally also reduce compliance costs for taxpayers.

For those statutory provisions for which similar taxpayers would generally adopt similar interpretations of the statute even in the absence of guidance, the final regulations provide value by helping to ensure that those interpretations are consistent with the intent and purpose of the statute. For example, the final regulations may specify a tax treatment that few or no taxpayers would adopt in the absence of specific guidance.

The Treasury Department and the IRS projected that the proposed regulations would have annual economic effects of less than \$100 million (2018\$) if they were to be finalized. The final regulations differ from the proposed regulations primarily by incorporating certain changes that reduce administrative and compliance costs (relative to the proposed regulations) without substantially altering the final regulations' effectiveness (with regard to the intent and purpose of the statute). The assessment that the annual economic effects of the final regulations will be less than \$100 million, relative to the no-action baseline, is unchanged.

The Treasury Department and the IRS undertook a rough estimate of the economic effects of the final regulations. As explained later, we estimate that roughly 9,000 unique taxpayers are potentially

affected by the regulations. We assumed that the effect of the final regulations would be the denial of between 1 and 4 percent of the interest paid deductions by these potentially affected taxpayers; these are deductions that we assumed would be denied beyond those that would be disallowed under the no-action baseline.<sup>5</sup> The Treasury Department and the IRS note that because the presence of a hybrid arrangement is not reported on a tax return, we do not have any specific data on the percent of interest paid deductions that are not allowed by the statute nor on the incremental portion of deductions that would not be allowed specifically by these final regulations. We further do not have readily available data or results from the academic literature to determine whether the assumed 1 to 4 percent range is accurate. We have selected these percentages to illustrate a plausible calculation of the final regulations' economic effects.<sup>6</sup>

We assume that taxpayers will respond to the disallowance of hybrids by substituting towards other tax-reduction strategies. These strategies must necessarily be less beneficial to the taxpayer than the hybrid arrangements because otherwise the taxpayer would have adopted those strategies under the baseline. The Treasury Department and the IRS do not have readily available data or models to estimate the cost or availability of these tax strategies for particular taxpayers. In this exercise for the final regulations, we assume that taxpayers will effectively continue to be able to claim between 85 to 100 percent of the disallowed interest deductions through alternative tax-reduction strategies. This results in a net disallowance of interest deductions of between 0 and 0.6 percent.

We next applied Treasury Department models to confidential tax data for tax year 2017 to calculate average effective tax rates for these potentially affected taxpayers.<sup>7</sup> Because taxpayers are assumed to be unable to fully offset the disallowed interest deductions under the final regulations, their effective tax rates will rise. We modeled taxpayers' average effective tax rates with and without the assumed range

<sup>5</sup> While section 267A applies to both interest and royalty deductions, the Treasury Department and IRS do not have readily available data on royalty deductions.

<sup>6</sup> These percentages are comparable to estimates provided in OECD *Measuring and Monitoring BEPS, Action 11 – 2015 Final Report*. <https://doi.org/10.1787/9789264241343-en>.

<sup>7</sup> Because the most recently available complete tax data available for this exercise are from 2017, we multiplied average effective tax rates by 21/35 to reflect the 21 percent corporate tax rate that applies to these final regulations relative to the 35 percent rate that applied in 2017. Because effective tax rates are not readily defined for taxpayers with zero or negative taxable income, our model assumes the effective rate to be the statutory rate for those taxpayers.

of denied interest paid deductions that would result from the final regulations to estimate the changes in effective tax rates attributable to the final regulations.

As a final step, we applied an estimate of the semi-elasticity of taxable income (0.2) to the range of estimated increases in the effective tax rates.<sup>8</sup> The result is an estimate of the reduction in taxable income for these taxpayers that results from their response to higher effective tax rates.

Based on these assumptions and modeling, the Treasury Department and the IRS estimate that the change in economic activity as a result of these final regulations, relative to the no-action baseline, is a decline of between \$0 and \$83 million (2019\$) per year, with this number growing over time at the real rate of growth of taxable income.

This approach does not capture many other important economic effects of the final regulations: (1) Under this approach, there is an increase in Federal tax revenue relative to the no-action baseline but the calculations do not include the effect of this increase on the rest of the United States economy. For example, an increase in Federal tax revenue resulting from these final regulations would either reduce the deficit or allow reductions in other taxes, and these changes would have their own set of economic effects. Incorporating these effects would reduce the net decline in economic activity that we estimate. Indeed, if the elasticity of taxable income were the same across all taxpayers and if Federal tax revenue were held constant, the particular economic effects estimated here would be zero except for any change in compliance costs, relative to the baseline.

(2) This estimate does not account for the improved efficiency in the affected sectors that would result from the certainty and clarity provided by the final regulations, relative to the no-action baseline. Incorporating this factor would reduce the net decline in economic activity that we estimate and could lead the average estimate of economic effects to be positive rather than negative.

(3) Finally, this estimate does not include any reduction in economically wasteful planning and monitoring (by taxpayers) of the amount of foregone hybrid arrangements. To the extent that taxpayers use hybrid arrangements solely for tax shifting and those arrangements are economically unproductive, our assumed range should include a negative end; that is, there may be an increase in real economic activity as a result of the final regulations. Incorporating this effect would reduce the net decline in economic activity that we estimate.

The Treasury Department and the IRS have not undertaken more precise quantitative estimates of the economic effects of the final regulations because we do not have readily available data or models to estimate with reasonable precision (i) the types or volume of hybrid arrangements that taxpayers would likely use under these regulations, under the no-action baseline, or under alternative regulatory approaches; nor (ii) the effects of those hybrid arrangements on businesses' overall economic performance, including possible differences in compliance costs.

In the absence of such quantitative estimates, the Treasury Department and the IRS have undertaken a qualitative analysis of the economic effects of the final regulations relative to the no-action baseline and relative to alternative regulatory approaches. This analysis is presented in part I.D.4 of this Special Analyses section.

### 3. Number and Characteristics of Affected Taxpayers

The Treasury Department and the IRS project that the upper bound of taxpayers likely to be affected by section 245A(e) is 2,000 and the upper bound likely to be affected by section 267A is 8,000.<sup>9</sup> These estimates are based on the top 10 percent of taxpayers (by gross receipts) that filed a domestic corporate income tax return with a Form 5471 attached (therefore potentially affected by section 245A(e)), or that filed a domestic corporate income tax return with a Form 5472, "Information

Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business," or Form 8865, "Return of U.S. Persons With Respect to Certain Foreign Partnerships," attached or a foreign corporate income tax return with a Form 5472 attached (therefore potentially affected by section 267A) for tax year 2017.<sup>10</sup> These estimates are upper bounds of the number of large corporations affected because they are based on all transactions, even though only a portion of such transactions involve hybrid arrangements. The tax data do not report whether these reported dividends or deductions were part of a hybrid arrangement because such information was not relevant for calculating tax prior to the Act.

The Treasury Department and the IRS also projected the types of taxpayers affected. We project that the population of taxpayers affected by section 267A and the final regulations under section 267A will seldom include U.S.-based companies as these companies are taxed under the new GILTI regime as well as subpart F. Instead, section 267A and the final regulations apply predominantly to U.S. affiliates of foreign-headquartered companies that employ hybrid arrangements to shift income out of the U.S. The Treasury Department and the IRS project that section 245A(e) applies primarily to U.S.-based companies. The amounts of dividends affected, however, are not likely to be large because a large portion of distributions will be treated as previously taxed earnings and profits due to the operation of both the GILTI regime and the transition tax under section 965, and such distributions are not subject to section 245A(e).

### 4. Economic Effects of Specific Provisions

#### i. Delayed basis for hybrid deduction characterizations

In the proposed regulations under section 245A(e), taxpayers were instructed

<sup>8</sup>The semi-elasticity measures the percent change in taxable income that results from a one percentage point change in the effective tax rate. The parameter used for this exercise reflects the fact that this income is generally considered to be a supernormal return to investment. Supernormal income is highly inelastic.

<sup>9</sup>Approximately 1,000 taxpayers are affected by both sections, so the number of taxpayers affected by at least one provision is approximately 9,000.

<sup>10</sup>Because of the complexities involved, primarily only large taxpayers engage in hybrid arrangements. The estimate that the top 10 percent of otherwise-relevant taxpayers (by gross receipts) are likely to engage in hybrid arrangements is based on the judgment of the Treasury Department and IRS.

that notional interest deductions (NIDs) allowed to a CFC would be considered hybrid deductions. The final regulations retain this characterization, but on a delayed basis (relative to the proposed regulations). Thus, the final regulations provide that only NIDs allowed to a CFC for taxable years beginning on or after December 20, 2018, are hybrid deductions for purposes of section 245A(e). Similarly, the final regulations provide that NIDs give rise to hybrid arrangements for section 267A purposes starting for accounting periods beginning on or after December 20, 2018. In addition, transition relief is provided for structured arrangements (that is, certain arrangements among unrelated parties) entered into before the enactment of the Act, such that section 267A does not apply to payments made pursuant to such arrangements until taxable years beginning after December 31, 2020. These delays provide affected taxpayers more time (relative to the proposed regulations) to restructure instruments, seek alternative investment arrangements, or otherwise take into account the application of the relevant rules to structured arrangements or arrangements involving NIDs. These delays may, in some circumstances, allow taxpayers to unwind current financial arrangements in a less costly way than they would if no such delay were provided.

Allowing a delay in the characterization of certain hybrid deductions will lower the compliance costs (relative to the proposed regulations) for some taxpayers. Taxpayers commented that accounting for those deductions back to the beginning of 2018 would be difficult, and the delay offered by the final regulations obviates the need to account for those deductions back to the beginning of 2018. In addition, the delay provided by the final regulations may facilitate restructurings (for example, the unwinding of certain structured arrangements) such that, following the delay, fewer taxpayers will incur hybrid deductions. However, the reduction in compliance costs (relative to the proposed regulations) as a result of that delay will only be temporary, as the regime for those instruments as specified under the proposed regulations and as retained for the final regulations will take effect after the delay period.

#### ii. De minimis exception

The proposed regulations provided a de minimis rule that exempted a specified party from the application of 267A for any taxable year in the which the sum of the party's interest and royalty deductions (plus interest and royalty deductions of certain related persons) is below \$50,000 (regardless of hybridity). The final regulations keep this threshold but specify that the deductible payments only count towards the de minimis threshold if they are from hybrid arrangements.

Without this exception, two taxpayers with the same value of hybrid deductions (under \$50,000) might be treated differently simply because one taxpayer operated in an industry with more royalties or interest payments than the other, with these royalties or interest payments arising as a normal course of business in that industry rather than as a tax-avoidance mechanism. Under the final regulations, the de minimis exception focuses only on payments the statute is looking to limit, the hybrid payments themselves, as opposed to all interest and royalties. This enhanced focus will potentially allow small firms to make decisions in their best economic interest as opposed to needing to structure contracts and payments (that did not even involve hybrid arrangements) in a way that would avoid exceeding the de minimis threshold.

This provision expands the pool of taxpayers excepted from the hybrid provisions of the statute, relative to the proposed regulations. The Treasury Department and the IRS do not have readily available data to provide a reasonably precise projection of the number of taxpayers that would be affected by the de minimis provision under the final regulations.

#### iii. Timing differences under section 245A(e)

For some taxpayers and some transactions, there may be a timing difference between when a CFC pays an amount constituting a dividend for U.S. tax purposes and when the CFC receives a deduction or other tax benefit (a hybrid deduction) for the amount in a foreign jurisdiction. Tax regulations are necessary to make clear whether a deduction is considered a hybrid deduction and thus whether a dividend is

considered a hybrid dividend in such situations. In the absence of such guidance, taxpayers could be uncertain about the tax treatment of certain dividends, an uncertainty that may result in an inefficient pattern of financing across taxpayers.

The proposed regulations addressed the timing difference by requiring the establishment of "hybrid deduction accounts" and specifying rules to be used for these accounts. These accounts are to be maintained across years so that hybrid deductions that accrue in one year will be matched up with dividends arising in a different year, thus providing clear rules for when a dividend is a hybrid dividend and generally ensuring that income is neither doubly taxed nor doubly non-taxed. The final regulations reaffirm this approach, and add additional guidance and clarifications as necessary, such as guidance regarding mid-year stock transfers and what types of deductions and other tax benefits are hybrid deductions.

The final regulations also respond to a comment that suggested that a deduction could only be a hybrid deduction if it was currently used to reduce foreign tax. The final regulations determined that such an interpretation would not be appropriate, and provide additional clarity that a deduction can be a hybrid deduction regardless of whether it is currently used under relevant foreign tax law. Were the final regulations to adopt the approach of the commenter, taxpayers would be required to undertake potentially burdensome analyses regarding the extent that a deduction is used currently under foreign tax law and, to the extent not used currently, track the deduction across other tax years so as to ensure that, when the deduction is ultimately used, it becomes a hybrid deduction at that point.

#### iv. Determination of a hybrid dividend under section 245A(e)

The proposed regulations required taxpayers to maintain hybrid deduction accounts. A hybrid deduction account generally reflects the amount of deductions or other tax benefits allowed to the CFC (or a person related to the CFC) under a foreign tax law with respect to instruments of the CFC that U.S. tax law views as stock, and thus generally reflects an amount of

earnings of a CFC sheltered from foreign tax by reason of a hybrid arrangement. The proposed regulations provided that a dividend received by a domestic corporation that is a U.S. shareholder from a CFC is a hybrid dividend to the extent of the balance of the U.S. shareholder's hybrid deduction accounts with respect to its stock of the CFC. Some comments suggested modifications to this approach. The final regulations retain the approach in the proposed regulations, with small revisions made in part to respond to certain comments.

One option for revising the approach in response to comments was to provide exceptions to the definition of a hybrid dividend such that certain dividends cannot be hybrid dividends, such as some dividends arising by reason of a transaction that under the foreign tax law does not give rise to a deduction (for example, a sale of stock that gives rise to a section 1248(a) dividend). However, the Department of Treasury and IRS decided not to adopt this approach because the dividend, to the extent of the balance of the hybrid deduction accounts, is likely composed of earnings that were sheltered from foreign tax by reason of a hybrid arrangement and is therefore one for which Congress did not intend that the section 245A(a) deduction be available.

A second option was to provide an exception to when the hybrid deduction account rules apply, such that certain amounts (such as amounts that will be paid within 36-months from when the deduction is allowed under the foreign tax law) are not taken into account for purposes of determining a hybrid deduction account but instead are treated as hybrid dividends when paid. While such an approach might address D/NI outcomes resulting from hybrid arrangements in a tailored manner, it would also increase complexity and compliance burden, because it would in effect require two regimes under section 245A(e): the hybrid deduction account rules and separate tracking rules for cases in which an amount is excepted from the hybrid deduction account rules.

The third option, and the one adopted by the final regulations was to retain the approach of the proposed regulations, and thus continue to treat a dividend as a hybrid dividend to the extent of the balance

of the U.S. shareholder's hybrid deduction accounts with respect to its shares of stock of the CFC. This option both avoids incentivizing double non-taxation and avoids the complexities of needing multiple accounts.

#### v. No inclusion in a third country under section 267A

The proposed regulations generally deny a deduction for an interest or royalty payment if the payment is not included in income in a foreign country by reason of a hybrid arrangement, regardless of whether the payment is included in income in a different foreign country (a "third country"). Absent such an approach, payments involving hybrid arrangements could be funneled through low-tax countries, with an inclusion in the low-tax country turning off section 267A even though a no-inclusion occurs in a high-tax country by reason of a hybrid arrangement. Some comments suggested modifications to this approach. The final regulations retain the approach of the proposed regulations.

One option for responding to comments was to allow an inclusion in the third country to turn off section 267A. Although this would be a simple approach, it would permit inclusions in a low-taxed country to turn off section 267A even though a no-inclusion occurs in a high-tax country. Such an approach could thus incentivize certain hybrid arrangements, as it could allow parties to achieve a better tax result through a hybrid arrangement than they would have had the arrangement not existed with no corresponding productive economic activity.

A second option was to only allow an inclusion in the third country to turn off section 267A if the third country's tax rate is at least equal to a certain rate (for example, the U.S. tax rate, or the tax rate of the foreign country where the no-inclusion occurs). This approach would result in additional complexity, and would key the application of the hybrid rules on minimum effective rates of tax, which is beyond the scope of anti-hybrid rules.

A third option was to not allow an inclusion in a third country to turn off section 267A. The final regulations adopt this approach, as it prevents inclusions in low-tax countries from turning off

section 267A and thus prevents hybrid arrangements from being used to reduce U.S. tax without any accompanying productive economic activity. The Treasury Department and the IRS have determined that the advantages of this approach outweigh the drawbacks, including potential instances of double-taxation, relative to other regulatory approaches. First, absent the approach, payments could be routed through low-tax countries in a manner that would turn off section 267A, thus giving rise to at least partial double non-taxation and tax planning opportunities. Second, the approach is less complex – and easier to administer – than a more precise one which would calibrate the disallowed deduction based on the amount of tax avoided by reason of the hybrid arrangement (which would have to in part take into account relevant tax rates). Third, these types of structures are generally planned in advance and thus the approach would deter behavior. In particular, it would be relatively easy for taxpayers to avoid these structures and it is unlikely that taxpayers would have these structures arise by accident.

#### vi. Conduit arrangements/imported mismatches

Section 267A(e)(1) provides regulatory authority to apply the rules of section 267A to conduit arrangements and thus to disallow a deduction in cases in which income attributable to a payment is directly or indirectly offset by an offshore hybrid deduction. Under the proposed regulations, the Treasury Department and the IRS implemented rules that applied to so-called imported mismatch payments. These rules are generally similar to the Organization of Economic Cooperation and Development's Base Erosion and Profit Shifting project's (BEPS) imported mismatch rules. *See* Hybrid Mismatch Report Recommendation 8; *see also* Branch Mismatch Report Recommendation 5.

Some commenters suggested that the proposed regulations were too complex and would be difficult to comply with. However, the Treasury Department and IRS decided in the final regulations that the approach taken in the proposed regulations was appropriate. The first advantage of this approach is that it provides

certainty to taxpayers over a greater range of arrangements about whether a deduction will or will not be disallowed under the rule relative to other possible regulatory approaches. A second advantage of this approach is that it helps ensure that income is not subject either to double non-taxation or double taxation. This approach minimizes the chances of double taxation because it is modeled off the BEPS approach, which is being implemented by other countries, and it also contains explicit rules to coordinate with foreign tax law. Coordinating with the global tax community reduces opportunities for tax avoidance that is not otherwise economically productive.

As noted in the preamble to the proposed regulations, although such an approach involves greater complexity than alternative regulatory approaches, the Treasury Department and IRS expect the benefits of this approach's comprehensiveness, administrability, and conduciveness to taxpayer certainty, to be substantially greater than the complexity burden in comparison with available alternative approaches.

#### vii. Deemed branch payments and branch mismatch payments

The proposed regulations expand the application of section 267A to certain transactions involving branches. This treatment was necessary to ensure that taxpayers could not avoid section 267A by engaging in transactions that were economically similar to the hybrid arrangements that are covered by the statute. If these types of arrangements were not addressed, some firms would have likely used branch structures to avoid paying U.S. tax. In some cases, these structures would have been created solely to avoid section 267A, resulting in potential efficiency loss. The final regulations maintain the position of the proposed regulations.

#### viii. Exceptions for income included in U.S. tax and GILTI inclusions

Section 267A(b)(1) provides that deductions for interest and royalties that are paid to a CFC and included under section 951(a) in income (as subpart F income) by a United States shareholder of such

CFC are not subject to disallowance under section 267A. The statute does not state whether section 267A applies to a payment that is included directly in the U.S. tax base (for example, because the payment is made directly to a U.S. taxpayer or a U.S. taxable branch), or a payment made to a CFC that is taken into account under GILTI (as opposed to being included as subpart F income) by such CFC's United States shareholders. However, the grant of regulatory authority in section 267A(e) includes a specific mention of exceptions in "cases which the Secretary determines do not present a risk of eroding the Federal tax base." See section 267A(e)(7)(B). Payments that are included directly in the U.S. tax base or that are included in GILTI do not give rise to a D/NI outcome and, therefore, in the proposed regulations, it was deemed consistent with the policy of section 267A and the grant of authority in section 267A(e) to exempt them from disallowance under section 267A.

Several comments suggested small revisions to this provision to avoid potential arbitrage, and such small revisions were made in the final regulations while maintaining the overall approach to income included in U.S. tax and GILTI inclusions.

#### ix. Link between hybridity and D/NI

The proposed regulations limited disallowance to cases in which the no-inclusion portion of the D/NI outcome is a result of hybridity as opposed to a different feature of foreign tax law, such as a general preference for royalty income. Disallowing hybrid arrangements in which the D/NI outcome was not the result of hybridity would have forced taxpayers to undertake potentially costly restructuring of arrangements with no change in outcome, since the hybridity was irrelevant to the D/NI outcome. The final regulations maintain this position.

#### x. Timing differences under section 267A

A similar timing issue that was addressed for section 245A(e) arises under section 267A. Here, there may be a timing difference between when the deduction is otherwise permitted under U.S. tax law and when the payment is included in the payee's income under foreign tax law. The

legislative history to section 267A indicates that in certain cases such timing differences can lead to "long term deferral" and that such long-term deferral should be treated as giving rise to a D/NI outcome. Examples of such long-term deferral include cases in which under the foreign tax law the payment is a recovery of principal or basis, or the payment is pursuant to a hybrid sale/license transaction.

The Treasury Department and IRS decided to address only certain timing differences — namely, long-term timing differences, in the proposed regulations. The proposed regulations generally denied a deduction for an interest or royalty payment if, under foreign tax law, the payment is not included in the payee's income within 36-months. Some comments suggested modifications to this approach. The final regulations retain this overall approach but with small revisions, made in part to respond to certain comments.

One option for responding to comments was to not address long-term deferral, because it will eventually reverse over time. Although this would be a simpler approach than the option adopted for the final regulations, the Treasury Department and IRS did not adopt this approach because, as indicated in the legislative history, long-term deferral can be equivalent to a permanent exclusion, and could lead to widespread avoidance.

A second option was to continue to address long-term deferral but to not treat recovery of basis or principal as creating long-term deferral to the extent that the transaction giving rise to the basis, or the transaction pursuant to which the principal funds were generated, did not involve a hybrid arrangement. Although such an approach might be conceptually pure, it would raise significant practical and administrative difficulties. It would also be inconsistent with other areas of the Code, in that basis generally provides a dollar-for-dollar offset against income, as opposed to providing an offset against income only to the extent that the inclusion that generated the basis was at a tax rate at least equal to the tax rate at which the income is taken into account.

The final option was to address long-term deferral but provide targeted modifications to excuse transactions unlikely to give rise to double non-taxation con-



cerns – for example, hybrid sale/license cases, or cases in which different ordering or recovery rules under U.S. and foreign tax law reverse within 36-months.<sup>11</sup> The final regulations adopt this approach, because it strikes an appropriate balance between administrability and ensuring that similar economic activities were taxed similarly.

## II. Paperwork Reduction Act

The collections of information in the final regulations with respect to sections 245A(e) and 267A are in §§1.6038-2(f)(13) and (14), 1.6038-3(g)(3), and 1.6038A-2(b)(5)(iii). These collections of information retain the collections of information in the proposed regulations, with a minor refinement to §1.6038-2(f)(14) to ensure that the IRS may require the reporting of certain information that will facilitate compliance with section 245A(e) and §1.245A(e)-1.

The collection of information in §1.6038-2(f)(14) requires a U.S. person that controls a foreign corporation that pays or receives a hybrid dividend or tiered hybrid dividend under section 245A(e) during an annual accounting period to provide information about the hybrid dividend or tiered hybrid dividend on

Form 5471, “Information Return of U.S. Persons With Respect to Certain Foreign Corporations,” (OMB control number 1545-0123), as the form and its instructions may prescribe. Section 1.6038-2(f)(14) was revised to ensure that the IRS may require the reporting of certain information that will facilitate compliance with section 245A(e) and §1.245A(e)-1 (such as information about hybrid deduction accounts). For purposes of the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)) (“PRA”), the reporting burden associated with §1.6038-2(f)(14) will be reflected in the PRA submission associated with Form 5471 (see chart at the end of this part II of this Special Analyses section for the status of the PRA submission for Form 5471). The estimated number of respondents for the reporting burden associated with §1.6038-2(f)(14) is based on a percentage of large taxpayers that file income tax returns with a Form 5471 attached and Schedule I, “Summary of Shareholder’s Income From Foreign Corporations,” completed because only filers that are controlling U.S. shareholders of CFCs that pay or receive a dividend would be subject to the information collection requirements. As provided below, the IRS estimates the number of affected filers to be 2,000.

As explained in the preamble to the proposed regulations, the remaining collections of information in §§1.6038-2(f)(13), 1.6038-3(g)(3), and 1.6038A-2(b)(5)(iii) will facilitate compliance with section 267A and the final regulations thereunder. For purposes of the PRA, the reporting burdens associated with §§1.6038-2(f)(13), 1.6038-3(g)(3), and 1.6038A-2(b)(5)(iii) will be reflected in the PRA submissions associated with Form 5471, Form 8865, “Return of U.S. Persons With Respect to Certain Foreign Partnerships,” (OMB control number 1545-1668), and Form 5472, “Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business,” (OMB control number 1545-0123), respectively (see chart at the end of this part II of this Special Analyses section for the status of the PRA submissions for Forms 5471, 8865, and 5472). The estimated number of respondents for the reporting burdens associated with §§1.6038-2(f)(13), 1.6038-3(g)(3), and 1.6038A-2(b)(5)(iii) is based on a percentage of large taxpayers that file income tax returns with a Form 5471 (Schedule G, Other Information), Form 8865, or Form 5472 attached. The IRS estimates the number of affected filers to be the following.

Collection of information	Tax Forms Impacted	
	Number of respondents (estimated, rounded to nearest 1,000)	Forms in which information may be collected
§1.6038-2(f)(13)	1,000	Form 5471 (Schedule G)
§1.6038-2(f)(14)	2,000	Form 5471 (Schedule I)
§1.6038A-2(b)(5)(iii)	7,000	Form 5472
§1.6038-3(g)(3)	<1,000	Form 8865

Source: IRS data (MeF, DCS, and Compliance Data Warehouse)

The current status of the PRA submissions related to the tax forms that will be revised as a result of the information collections in the final regulations is provided in the accompanying table. As described above, the reporting burdens associated with the information collections in §§1.6038-2(f)(13) and (14) and 1.6038A-2(b)(5)(iii) are included in the

aggregated burden estimates for OMB control number 1545-0123, which represents a total estimated burden time for all forms and schedules for corporations of 3.157 billion hours and total estimated monetized costs of \$58.148 billion (\$2017). The overall burden estimates provided for OMB control number 1545-0123 are aggregate amounts that relate

to the entire package of forms associated with the OMB control number and will in the future include but not isolate the estimated burden of the tax forms that will be revised as a result of the information collections in the proposed regulations. These burden estimates are therefore not accurate for future calculations needed to assess the burden imposed by the pro-

<sup>11</sup> Other areas of the Code similarly adopt a 36-month period for administrability purposes. See, for example, §1.884-1(g) (36-month period for testing whether a foreign corporation is eligible to claim an exemption from, or a reduced rate of, branch profits tax); §1.7874-10 (36-month period for measuring whether prior distributions should be taken into account for purposes of the non-ordinary course distribution rule).

posed regulations. These burden estimates have been reported for other regulations related to the taxation of cross-border income. The Treasury Department and IRS urge readers to recognize that many of the burden estimates reported for regulations related to taxation of cross-border income are duplicates and to guard against overcounting the burden that international tax provisions impose. No burden estimates specific to the final regulations are currently available. The Treasury Department and IRS have not identified any

burden estimates, including those for new information collections, related to the requirements under the final regulations. The Treasury Department and the IRS estimate PRA burdens on a taxpayer-type basis rather than a provision-specific basis. Those estimates capture both changes made by the Act and those that arise out of discretionary authority exercised in the final regulations.

The Treasury Department and the IRS request comments on all aspects of information collection burdens related to the

final regulations, including estimates for how much time it would take to comply with the paperwork burdens described above for each relevant form and ways for the IRS to minimize the paperwork burden. Proposed revisions (if any) to these forms that reflect the information collections contained in these final regulations will be made available for public comment at <https://apps.irs.gov/app/picklist/list/draftTaxForms.html> and will not be finalized until after these forms have been approved by OMB under the PRA.

Form	Type of Filer	OMB Number(s)	Status
Form 5471	Business (NEW MODEL)	1545-0123	Published in the Federal Register on 9/30/19 (84 FR 51718). Public Comment period closed on 11/29/19. Approved by OMB through 1/31/2021.
	Link: <a href="https://www.federalregister.gov/documents/2019/09/30/2019-21068/proposed-collection-comment-request-for-forms-1065-1066-1120-1120-c-1120-f-1120-h-1120-nd-1120-s">https://www.federalregister.gov/documents/2019/09/30/2019-21068/proposed-collection-comment-request-for-forms-1065-1066-1120-1120-c-1120-f-1120-h-1120-nd-1120-s</a>		
	Individual (NEW Model)	1545-0074	Published in the Federal Register on 9/30/19 (84 FR 51712). Public Comment period closed on 11/29/19. Approved by OMB through 1/31/2021.
	Link: <a href="https://www.federalregister.gov/documents/2019/09/30/2019-21066/proposed-collection-comment-request-for-form-1040-form-1040nr-form-1040nr-ez-form-1040x-1040-sr-and-u">https://www.federalregister.gov/documents/2019/09/30/2019-21066/proposed-collection-comment-request-for-form-1040-form-1040nr-form-1040nr-ez-form-1040x-1040-sr-and-u</a>		
Form 5472	Business (NEW Model)	1545-0123	Published in the Federal Register on 9/30/19 (84 FR 51718). Public Comment period closed on 11/29/19. Approved by OMB through 1/31/2021.
	Link: <a href="https://www.federalregister.gov/documents/2019/09/30/2019-21068/proposed-collection-comment-request-for-forms-1065-1066-1120-1120-c-1120-f-1120-h-1120-nd-1120-s">https://www.federalregister.gov/documents/2019/09/30/2019-21068/proposed-collection-comment-request-for-forms-1065-1066-1120-1120-c-1120-f-1120-h-1120-nd-1120-s</a>		
	Individual (NEW Model)	1545-0074	Published in the Federal Register on 9/30/19 (84 FR 51712). Public Comment period closed on 11/29/19. Approved by OMB through 1/31/2021.
	Link: <a href="https://www.federalregister.gov/documents/2019/09/30/2019-21066/proposed-collection-comment-request-for-form-1040-form-1040nr-form-1040nr-ez-form-1040x-1040-sr-and-u">https://www.federalregister.gov/documents/2019/09/30/2019-21066/proposed-collection-comment-request-for-form-1040-form-1040nr-form-1040nr-ez-form-1040x-1040-sr-and-u</a>		
Form 8865	All other Filers (mainly trusts and estates) (Legacy system)	1545-1668	Published in the Federal Register on 10/1/18 (83 FR 49455). Public Comment period closed on 11/30/18. Approved by OMB through 12/31/2021.
	Link: <a href="https://www.federalregister.gov/documents/2018/10/01/2018-21288/proposed-collection-comment-request-for-regulation-project">https://www.federalregister.gov/documents/2018/10/01/2018-21288/proposed-collection-comment-request-for-regulation-project</a>		
	Business (NEW Model)	1545-0123	Published in the Federal Register on 9/30/19 (84 FR 51718). Public Comment period closed on 11/29/19. Approved by OMB through 1/31/2021.
	Link: <a href="https://www.federalregister.gov/documents/2019/09/30/2019-21068/proposed-collection-comment-request-for-forms-1065-1066-1120-1120-c-1120-f-1120-h-1120-nd-1120-s">https://www.federalregister.gov/documents/2019/09/30/2019-21068/proposed-collection-comment-request-for-forms-1065-1066-1120-1120-c-1120-f-1120-h-1120-nd-1120-s</a>		
	Individual (NEW Model)	1545-0074	Published in the Federal Register on 9/30/19 (84 FR 51712). Public Comment period closed on 11/29/19. Approved by OMB through 1/31/2021.
	Link: <a href="https://www.federalregister.gov/documents/2019/09/30/2019-21066/proposed-collection-comment-request-for-form-1040-form-1040nr-form-1040nr-ez-form-1040x-1040-sr-and-u">https://www.federalregister.gov/documents/2019/09/30/2019-21066/proposed-collection-comment-request-for-form-1040-form-1040nr-form-1040nr-ez-form-1040x-1040-sr-and-u</a>		

### III. Regulatory Flexibility Act

It is hereby certified that this final rule will not have a significant economic impact on a substantial number of small entities within the meaning of section 601(6)

of the Regulatory Flexibility Act (5 U.S.C. chapter 6).

The small entities that are subject to §§1.6038-2(f)(13), 1.6038-3(g)(3), and 1.6038A-2(b)(5)(iii) are small entities that are controlling U.S. shareholders

of a CFC that is disallowed a deduction under section 267A, small entities that are controlling fifty-percent partners of a foreign partnership that makes a payment for which a deduction is disallowed under section 267A, and small entities that

are 25 percent foreign-owned domestic corporations and disallowed a deduction under section 267A, respectively. In addition, the small entities that are subject to §1.6038-2(f)(14) are controlling U.S. shareholders of a CFC that pays or receives a hybrid dividend or a tiered hybrid dividend.

A controlling U.S. shareholder of a CFC is a U.S. person that owns more than 50 percent of the CFC's stock. A controlling fifty-percent partner is a U.S. person that owns more than a fifty-percent interest in the foreign partnership. A 25 percent foreign-owned domestic corporation is a domestic corporation at least 25 percent of the stock of which is owned by a foreign person.

The Treasury Department and the IRS estimate that 15 taxpayers with gross receipts below \$25 million (or \$41.5 million for financial entities) would potentially be affected by these regulations.<sup>12</sup> These are taxpayers who filed a domestic corporate income tax return in 2016 with gross receipts below \$25 million (or \$41.5 million for financial entities) and that (i) attached either a Form 5471 (therefore potentially affected by section 245A(e)) or a Form 5472 (therefore potentially affected by section 267A) and (ii) reported on Form 5471 dividends received by the domestic corporation from the foreign corporation, or on Form 5472 interest or royalty payments by the domestic corporation; and (iii) in the case of interest or royalties reported on Form 5472, the interest and royalty payments were above the \$50,000 de minimis threshold for section 267A. The de minimis exception under section 267A excepts many small entities from the application of section 267A for any taxable year for which the sum of its interest and royalty deductions (plus interest and royalty deductions of certain related persons) involving hybrid arrangements is below \$50,000. This estimate of 15 potentially affected taxpayers with gross receipts below the stated thresholds is less than 2 percent of potentially affected taxpayers of all sizes.

The Treasury Department and the IRS cannot readily identify from these data amounts that are paid pursuant to hybrid arrangements because those amounts

are not separately reported on tax forms. Thus, dividends received as reported on Form 5471, and interest and royalty expenses as reported on Form 5472, are an upper bound on the amount of hybrid arrangements by these taxpayers.

The Treasury Department and the IRS estimated the upper bound of the relative cost of the statutory and regulatory hybrids provisions, as a percentage of revenue, for these taxpayers as (i) the statutory tax rate of 21 percent multiplied by dividends received as reported on Form 5471 and or interest and royalty payments as reported on Form 5472, divided by (ii) the taxpayer's gross receipts. Based on this calculation, the Treasury Department and the IRS estimate that the upper bound of the relative cost of these statutory and regulatory provisions is above 3 percent for more than half but fewer than all of the 15 entities identified in the preceding paragraph. Because this estimate is an upper bound, a smaller subset of these taxpayers (including potentially zero taxpayers) is likely to have a cost above three percent of gross receipts.

Therefore, the Treasury Department and the IRS project that a substantial number of domestic small business entities will not be subject to §1.6038-2(f)(13) or (14), §1.6038-3(g)(3), or §1.6038A-2(b)(5)(iii). Accordingly, the Treasury Department and the IRS project that §1.6038-2(f)(13) or (14), §1.6038-3(g)(3), or §1.6038A-2(b)(5)(iii) will not have a significant economic impact on a substantial number of small entities.

### Drafting Information

The principal authors of the final regulations are Shane M. McCarrick and Tracy M. Vilecco of the Office of Associate Chief Counsel (International). However, other personnel from the Treasury Department and the IRS participated in the development of the final regulations.

### List of Subjects

#### 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

#### 26 CFR Part 301

Employment taxes, Estate taxes, Excise taxes, Gift taxes, Income taxes, Penalties, Reporting and recordkeeping requirements.

### Amendments to the Regulations

Accordingly, 26 CFR parts 1 and 301 are amended as follows:

#### PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by adding sectional authorities for §§1.245A(e)-1 and 1.267A-1 through 1.267A-7 in numerical order and revising the entry for §1.6038A-2 to read in part as follows:

Authority: 26 U.S.C. 7805 \* \* \*

Section 1.245A(e)-1 also issued under 26 U.S.C. 245A(g).

\* \* \* \* \*

Sections 1.267A-1 through 1.267A-7 also issued under 26 U.S.C. 267A(e).

\* \* \* \* \*

Section 1.6038A-2 also issued under 26 U.S.C. 6038A and 6038C.

\* \* \* \* \*

Par. 2. Section 1.245A(e)-1 is added to read as follows:

*§1.245A(e)-1 Special rules for hybrid dividends.*

(a) *Overview.* This section provides rules for hybrid dividends. Paragraph (b) of this section disallows the deduction under section 245A(a) for a hybrid dividend received by a United States shareholder from a CFC. Paragraph (c) of this section provides a rule for hybrid dividends of tiered corporations. Paragraph (d) of this section sets forth rules regarding a hybrid deduction account. Paragraph (e) of this section provides an anti-avoidance rule. Paragraph (f) of this section provides definitions. Paragraph (g) of this section illustrates the application of the rules of this section through examples. Paragraph (h) of this section provides the applicability date.

(b) *Hybrid dividends received by United States shareholders—(1) In general.* If a United States shareholder receives a hybrid dividend, then—

<sup>12</sup>This estimate is limited to those taxpayers who report gross receipts above \$0.

(i) The United States shareholder is not allowed a deduction under section 245A(a) for the hybrid dividend; and

(ii) The rules of section 245A(d) (disallowance of foreign tax credits and deductions) apply to the hybrid dividend. See paragraph (g)(1) of this section for an example illustrating the application of paragraph (b) of this section.

(2) *Definition of hybrid dividend.* The term *hybrid dividend* means an amount received by a United States shareholder from a CFC for which, without regard to section 245A(e) and this section as well as §1.245A-5T, the United States shareholder would be allowed a deduction under section 245A(a), to the extent of the sum of the United States shareholder's hybrid deduction accounts (as described in paragraph (d) of this section) with respect to each share of stock of the CFC, determined at the close of the CFC's taxable year (or in accordance with paragraph (d)(5) of this section, as applicable). No other amount received by a United States shareholder from a CFC is a hybrid dividend for purposes of section 245A.

(3) *Special rule for certain dividends attributable to earnings of lower-tier foreign corporations.* This paragraph (b)(3) applies if a domestic corporation directly or indirectly (as determined under the principles of §1.245A-5T(g)(3)(ii)) sells or exchanges stock of a foreign corporation and, pursuant to section 1248, the gain recognized on the sale or exchange is included in gross income as a dividend. In such a case, for purposes of this section—

(i) To the extent that earnings and profits of a lower-tier CFC gave rise to the dividend under section 1248(c)(2), those earnings and profits are treated as distributed as a dividend by the lower-tier CFC directly to the domestic corporation under the principles of §1.1248-1(d); and

(ii) To the extent the domestic corporation indirectly owns (within the meaning of section 958(a)(2), and determined by treating a domestic partnership as foreign) shares of stock of the lower-tier CFC, the hybrid deduction accounts with respect to those shares are treated as the domestic corporation's hybrid deduction accounts with respect to stock of the lower-tier CFC. Thus, for example, if a domestic corporation sells or exchanges all the stock of an

upper-tier CFC and under this paragraph (b)(3) there is considered to be a dividend paid directly by the lower-tier CFC to the domestic corporation, then the dividend is generally a hybrid dividend to the extent of the sum of the upper-tier CFC's hybrid deduction accounts with respect to stock of the lower-tier CFC.

(4) *Ordering rule.* Amounts received by a United States shareholder from a CFC are subject to the rules of section 245A(e) and this section based on the order in which they are received. Thus, for example, if on different days during a CFC's taxable year a United States shareholder receives dividends from the CFC, then the rules of section 245A(e) and this section apply first to the dividend received on the earliest date (based on the sum of the United States shareholder's hybrid deduction accounts with respect to each share of stock of the CFC), and then to the dividend received on the next earliest date (based on the remaining sum).

(c) *Hybrid dividends of tiered corporations—(1) In general.* If a CFC (the *receiving CFC*) receives a tiered hybrid dividend from another CFC, and a domestic corporation is a United States shareholder with respect to both CFCs, then, notwithstanding any other provision of the Code—

(i) For purposes of section 951(a) as to the United States shareholder, the tiered hybrid dividend is treated for purposes of section 951(a)(1)(A) as subpart F income of the receiving CFC for the taxable year of the CFC in which the tiered hybrid dividend is received;

(ii) The United States shareholder includes in gross income an amount equal to its pro rata share (determined in the same manner as under section 951(a)(2)) of the subpart F income described in paragraph (c)(1)(i) of this section; and

(iii) The rules of section 245A(d) (disallowance of foreign tax credit, including for taxes that would have been deemed paid under section 960(a) or (b), and deductions) apply to the amount included under paragraph (c)(1)(ii) of this section in the United States shareholder's gross income. See paragraph (g)(2) of this section for an example illustrating the application of paragraph (c) of this section.

(2) *Definition of tiered hybrid dividend.* The term *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 under paragraph (b)(2) of this section if, for purposes of section 245A and the regulations in this part under section 245A (except for section 245A(e)(2) and this paragraph (c)), the receiving CFC were a domestic corporation. A tiered hybrid dividend does not include an amount described in section 959(b). No other amount received by a receiving CFC from another CFC is a tiered hybrid dividend for purposes of section 245A.

(3) *Special rule for certain dividends attributable to earnings of lower-tier foreign corporations.* This paragraph (c) (3) applies if a CFC directly or indirectly (as determined under the principles of §1.245A-5T(g)(3)(ii)) sells or exchanges stock of a foreign corporation and pursuant to section 964(e)(1) the gain recognized on the sale or exchange is included in gross income as a dividend. In such a case, the rules of paragraph (b)(3) of this section apply, by treating the CFC as the domestic corporation described in paragraph (b)(3) of this section and substituting the phrase “sections 964(e)(1) and 1248(c)(2)” for the phrase “section 1248(c)(2)” in paragraph (b)(3)(i) of this section.

(4) *Interaction with rules under section 964(e).* To the extent a dividend described in section 964(e)(1) (gain on certain stock sales by CFCs treated as dividends) is a tiered hybrid dividend, the rules of section 964(e)(4) do not apply as to a domestic corporation that is a United States shareholder of both of the CFCs described in paragraph (c)(1) of this section and, therefore, such United States shareholder is not allowed a deduction under section 245A(a) for the amount included in gross income under paragraph (c)(1)(ii) of this section.

(d) *Hybrid deduction accounts—(1) In general.* A specified owner of a share of CFC stock must maintain a hybrid deduction account with respect to the share. The hybrid deduction account with respect to the share must reflect the amount of hybrid deductions of the CFC allocated to the share (as determined under paragraphs (d)(2) and (3) of this section), and must be

maintained in accordance with the rules of paragraphs (d)(4) through (6) of this section.

(2) *Hybrid deductions*—(i) *In general.* The term *hybrid deduction* of a CFC means a deduction or other tax benefit (such as an exemption, exclusion, or credit, to the extent equivalent to a deduction) for which the requirements of paragraphs (d)(2)(i)(A) and (B) of this section are both satisfied.

(A) The deduction or other tax benefit is allowed to the CFC (or a person related to the CFC) under a relevant foreign tax law, regardless of whether the deduction or other tax benefit is used, or otherwise reduces tax, currently under the relevant foreign tax law.

(B) 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 U.S. tax purposes, or is a deduction allowed to the CFC with respect to equity. Examples of such a deduction or other tax benefit include an interest deduction, a dividends paid deduction, and a notional interest deduction (or similar deduction determined with respect to the CFC's equity). However, a deduction or other tax benefit relating to or resulting from a distribution by the CFC that is a dividend 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 (determined under the principles of §1.267A-3(a)) or otherwise subject to tax under such tax law. Thus, for example, upon a distribution by a CFC that is treated as a dividend for purposes of the CFC's tax law to a shareholder of the CFC, a dividends paid deduction allowed to the CFC under its tax law (or a refund to the shareholder, including through a credit, of tax paid by the CFC on the earnings that funded the distribution) pursuant to an integration or imputation system is not a hybrid deduction of the CFC to the extent that the shareholder, if a tax resident of the CFC's country, includes the distribution in income under the CFC's tax law or, if not a tax resident of the CFC's country, is subject to withholding tax (as defined in section 901(k)(1)(B)) on the distribution under the CFC's tax law. As an additional example, upon a distribution by a CFC

to a shareholder of the CFC that is a tax resident of the CFC's country, a dividends received deduction allowed to the shareholder under the tax law of such foreign country pursuant to a regime intended to relieve double-taxation within the group is not a hybrid deduction of the CFC (though if the CFC were also allowed a deduction or other tax benefit for the distribution under such tax, such deduction or other tax benefit would be a hybrid deduction of the CFC). See paragraphs (g)(1) and (2) of this section for examples illustrating the application of paragraph (d) of this section.

(ii) *Coordination with foreign disallowance rules.* The following special rules apply for purposes of determining whether a deduction or other tax benefit is allowed to a CFC (or a person related to the CFC) under a relevant foreign tax law:

(A) Whether the deduction or other tax benefit is allowed is determined without regard to a rule under the relevant foreign tax law that disallows or suspends deductions if a certain ratio or percentage is exceeded (for example, a thin capitalization rule that disallows interest deductions if debt to equity exceeds a certain ratio, or a rule similar to section 163(j) that disallows or suspends interest deductions if interest exceeds a certain percentage of income).

(B) Except as provided in this paragraph (d)(2)(ii)(B), whether the deduction or other tax benefit is allowed is determined without regard to hybrid mismatch rules, if any, under the relevant foreign tax law that may disallow such deduction or other tax benefit. However, whether the deduction or other tax benefit is allowed is determined with regard to hybrid mismatch rules under the relevant foreign tax law if the amount giving rise to the deduction or other tax benefit neither gives rise to a dividend for U.S. tax purposes nor, based on all the facts and circumstances, is reasonably expected to give rise to a dividend for U.S. tax purposes that will be paid within 12 months from the end of the taxable period for which the deduction or other tax benefit would be allowed but for the hybrid mismatch rules. For purposes of this paragraph (d)(2)(ii)(B), the term hybrid mismatch rules has the meaning provided in §1.267A-5(b)(10).

(iii) *Anti-duplication rule.* A deduction or other tax benefit allowed to a CFC

(or a person related to the CFC) under a relevant foreign tax law for an amount paid, accrued, or distributed with respect to an instrument issued by the CFC is not a hybrid deduction to the extent that treating it as a hybrid deduction would have the effect of duplicating a hybrid deduction that is a deduction or other tax benefit allowed under such tax law for an amount paid, accrued, or distributed with respect to an instrument that is issued by a CFC at a higher tier and that has terms substantially similar to the terms of the first instrument. For example, if an upper tier CFC issues to a corporate United States shareholder a hybrid instrument (the "upper tier instrument"), a lower tier CFC issues to the upper tier CFC a hybrid instrument that has terms substantially similar to the terms of the upper tier instrument (the "mirror instrument"), the CFCs are tax residents of the same foreign country, and the upper tier CFC includes in income under its tax law (as determined under the principles of §1.267A-3(a)) amounts accrued with respect to the mirror instrument, then a deduction allowed to the lower tier CFC under such foreign tax law for an amount accrued pursuant to the mirror instrument is not a hybrid deduction (but a deduction allowed to the upper tier CFC under the foreign tax law for an amount accrued with respect to the upper tier instrument is a hybrid deduction).

(iv) *Application limited to items allowed in taxable years ending on or after December 20, 2018; special rule for deductions with respect to equity.* A deduction or other tax benefit, other than a deduction with respect to equity, allowed to a CFC (or a person related to the CFC) under a relevant foreign tax law is taken into account for purposes of this section only if it was allowed with respect to a taxable year under the relevant foreign tax law ending on or after December 20, 2018. A deduction with respect to equity allowed to a CFC under a relevant foreign tax law is taken into account for purposes of this section only if it was allowed with respect to a taxable year under the relevant foreign tax law beginning on or after December 20, 2018.

(3) *Allocating hybrid deductions to shares.* A hybrid deduction is allocated to a share of stock of a CFC to the extent that

the hybrid deduction (or amount equivalent to a deduction) relates to an amount paid, accrued, or distributed by the CFC with respect to the share. However, in the case of a hybrid deduction that is a deduction with respect to equity (such as a notional interest deduction), the deduction is allocated to a share of stock of a CFC based on the product of—

(i) The amount of the deduction allowed for all of the equity of the CFC; and

(ii) A fraction, the numerator of which is the value of the share and the denominator of which is the value of all of the stock of the CFC.

(4) *Maintenance of hybrid deduction accounts*—(i) *In general.* A specified owner's hybrid deduction account with respect to a share of stock of a CFC is, as of the close of the taxable year of the CFC, adjusted pursuant to the following rules.

(A) First, the account is increased by the amount of hybrid deductions of the CFC allocated to the share for the taxable year.

(B) [Reserved]

(C) Third, 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. If the 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 this paragraph (d) (4)(i)(C).

(ii) [Reserved]

(iii) *Acquisition of account and certain other adjustments*—(A) *In general.* The following rules apply when a person (the *acquirer*) directly or indirectly through a partnership, trust, or estate acquires a share of stock of a CFC from another person (the *transferor*).

(1) In the case of an acquirer that is a specified owner of the share immediately after the acquisition, the transferor's hybrid deduction account, if any, with respect to the share becomes the hybrid deduction account of the acquirer.

(2) In the case of an acquirer that is not a specified owner of the share immediately after the acquisition, the transferor's hybrid deduction account, if any, is elim-

inated and accordingly is not thereafter taken into account by any person.

(B) *Additional rules.* The following rules apply in addition to the rules of paragraph (d)(4)(iii)(A) of this section.

(1) *Certain section 354 or 356 exchanges.* The following rules apply when a shareholder of a CFC (the CFC, the *target CFC*; the shareholder, the *exchanging shareholder*) exchanges stock of the target CFC for stock of another CFC (the *acquiring CFC*) pursuant to an exchange described in section 354 or 356 that occurs in connection with a transaction described in section 381(a) (2) in which the target CFC is the transferor corporation.

(i) In the case of an exchanging shareholder that is 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 the shares of stock of the target CFC that it exchanges are attributed to the shares of stock of the acquiring CFC that it receives in the exchange.

(ii) 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 and accordingly are not thereafter taken into account by any person.

(2) *Section 332 liquidations.* If a CFC is a distributor corporation in a transaction described in section 381(a)(1) (the *distributor CFC*) in which a controlled foreign corporation is the acquiring corporation (the *distributee CFC*), then each hybrid deduction account with respect to a share of stock of the distributee CFC is increased pro rata by the sum of the hybrid deduction accounts with respect to shares of stock of the distributor CFC.

(3) *Recapitalizations.* If a shareholder of a CFC exchanges stock of the CFC pursuant to a reorganization described in section 368(a)(1)(E) or a transaction to which section 1036 applies, then the shareholder's hybrid deduction accounts with respect to the stock of the CFC that it exchanges are attributed to the shares of stock of the CFC that it receives in the exchange.

(4) *Certain distributions involving section 355 or 356.* In the case of a transaction involving a distribution under section 355 (or so much of section 356 as it relates to section 355) by a CFC (the *distributing CFC*) of stock of another CFC (the *controlled CFC*), the balance of the hybrid deduction accounts with respect to stock of the distributing CFC is attributed to stock of the controlled CFC in a manner similar to how earnings and profits of the distributing CFC and controlled CFC are adjusted. To the extent the balance of the hybrid deduction accounts with respect to stock of the distributing CFC is not so attributed to stock of the controlled CFC, such balance remains as the balance of the hybrid deduction accounts with respect to stock of the distributing CFC.

(5) *Effect of section 338(g) election*—(i) *In general.* If an election under section 338(g) is made with respect to a qualified stock purchase (as described in section 338(d)(3)) of stock of a CFC, then a hybrid deduction account with respect to a share of stock of the old target is not treated as (or attributed to) a hybrid deduction account with respect to a share of stock of the new target. Accordingly, immediately after the deemed asset sale described in §1.338-1, the balance of a hybrid deduction account with respect to a share of stock of the new target is zero; the account must then be maintained in accordance with the rules of paragraph (d) of this section.

(ii) *Special rule regarding carryover FT stock.* Paragraph (d)(4)(iii)(B)(5)(i) of this section does not apply as to a hybrid deduction account with respect to a share of carryover FT stock (as described in §1.338-9(b)(3)(i)). A hybrid deduction account with respect to a share of carryover FT stock is attributed to the corresponding share of stock of the new target.

(5) *Determinations and adjustments made during year of transfer in certain cases.* This paragraph (d)(5) applies if on a date other than the date that is the last day of the CFC's taxable year a United States shareholder of the CFC or an upper-tier CFC with respect to the CFC directly or indirectly (as determined under the principles of §1.245A-5T(g)(3)(ii)) transfers a share of stock of the CFC, and, during the taxable year, but on or before the transfer date, the United States shareholder or up-

per-tier CFC receives an amount from the CFC that is subject to the rules of section 245A(e) and this section. In such a case, the following rules apply:

(i) As to the United States shareholder or upper-tier CFC and the United States shareholder's or upper-tier CFC's hybrid deduction accounts with respect to each share of stock of the CFC (regardless of whether such share is transferred), the determinations and adjustments under this section that would otherwise be made at the close of the CFC's taxable year are made at the close of the date of the transfer. When making these determinations and adjustments at the close of the date of the transfer, each hybrid deduction account described in the previous sentence is pursuant to paragraph (d)(4)(ii)(A) of this section increased by a ratable portion (based on the number of days in the taxable year within the pre-transfer period to the total number of days in the taxable year) of the hybrid deductions of the CFC allocated to the share for the taxable year, and pursuant to paragraph (d)(4)(ii)(C) of this section decreased by the amount of hybrid deductions in the account that gave rise to a hybrid dividend or tiered hybrid dividend during the portion of the taxable year up to and including the transfer date. Thus, for example, if a United States shareholder of a CFC exchanges stock of the CFC in an exchange described in §1.367(b)-4(b)(1)(i) and is required to include in income as a deemed dividend the section 1248 amount attributable to the stock exchanged, then: as of the close of the date of the exchange, each of the United States shareholder's hybrid deductions accounts with respect to a share of stock of the CFC is increased by a ratable portion of the hybrid deductions of the CFC allocated to the share for the taxable year (based on the number of days in the taxable year within the pre-transfer period to the total number of days in the taxable year); the deemed dividend is 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; and, as the close of the date of the exchange, each of the accounts is decreased by the amount of hybrid deductions in the account that gave rise to a hybrid dividend during the

portion of the taxable year up to and including the date of the exchange.

(ii) As to a hybrid deduction account described in paragraph (d)(5)(i) of this section, the adjustments to the account as of the close of the taxable year of the CFC must take into account the adjustments, if any, occurring with respect to the account pursuant to paragraph (d)(5)(i) of this section. Thus, for example, if an acquisition of a share of stock of a CFC occurs on a date other than the date that is the last day of the CFC's taxable year and pursuant to paragraph (d)(4)(iii)(A) (I) of this section the acquirer succeeds to the transferor's hybrid deduction account with respect to the share, then, as of the close of the taxable year of the CFC, the account is increased by a ratable portion of the hybrid deductions of the CFC allocated to the share for the taxable year (based on the number of days in the taxable year within the post-transfer period to the total number of days in the taxable year), and, decreased by the amount of hybrid deductions in the account that gave rise to a hybrid dividend or tiered hybrid dividend during the portion of the taxable year following the transfer date.

(6) *Effects of CFC functional currency*—(i) *Maintenance of the hybrid deduction account.* A hybrid deduction account with respect to a share of CFC stock must be maintained in the functional currency (within the meaning of section 985) of the CFC. Thus, for example, the amount of a hybrid deduction and the adjustments described in paragraphs (d)(4)(i)(A) and (B) of this section are determined based on the functional currency of the CFC. In addition, for purposes of this section, the amount of a deduction or other tax benefit allowed to a CFC (or a person related to the CFC) is determined taking into account foreign currency gain or loss recognized with respect to such deduction or other tax benefit under a provision of foreign tax law comparable to section 988 (treatment of certain foreign currency transactions).

(ii) *Determination of amount of hybrid dividend.* This paragraph (d)(6)(ii) applies if a CFC's functional currency is other than the functional currency of a United States shareholder or upper-tier CFC that receives an amount from the CFC that is subject to the rules of section 245A(e) and

this section. In such a case, the sum of the United States shareholder's or upper-tier CFC's hybrid deduction accounts with respect to each share of stock of the CFC is, for purposes of determining the extent that a dividend is a hybrid dividend or tiered hybrid dividend, translated into the functional currency of the United States shareholder or upper-tier CFC based on the spot rate (within the meaning of §1.988-1(d)) as of the date of the dividend.

(e) *Anti-avoidance rule.* Appropriate adjustments are made pursuant to this section, including adjustments that would disregard the transaction or arrangement, if a transaction or arrangement is undertaken with a principal purpose of avoiding the purposes of section 245A(e) and this section. For example, if a specified owner of a share of CFC stock transfers the share to another person, and a 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 this section the shifting or elimination of the hybrid deduction account is disregarded as to the transferor. As another example, if a transaction or arrangement is undertaken to affirmatively fail to satisfy the holding period requirement under section 246(c)(5) with a principal purpose of avoiding the tiered hybrid dividend rules described in paragraph (c) of this section, the transaction or arrangement is disregarded for purposes of this section. This paragraph (e) will not apply, however, to disregard (or make other adjustments with respect to) a transaction pursuant to which an instrument or arrangement that gives rise to hybrid deductions is eliminated or otherwise converted into another instrument or arrangement that does not give rise to hybrid deductions.

(f) *Definitions.* The following definitions apply for purposes of this section.

(1) The term *controlled foreign corporation* (or *CFC*) has the meaning provided in section 957.

(2) The term *domestic corporation* means an entity classified as a domestic corporation under section 7701(a)(3) and (4) or otherwise treated as a domestic corporation by the Internal Revenue Code. However, for purposes of this section, a domestic corporation does not

include a regulated investment company (as described in section 851), a real estate investment trust (as described in section 856), or an S corporation (as described in section 1361).

(3) The term *person* has the meaning provided in section 7701(a)(1).

(4) The term *related* has the meaning provided in this paragraph (f)(4). A person is related to a CFC if the person is a related person within the meaning of section 954(d)(3). See also §1.954-1(f)(2)(iv)(B) (I) (neither section 318(a)(3), nor §1.958-2(d) or the principles thereof, applies to attribute stock or other interests).

(5) The term *relevant foreign tax law* means, with respect to a CFC, any regime of any foreign country or possession of the United States that imposes an income, war profits, or excess profits tax with respect to income of the CFC, other than a foreign anti-deferral regime under which a person that owns an interest in the CFC is liable to tax. If a foreign country has an income tax treaty with the United States that applies to taxes imposed by a political subdivision or other local authority of that country, then the tax law of the political subdivision or other local authority is deemed to be a tax law of a foreign country. Thus, the term includes any regime of a foreign country or possession of the United States that imposes income, war profits, or excess profits tax under which—

(i) The CFC is liable to tax as a resident;

(ii) The CFC has a branch that gives rise to a taxable presence in the foreign country or possession of the United States; or

(iii) A person related to the CFC is liable to tax as a resident, provided that under such person's tax law the person is allowed a deduction for amounts paid or accrued by the CFC (because the CFC is fiscally transparent under the person's tax law).

(6) The term *specified owner* means, with respect to a share of stock of a CFC, a person for which the requirements of paragraphs (f)(6)(i) and (ii) of this section are satisfied.

(i) The person is a domestic corporation that is a United States shareholder of the CFC, or is an upper-tier CFC that would be a United States shareholder of the CFC were the upper-tier CFC a domestic corporation (provided that, for

purposes of sections 951 and 951A, a domestic corporation that is a United States shareholder of the upper-tier CFC owns (within the meaning of section 958(a), and determined by treating a domestic partnership as foreign) one or more shares of stock of the upper-tier CFC).

(ii) The person owns the share directly or indirectly through a partnership, trust, or estate. Thus, 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 the shares of stock of another CFC, the domestic corporation is the specified owner with respect to each share of stock of the upper-tier CFC and the upper-tier CFC is the specified owner with respect to each share of stock of the other CFC.

(7) The term *United States shareholder* has the meaning provided in section 951(b).

(g) *Examples.* This paragraph (g) provides examples that illustrate the application of this section. For purposes of the examples in this paragraph (g), unless otherwise indicated, the following facts are presumed. US1 is a domestic corporation. FX and FZ are CFCs formed at the beginning of year 1, and the functional currency (within the meaning of section 985) of each of FX and FZ is the dollar. FX is a tax resident of Country X and FZ is a tax resident of Country Z. US1 is a United States shareholder with respect to FX and FZ. No distributed amounts are attributable to amounts which are, or have been, included in the gross income of a United States shareholder under section 951(a). All instruments are treated as stock for U.S. tax purposes. Only the tax law of the United States contains hybrid mismatch rules.

(1) *Example 1. Hybrid dividend resulting from hybrid instrument—(i) Facts.* US1 holds both shares of stock of FX, which have an equal value. One share is treated as indebtedness for Country X tax purposes ("Share A"), and the other is treated as equity for Country X tax purposes ("Share B"). During year 1, under Country X tax law, FX accrues \$80x of interest to US1 with respect to Share A and is allowed a deduction for the amount (the "Hybrid Instrument Deduction"). During year 2, FX distributes \$30x to US1 with respect to each of Share A and Share B. For U.S. tax purposes, each of the \$30x distributions is treated as a dividend for which, without regard to section 245A(e) and this section as well as §1.245A-5T, US1 would be allowed a deduction under section 245A(a). For Country X tax purposes, the \$30x distribution with respect to Share A represents a payment of interest for which a deduction was already

allowed (and thus FX is not allowed an additional deduction for the amount), and the \$30x distribution with respect to Share B is treated as a dividend (for which no deduction is allowed).

(ii) *Analysis.* The entire \$30x of each dividend received by US1 from FX during year 2 is a hybrid dividend, because the sum of US1's hybrid deduction accounts with respect to each of its shares of FX stock at the end of year 2 (\$80x) is at least equal to the amount of the dividends (\$60x). See paragraph (b)(2) of this section. This is the case for the \$30x dividend with respect to Share B even though there are no hybrid deductions allocated to Share B. See paragraph (b)(2) of this section. As a result, US1 is not allowed a deduction under section 245A(a) for the entire \$60x of hybrid dividends and the rules of section 245A(d) (disallowance of foreign tax credits and deductions) apply. See paragraph (b)(1) of this section. Paragraphs (g)(1)(ii)(A) through (D) of this section describe the determinations under this section.

(A) At the end of year 1, US1's hybrid deduction accounts with respect to Share A and Share B are \$80x and \$0, respectively, calculated as follows.

(1) The \$80x Hybrid Instrument Deduction allowed to FX under Country X tax law (a relevant foreign tax law) is a hybrid deduction of FX, because the deduction is allowed to FX and relates to or results from an amount accrued with respect to an instrument issued by FX and treated as stock for U.S. tax purposes. See paragraph (d)(2)(i) of this section. Thus, FX's hybrid deductions for year 1 are \$80x.

(2) The entire \$80x Hybrid Instrument Deduction is allocated to Share A, because the deduction was accrued with respect to Share A. See paragraph (d)(3) of this section. As there are no additional hybrid deductions of FX for year 1, there are no additional hybrid deductions to allocate to either Share A or Share B. Thus, there are no hybrid deductions allocated to Share B.

(3) At the end of year 1, US1's hybrid deduction account with respect to Share A is increased by \$80x (the amount of hybrid deductions allocated to Share A). See paragraph (d)(4)(i)(A) of this section. Because FX did not pay any dividends with respect to either Share A or Share B during year 1 (and therefore did not pay any hybrid dividends or tiered hybrid dividends), no further adjustments are made. See paragraph (d)(4)(i)(C) of this section. Therefore, at the end of year 1, US1's hybrid deduction accounts with respect to Share A and Share B are \$80x and \$0, respectively.

(B) At the end of year 2, and before the adjustments described in paragraph (d)(4)(i)(C) of this section, US1's hybrid deduction accounts with respect to Share A and Share B remain \$80x and \$0, respectively. This is because there are no hybrid deductions of FX for year 2. See paragraph (d)(4)(i)(A) of this section.

(C) Because at the end of year 2 (and before the adjustments described in paragraph (d)(4)(i)(C) of this section) the sum of US1's hybrid deduction accounts with respect to Share A and Share B (\$80x, calculated as \$80x plus \$0) is at least equal to the aggregate \$60x of year 2 dividends, the entire \$60x dividend is a hybrid dividend. See paragraph (b)(2) of this section.

(D) At the end of year 2, US1's hybrid deduction account with respect to Share A is decreased



by \$60x, the amount of the hybrid deductions in the account that gave rise to a hybrid dividend or tiered hybrid dividend during year 2. See paragraph (d)(4)(i)(C) of this section. Because there are no hybrid deductions in the hybrid deduction account with respect to Share B, no adjustments with respect to that account are made under paragraph (d)(4)(i)(C) of this section. Therefore, at the end of year 2 and taking into account the adjustments under paragraph (d)(4)(i)(C) of this section, US1's hybrid deduction account with respect to Share A is \$20x (\$80x less \$60x) and with respect to Share B is \$0.

(iii) *Alternative facts – notional interest deductions.* The facts are the same as in paragraph (g)(1)(i) of this section, except that for each of year 1 and year 2 FX is allowed \$10x of notional interest deductions with respect to its equity, Share B, under Country X tax law (the “NIDs”). In addition, during year 2, FX distributes \$47.5x (rather than \$30x) to US1 with respect to each of Share A and Share B. For U.S. tax purposes, each of the \$47.5x distributions is treated as a dividend for which, without regard to section 245A(e) and this section as well as §1.245A-5T, US1 would be allowed a deduction under section 245A(a). For Country X tax purposes, the \$47.5x distribution with respect to Share A represents a payment of interest for which a deduction was already allowed (and thus FX is not allowed an additional deduction for the amount), and the \$47.5x distribution with respect to Share B is treated as a dividend (for which no deduction is allowed). The entire \$47.5x of each dividend received by US1 from FX during year 2 is a hybrid dividend, because the sum of US1's hybrid deduction accounts with respect to each of its shares of FX stock at the end of year 2 (\$80x plus \$20x, or \$100x) is at least equal to the amount of the dividends (\$95x). See paragraph (b)(2) of this section. As a result, US1 is not allowed a deduction under section 245A(a) for the \$95x hybrid dividend and the rules of section 245A(d) (disallowance of foreign tax credits and deductions) apply. See paragraph (b)(1) of this section. Paragraphs (g)(1)(iii)(A) through (D) of this section describe the determinations under this section.

(A) The \$10x of NIDs allowed to FX under Country X tax law in year 1 are hybrid deductions of FX for year 1. See paragraph (d)(2)(i) of this section. The \$10x of NIDs is allocated equally to each of Share A and Share B, because the hybrid deduction is with respect to equity and the shares have an equal value. See paragraph (d)(3) of this section. Thus, \$5x of the NIDs is allocated to each of Share A and Share B for year 1. For the reasons described in paragraph (g)(1)(ii)(A)(2) of this section, the entire \$80x Hybrid Instrument Deduction is allocated to Share A. Therefore, at the end of year 1, US1's hybrid deduction accounts with respect to Share A and Share B are \$85x and \$5x, respectively.

(B) Similarly, the \$10x of NIDs allowed to FX under Country X tax law in year 2 are hybrid deductions of FX for year 2, and \$5x of the NIDs is allocated to each of Share A and Share B for year 2. See paragraphs (d)(2)(i) and (d)(3) of this section. Thus, at the end of year 2 (and before the adjustments described in paragraph (d)(4)(i)(C) of this section), US1's hybrid deduction account with respect to Share A is \$90x (\$85x plus \$5x) and with respect to Share B is \$10x (\$5x plus \$5x). See paragraph (d)(4)(i) of this section.

(C) Because at the end of year 2 (and before the adjustments described in paragraph (d)(4)(i)(C) of this section) the sum of US1's hybrid deduction accounts with respect to Share A and Share B (\$100x, calculated as \$90x plus \$10x) is at least equal to the aggregate \$95x of year 2 dividends, the entire \$95x of dividends are hybrid dividends. See paragraph (b)(2) of this section.

(D) At the end of year 2, US1's hybrid deduction accounts with respect to Share A and Share B are decreased by the amount of hybrid deductions in the accounts that gave rise to a hybrid dividend or tiered hybrid dividend during year 2. See paragraph (d)(4)(i)(C) of this section. A total of \$95x of hybrid deductions in the accounts gave rise to a hybrid dividend during year 2. For the hybrid deduction account with respect to Share A, \$85.5x in the account is considered to have given rise to a hybrid deduction (calculated as \$95x multiplied by  $\frac{90x}{100x}$ ). See paragraph (d)(4)(i)(C) of this section. For the hybrid deduction account with respect to Share B, \$9.5x in the account is considered to have given rise to a hybrid deduction (calculated as \$95x multiplied by  $\frac{10x}{100x}$ ). See paragraph (d)(4)(i)(C) of this section. Thus, following these adjustments, at the end of year 2, US1's hybrid deduction account with respect to Share A is \$4.5x ( $\$90x$  less  $\$85.5x$ ) and with respect to Share B is \$0.5x ( $\$10x$  less  $\$9.5x$ ).

(iv) *Alternative facts – deduction in branch country—(A) Facts.* The facts are the same as in paragraph (g)(1)(i) of this section, except that for Country X tax purposes Share A is treated as equity (and thus the Hybrid Instrument Deduction does not exist, and under Country X tax law FX is not allowed a deduction for the \$30x distributed in year 2 with respect to Share A). However, FX has a branch in Country Z that gives rise to a taxable presence under Country Z tax law, and for Country Z tax purposes Share A is treated as indebtedness and Share B is treated as equity. Also, during year 1, for Country Z tax purposes, FX accrues \$80x of interest to US1 with respect to Share A and is allowed an \$80x interest deduction with respect to its Country Z branch income. Moreover, for Country Z tax purposes, the \$30x distribution with respect to Share A in year 2 represents a payment of interest for which a deduction was already allowed (and thus FX is not allowed an additional deduction for the amount), and the \$30x distribution with respect to Share B in year 2 is treated as a dividend (for which no deduction is allowed).

(B) *Analysis.* The \$80x interest deduction allowed to FX under Country Z tax law (a relevant foreign tax law) with respect to its Country Z branch income is a hybrid deduction of FX for year 1. See paragraphs (d)(2)(i) and (f)(5) of this section. For reasons similar to those discussed in paragraph (g)(1)(ii) of this section, at the end of year 2 (and before the adjustments described in paragraph (d)(4)(i)(C) of this section), US1's hybrid deduction accounts with respect to Share A and Share B are \$80x and \$0, respectively, and the sum of the accounts is \$80x. Accordingly, the entire \$60x of the year 2 dividend is a hybrid dividend. See paragraph (b)(2) of this section. Further, for the reasons described in paragraph (g)(1)(ii)(D) of this section, at the end of year 2 and taking into account the adjustments under paragraph (d)(4)(i)(C) of this section, US1's hybrid deduction account with respect to

Share A is \$20x (\$80x less \$60x) and with respect to Share B is \$0.

(2) *Example 2. Tiered hybrid dividend rule; tax benefit equivalent to a deduction—(i) Facts.* US1 holds all the stock of FX, and FX holds all 100 shares of stock of FZ (the “FZ shares”), which have an equal value. The FZ shares are treated as equity for Country Z tax purposes. At the end of year 1, the sum of FX's hybrid deduction accounts with respect to each of its shares of FZ stock is \$0. During year 2, FZ distributes \$10x to FX with respect to each of the FZ shares, for a total of \$1,000x. The \$1,000x is treated as a dividend for U.S. and Country Z tax purposes, and is not deductible for Country Z tax purposes. If FX were a domestic corporation, then, without regard to section 245A(e) and this section as well as §1.245A-5T, FX would be allowed a deduction under section 245A(a) for the \$1,000x. Under Country Z tax law, 75% of the corporate income tax paid by a Country Z corporation with respect to a dividend distribution is refunded to the corporation's shareholders (regardless of where such shareholders are tax residents) upon a dividend distribution by the corporation. The corporate tax rate in Country Z is 20%. With respect to FZ's distributions, FX is allowed a refundable tax credit of \$187.5x. The \$187.5x refundable tax credit is calculated as \$1,250x (the amount of pre-tax earnings that funded the distribution, determined as \$1,000x (the amount of the distribution) divided by 0.8 (the percentage of pre-tax earnings that a Country Z corporation retains after paying Country Z corporate tax)) multiplied by 0.2 (the Country Z corporate tax rate) multiplied by 0.75 (the percentage of the Country Z tax credit). Under Country Z tax law, FX is not subject to Country Z withholding tax (or any other tax) with respect to the \$1,000x dividend distribution.

(ii) *Analysis.* As described in paragraphs (g)(2)(ii)(A) and (B) of this section, the sum of FX's hybrid deduction accounts with respect to each of its shares of FZ stock at the end of year 2 is \$937.5x and, as a result, \$937.5x of the \$1,000x of dividends received by FX from FZ during year 2 is a tiered hybrid dividend. See paragraphs (b)(2) and (c)(2) of this section. The \$937.5x tiered hybrid dividend is treated for purposes of section 951(a)(1)(A) as subpart F income of FX and US1 must include in gross income its pro rata share of such subpart F income, which is \$937.5x. See paragraph (c)(1) of this section. This is the case notwithstanding any other provision of the Code, including section 952(c) or section 954(c)(3) or (6). In addition, the rules of section 245A(d) (disallowance of foreign tax credits and deductions) apply with respect to US1's inclusion. See paragraph (c)(1) of this section. Paragraphs (g)(2)(ii)(A) through (C) of this section describe the determinations under this section. The characterization of the FZ stock for Country X tax purposes (or for purposes of any other foreign tax law) does not affect this analysis.

(A) The \$187.5x refundable tax credit allowed to FX under Country Z tax law (a relevant foreign tax law) is equivalent to a \$937.5x deduction, calculated as \$187.5x (the amount of the credit) divided by 0.2 (the Country Z corporate tax rate). The \$937.5x is a hybrid deduction of FZ because it is allowed to FX (a person related to FZ), it relates to or results from amounts distributed with respect to instruments issued by FZ and treated as stock for U.S. tax pur-

poses, and it has the effect of causing the earnings that funded the distributions to not be included in income under Country Z tax law. See paragraph (d)(2)(i) of this section. \$9.375x of the hybrid deduction is allocated to each of the FZ shares, calculated as \$937.5x (the amount of the hybrid deduction) multiplied by 1/100 (the value of each FZ share relative to the value of all the FZ shares). See paragraph (d)(3) of this section. The result would be the same if FX were instead a tax resident of Country Z (and not Country X), FX were allowed the \$187.5x refundable tax credit under Country Z tax law, and under Country Z tax law FX were to not include the \$1,000x in income (because, for example, Country Z tax law provides Country Z resident corporations a 100% exclusion or dividends received deduction with respect to dividends received from a resident corporation). See paragraph (d)(2)(i) of this section.

(B) At the end of year 2, and before the adjustments described in paragraph (d)(4)(i)(C) of this section, the sum of FX's hybrid deduction accounts with respect to each of its shares of FZ stock is \$937.5x, calculated as \$9.375x (the amount in each account) multiplied by 100 (the number of accounts). See paragraph (d)(4)(i) of this section. Accordingly, \$937.5x of the \$1,000x dividend received by FX from FZ during year 2 is a tiered hybrid dividend. See paragraphs (b)(2) and (c)(2) of this section.

(C) At the end of year 2, each of FX's hybrid deduction accounts with respect to its shares of FZ is decreased by the \$9.375x in the account that gave rise to a hybrid dividend or tiered hybrid dividend during year 2. See paragraph (d)(4)(i)(C) of this section. Thus, following these adjustments, at the end of year 2, each of FX's hybrid deduction accounts with respect to its shares of FZ stock is \$0, calculated as \$9.375x (the amount in the account before the adjustments described in paragraph (d)(4)(i)(C) of this section) less \$9.375x (the adjustment described in paragraph (d)(4)(i)(C) of this section with respect to the account).

(iii) *Alternative facts – imputation system that taxes shareholders.* The facts are the same as in paragraph (g)(2)(i) of this section, except that under Country Z tax law the \$1,000x dividend to FX is subject to a 30% gross basis withholding tax, or \$300x, and the \$187.5x refundable tax credit is applied against and reduces the withholding tax to \$112.5x. The \$187.5x refundable tax credit provided to FX is not a hybrid deduction because FX was subject to Country Z withholding tax of \$300x on the \$1,000x dividend (such withholding tax being greater than the \$187.5x credit). See paragraph (d)(2)(i) of this section. If instead FZ were allowed a \$1,000x dividends paid deduction for the \$1,000x dividend (and FX were not allowed the refundable tax credit) and the dividend were subject to 5% gross basis withholding tax (or \$50x), then \$750x of the dividends paid deduction would be a hybrid deduction, calculated as the excess of \$1,000x (the dividends paid deduction) over \$250x (the amount of income that under Country Z tax law would produce an amount of tax equal to the \$50x of withholding tax, calculated as \$50x, the amount of withholding tax, divided by 0.2, the Country Z corporate tax rate). See paragraph (d)(2)(i) of this section.

(h) *Applicability dates—(1) In general.* Except as provided in paragraph (h)

(2) of this section, this section applies to distributions made after December 31, 2017, provided that such distributions occur during taxable years ending on or after December 20, 2018. However, taxpayers may apply this section in its entirety to distributions made after December 31, 2017 and occurring during taxable years ending before December 20, 2018. In lieu of applying the regulations in this section, taxpayers may apply the provisions matching this section from the Internal Revenue Bulletin (IRB) 2019-03 (<https://www.irs.gov/pub/irs-irbs/irb19-03.pdf>) in their entirety for all taxable years ending on or before April 8, 2020.

(2) [Reserved]

Par. 3. Sections 1.267A-1 through 1.267A-7 are added to read as follows:

Sec.

\* \* \* \* \*

1.267A-1 Disallowance of certain interest and royalty deductions.

1.267A-2 Hybrid and branch arrangements.

1.267A-3 Income inclusions and amounts not treated as disqualified hybrid amounts.

1.267A-4 Disqualified imported mismatch amounts.

1.267A-5 Definitions and special rules.

1.267A-6 Examples.

1.267A-7 Applicability dates.

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§1.267A-1 *Disallowance of certain interest and royalty deductions.*

(a) *Scope.* This section and §§1.267A-2 through 1.267A-5 provide rules regarding when a deduction for any interest or royalty paid or accrued is disallowed under section 267A. Section 1.267A-2 describes hybrid and branch arrangements. Section 1.267A-3 provides rules for determining income inclusions and provides that certain amounts are not amounts for which a deduction is disallowed. Section 1.267A-4 provides an imported mismatch rule. Section 1.267A-5 sets forth definitions and special rules that apply for purposes of section 267A. Section 1.267A-6 illustrates the application of section 267A through examples. Section 1.267A-7 provides applicability dates.

(b) *Disallowance of deduction.* This paragraph (b) sets forth the exclusive circumstances in which a deduction is disallowed under section 267A. Except as

provided in paragraph (c) of this section, a specified party's deduction for any interest or royalty paid or accrued (the amount paid or accrued with respect to the specified party, a *specified payment*) is disallowed under section 267A to the extent that the specified payment is described in this paragraph (b). See also §1.267A-5(b)(5) (treating structured payments as interest paid or accrued for purposes of section 267A and the regulations in this part under section 267A). A specified payment is described in this paragraph (b) to the extent that it is—

(1) A disqualified hybrid amount, as described in §1.267A-2 (hybrid and branch arrangements);

(2) A disqualified imported mismatch amount, as described in §1.267A-4 (payments offset by a hybrid deduction); or

(3) A specified payment for which the requirements of the anti-avoidance rule of §1.267A-5(b)(6) are satisfied.

(c) *De minimis exception.* Paragraph (b) of this section does not apply to a specified party for a taxable year in which the sum of the specified party's specified payments that but for this paragraph (c) would be described in paragraph (b) of this section is less than \$50,000. For purposes of this paragraph (c), specified parties that are related (within the meaning of §1.267A-5(a)(14)) are treated as a single specified party.

§1.267A-2 *Hybrid and branch arrangements.*

(a) *Payments pursuant to hybrid transactions—(1) In general.* If a specified payment is made pursuant to a hybrid transaction, then, subject to §1.267A-3(b) (amounts included or includible in income), the payment is a disqualified hybrid amount to the extent that—

(i) A specified recipient of the payment does not include the payment in income, as determined under §1.267A-3(a) (to such extent, a *no-inclusion*); and

(ii) The specified recipient's no-inclusion is a result of the payment being made pursuant to the hybrid transaction. For purposes of this paragraph (a)(1)(ii), the specified recipient's no-inclusion is a result of the specified payment being made pursuant to the hybrid transaction to the extent that the no-inclusion would not occur were the specified recipient's tax law to treat the payment as interest or a

royalty, as applicable. See §1.267A-6(c)(1) and (2) for examples illustrating the application of paragraph (a) of this section.

(2) *Definition of hybrid transaction*—(i) *In general.* The term *hybrid transaction* means any transaction, series of transactions, agreement, or instrument one or more payments with respect to which are treated as interest or royalties for U.S. tax purposes but are not so treated for purposes of the tax law of a specified recipient of the payment. Examples of a hybrid transaction include an instrument a payment with respect to which is treated as interest for U.S. tax purposes but, for purposes of a specified recipient's tax law, is treated as a distribution with respect to equity or a recovery of principal with respect to indebtedness.

(ii) *Special rules*—(A) *Long-term deferral.* A specified payment is deemed to be made pursuant to a hybrid transaction if the taxable year in which a specified recipient of the payment takes the payment into account in income under its tax law (or, based on all the facts and circumstances, is reasonably expected to take the payment into account in income 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 U.S. tax law. In addition, if the tax law of a specified recipient of the specified payment does not impose an income tax, then such tax law does not cause the payment to be deemed to be made pursuant to a hybrid transaction under this paragraph (a)(2)(ii)(A). See §1.267A-6(c)(8) for an example illustrating the application of this paragraph (a)(2)(ii)(A) in the context of the imported mismatch rule.

(B) *Royalties treated as payments in exchange for property under foreign law.* In the case of a specified payment that is a royalty for U.S. tax purposes and for purposes of the tax law of a specified recipient of the payment is consideration received in exchange for property, the tax law of the specified recipient is not treated as causing the payment to be made pursuant to a hybrid transaction.

(C) *Coordination with disregarded payment rule.* A specified payment is not considered made pursuant to a hybrid transaction if the payment is a disregarded

payment, as described in paragraph (b)(2) of this section.

(3) *Payments pursuant to securities lending transactions, sale-repurchase transactions, or similar transactions.* This paragraph (a)(3) applies if a specified payment is made pursuant to a repo transaction and is not regarded under a foreign tax law, but another amount connected to the payment (the *connected amount*) is regarded under such foreign tax law. For purposes of this paragraph (a)(3), a *repo transaction* means a transaction one or more payments with respect to which are treated as interest (as defined in §1.267A-5(a)(12)) or a structured payment (as defined in §1.267A-5(b)(5)(ii)) for U.S. tax purposes and that is a securities lending transaction or sale-repurchase transaction (including as described in §1.861-2(a)(7)), or other similar transaction or series of related transactions in which legal title to property is transferred and the property (or similar property, such as securities of the same class and issue) is reacquired or expected to be reacquired. For example, this paragraph (a)(3) applies if a specified payment arising from characterizing a repo transaction of stock in accordance with its substance (that is, characterizing the specified payment as interest) is not regarded as such under a foreign tax law but an amount consistent with the form of the transaction (such as a dividend) is regarded under such foreign tax law. When this paragraph (a)(3) applies, the determination of the identity of a specified recipient of the specified payment under the foreign tax law is made with respect to the connected amount. In addition, if the specified recipient includes the connected amount in income (as determined under §1.267A-3(a), by treating the connected amount as the specified payment), then the amount of the specified recipient's no-inclusion with respect to the specified payment is correspondingly reduced. Further, the principles of this paragraph (a)(3) apply to cases similar to repo transactions in which a foreign tax law does not characterize the transaction in accordance with its substance. See §1.267A-6(c)(2) for an example illustrating the application of this paragraph (a)(3).

(4) *Payments pursuant to interest-free loans and similar arrangements.* In the case of a specified payment that is interest

for U.S. tax purposes, the following special rules apply:

(i) The payment is deemed to be made pursuant to a hybrid transaction to the extent that—

(A) Under U.S. tax law, the payment is imputed (for example, under section 482 or 7872, including because the instrument pursuant to which it is made is indebtedness but the terms of the instrument provide for an interest rate equal to or less than the risk-free rate or the rate on sovereign debt with similar terms in the relevant foreign currency); and

(B) A tax resident or taxable branch to which the payment is made does not take the payment into account in income under its tax law because such tax law does not impute any interest. The rules of paragraph (b)(4) of this section apply for purposes of determining whether the specified payment is made indirectly to a tax resident or taxable branch.

(ii) A tax resident or taxable branch the tax law of which causes the payment to be deemed to be made pursuant to a hybrid transaction under paragraph (a)(4)(i) of this section is deemed to be a specified recipient of the payment for purposes of paragraph (a)(1) of this section.

(b) *Disregarded payments*—(1) *In general.* Subject to §1.267A-3(b) (amounts included or includible in income), the excess (if any) of the sum of a specified party's disregarded payments for a taxable year over its dual inclusion income for the taxable year is a disqualified hybrid amount. See §1.267A-6(c)(3) and (4) for examples illustrating the application of paragraph (b) of this section.

(2) *Definition of disregarded payment*—(i) *In general.* The term *disregarded payment* means a specified 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 (for example, because under such tax law it is a payment involving a single taxpayer or members of a group) and, were the payment to be regarded (and treated as interest or a royalty, as applicable) under such tax law, the tax resident or taxable branch would include the payment in income, as determined under §1.267A-3(a).

(ii) *Special rules*—(A) *Foreign consolidation and similar regimes.* A disregarded payment includes a specified payment

that, under the tax law of a tax resident or taxable branch to which the payment is made, is a payment that gives rise to a deduction or similar offset allowed to the tax resident or taxable branch (or group of entities that include the tax resident or taxable branch) under a foreign consolidation, fiscal unity, group relief, loss sharing, or any similar regime.

(B) *Certain payments of a U.S. taxable branch.* In the case of a specified payment of a U.S. taxable branch, the payment is not a disregarded payment to the extent that under the tax law of the tax resident to which the payment is made the payment is otherwise taken into account. See paragraph (c)(2) of this section for an example of when an amount may be otherwise taken into account.

(C) *Coordination with other hybrid and branch arrangements.* A disregarded payment does not include a deemed branch payment described in paragraph (c)(2) of this section, a specified payment pursuant to a repo transaction or similar transaction described in paragraph (a)(3) of this section, or a specified payment pursuant to an interest-free loan or similar transaction described in paragraph (a)(4) of this section.

(3) *Definition of dual inclusion income*—(i) *In general.* With respect to a specified party, the term *dual inclusion income* means the excess, if any, of—

(A) The sum of the specified party's items of income or gain for U.S. tax purposes that are included in the specified party's income, as determined under §1.267A-3(a) (by treating the items of income or gain as the specified payment; and, in the case of a specified party that is a CFC, by treating U.S. tax law as the CFC's tax law), to the extent the items of income or gain are included in the income of the tax resident or taxable branch to which the disregarded payments are made, as determined under §1.267A-3(a) (by treating the items of income or gain as the specified payment); over

(B) The sum of the specified party's items of deduction or loss for U.S. tax purposes (other than deductions for disregarded payments), to the extent the items of deduction or loss are allowable (or have been or will be allowable during a taxable year that ends no more than 36 months after the end of the specified party's taxable

year) under the tax law of the tax resident or taxable branch to which the disregarded payments are made.

(ii) *Special rule for certain dividends.* An item of income or gain of a specified party that is included in the specified party's income but not included in the income of the tax resident or taxable branch to which the disregarded payments are made is considered described in paragraph (b)(3)(i)(A) of this section to the extent that, under the tax resident's or taxable branch's tax law, the item is a dividend that would have been included in the income of the tax resident or taxable branch but for an exemption, exclusion, deduction, credit, or other similar relief particular to the item, provided that the party paying the item is not allowed a deduction or other tax benefit for it under its tax law. Similarly, an item of income or gain of a specified party that is included in the income of the tax resident or taxable branch to which the disregarded payments are made but not included in the specified party's income is considered described in paragraph (b)(3)(ii)(A) of this section to the extent that, under U.S. tax law, the item is a dividend that would have been included in the income of the specified party but for a dividends received deduction with respect to the dividend (for example, a deduction under section 245A(a)), provided that the party paying the item is not allowed a deduction or other tax benefit for it under its tax law. See §1.267A-6(c)(3)(iv) for an example illustrating the application of this paragraph (b)(3)(ii).

(4) *Payments made indirectly to a tax resident or taxable branch.* A specified payment made to an entity an interest of which is directly or indirectly (determined under the rules of section 958(a) without regard to whether an intermediate entity is foreign or domestic, or under substantially similar rules under a tax resident's or taxable branch's tax law) owned by a tax resident or taxable branch is considered made to the tax resident or taxable branch to the extent that, under the tax law of the tax resident or taxable branch, the entity to which the payment is made is fiscally transparent (and all intermediate entities, if any, are also fiscally transparent).

(c) *Deemed branch payments*—(1) *In general.* If a specified payment is a deemed branch payment, then the pay-

ment is a disqualified hybrid amount if the tax law of the home office provides an exclusion or exemption for income attributable to the branch. See §1.267A-6(c)(4) for an example illustrating the application of this paragraph (c).

(2) *Definition of deemed branch payment.* The term *deemed branch payment* means, with respect to a U.S. taxable branch that is a U.S. permanent establishment of a treaty resident eligible for benefits under an income tax treaty between the United States and the treaty country, any amount of interest or royalties allowable as a deduction in computing the business profits of the U.S. permanent establishment, to the extent the amount is deemed paid to the home office (or other branch of the home office), is not regarded (or otherwise taken into account) under the home office's tax law (or the other branch's tax law), and, were the payment to be regarded (and treated as interest or a royalty, as applicable) under the home office's tax law (or other branch's tax law), the home office (or other branch) would include the payment in income, as determined under §1.267A-3(a). An amount may be otherwise taken into account for purposes of this paragraph (c)(2) if, for example, under the home office's tax law a corresponding amount of interest or royalties is allocated and attributable to the U.S. permanent establishment and is therefore not deductible.

(d) *Payments to reverse hybrids*—(1) *In general.* If a specified payment is made to a reverse hybrid, then, subject to §1.267A-3(b) (amounts included or includible in income), the payment is a disqualified hybrid amount to the extent that--

(i) An investor, the tax law of which treats the reverse hybrid as not fiscally transparent, does not include the payment in income, as determined under §1.267A-3(a) (to such extent, a *no-inclusion*); and

(ii) The investor's no-inclusion is a result of the payment being made to the reverse hybrid. For purposes of this paragraph (d)(1)(ii), the investor's no-inclusion is a result of the specified payment being made to the reverse hybrid to the extent that the no-inclusion would not occur were the investor's tax law to treat the reverse hybrid as fiscally transparent (and treat the payment as interest or a royalty,

as applicable). See §1.267A-6(c)(5) for an example illustrating the application of paragraph (d) of this section.

(2) *Definition of reverse hybrid.* The term *reverse hybrid* means an entity (regardless of whether domestic or foreign) that is fiscally transparent under the tax law of the country in which it is created, organized, or otherwise established but not fiscally transparent under the tax law of an investor of the entity.

(3) *Payments made indirectly to a reverse hybrid.* A specified payment made to an entity an interest of which is directly or indirectly (determined under the rules of section 958(a) without regard to whether an intermediate entity is foreign or domestic, or under substantially similar rules under a tax resident's or taxable branch's tax law) owned by a reverse hybrid is considered made to the reverse hybrid to the extent that, under the tax law of an investor of the reverse hybrid, the entity to which the payment is made is fiscally transparent (and all intermediate entities, if any, are also fiscally transparent).

(4) *Exception for inclusion by taxable branch in establishment country.* Paragraph (d)(1) of this section does not apply to a specified payment made to a reverse hybrid to the extent that a taxable branch located in the country in which the reverse hybrid is created, organized, or otherwise established (and the activities of which are carried on by one or more investors of the reverse hybrid) includes the payment in income, as determined under §1.267A-3(a).

(e) *Branch mismatch payments—(1) In general.* If a specified payment is a branch mismatch payment, then, subject to §1.267A-3(b) (amounts included or includible in income), the payment is a disqualified hybrid amount to the extent that—

(i) A home office, the tax law of which treats the payment as income attributable to a branch of the home office, does not include the payment in income, as determined under §1.267A-3(a) (to such extent, a *no-inclusion*); and

(ii) The home office's no-inclusion is a result of the payment being a branch mismatch payment. For purposes of this paragraph (e)(1)(ii), the home office's no-inclusion is a result of the specified payment being a branch mismatch payment to the

extent that the no-inclusion would not occur were the home office's tax law to treat the payment as income that is not attributable a branch of the home office (and treat the payment as interest or a royalty, as applicable). See §1.267A-6(c)(6) for an example illustrating the application of paragraph (e) of this section.

(2) *Definition of branch mismatch payment.* The term *branch mismatch payment* means a specified payment for which the following requirements are satisfied:

(i) Under a home office's tax law, the payment is treated as income attributable to a branch of the home office; and

(ii) Either—

(A) The branch is not a taxable branch; or

(B) Under the branch's tax law, the payment is not treated as income attributable to the branch.

(f) *Relatedness or structured arrangement limitation.* A specified recipient, a tax resident or taxable branch to which a specified payment is made, an investor, or a home office is taken into account for purposes of paragraphs (a), (b), (d), and (e) of this section, respectively, only if the specified recipient, the tax resident or taxable branch, the investor, or the home office, as applicable, is related (as defined in §1.267A-5(a)(14)) to the specified party or is a party to a structured arrangement (as defined in §1.267A-5(a)(20)) pursuant to which the specified payment is made.

#### *§1.267A-3 Income inclusions and amounts not treated as disqualified hybrid amounts.*

(a) *Income inclusions—(1) General rule.* 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--

(i) It takes the payment into account (or has taken the payment into account, or, based on all the facts and circumstances, is reasonably expected to take the payment into account during a taxable year that ends no more than 36 months after the end of the specified party's taxable year) in its income or tax base at the full marginal rate imposed on ordinary income (or, if different, the full marginal rate imposed on interest or a royalty, as applicable); and

(ii) The payment is not reduced or offset by an exemption, exclusion, deduction, credit (other than for withholding tax imposed on the payment), or other similar relief particular to such type of payment. Examples of such reductions or offsets include a participation exemption, a dividends received deduction, a deduction or exclusion with respect to a particular category of income (such as income attributable to a branch, or royalties under a patent box regime), a credit for underlying taxes paid by a corporation from which a dividend is received, and a recovery of basis with respect to stock or a recovery of principal with respect to indebtedness. A specified payment is not considered reduced or offset by a deduction or other similar relief particular to the type of payment if it is offset by a generally applicable deduction or other tax attribute, such as a deduction for depreciation or a net operating loss. For purposes of this paragraph (a)(1)(ii), a deduction may be treated as being generally applicable even if it arises from a transaction related to the specified payment (for example, if the deduction and payment are in connection with a back-to-back financing arrangement).

(2) *Coordination with foreign hybrid mismatch rules.* Whether a tax resident or taxable branch includes in income a specified payment is determined without regard to any defensive or secondary rule contained in hybrid mismatch rules, if any, under the tax law of the tax resident or taxable branch. For purposes of this paragraph (a)(2), a defensive or secondary rule means a provision of hybrid mismatch rules that requires a tax resident or taxable branch to include an amount in income if a deduction for the amount is not disallowed under the payer's tax law. However, a defensive or secondary rule does not include a rule pursuant to which a participation exemption or similar relief particular to a dividend is inapplicable as to a dividend for which the payer is allowed a deduction or other tax benefit under its tax law. Thus, a defensive or secondary rule does not include a rule consistent with recommendation 2.1 in Chapter 2 of OECD/G-20, *Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2: 2015 Final Report* (October 2015).

(3) *Inclusions with respect to reverse hybrids.* With respect to a tax resident

or taxable branch that is an investor of a reverse hybrid, whether the investor includes in income a specified payment made to the reverse hybrid is determined without regard to a distribution from the reverse hybrid (or the right to a distribution from the reverse hybrid triggered by the payment). However, if the reverse hybrid distributes all of its income during a taxable year, then, for that year, the determination of whether an investor includes in income a specified payment made to the reverse hybrid is made with regard to one or more distributions from the reverse hybrid during the year, by treating a portion of the specified payment as relating to each distribution during the year. For purposes of this paragraph (a)(3), the portion of the specified payment that is considered to relate to a distribution is the lesser of—

(i) The specified payment multiplied by a fraction, the numerator of which is the amount of the distribution and the denominator of which is the aggregate amount of distributions from the reverse hybrid during the taxable year; and

(ii) The amount of the distribution multiplied by a fraction, the numerator of which is the specified payment and the denominator of which is the sum of all specified payments made to the reverse hybrid during the taxable year.

(4) *Inclusions with respect to certain payments pursuant to hybrid transactions.* This paragraph (a)(4) applies to a specified payment that is interest and that is made pursuant to a hybrid transaction, to the extent that, under the tax law of a specified recipient of the payment, the payment is a recovery of basis with respect to stock or a recovery of principal with respect to indebtedness such that, but for this paragraph (a)(4), a no-inclusion would occur with respect to the specified recipient. In such a case, an amount that is a repayment of principal for U.S. tax purposes and that is or has been paid (or, based on all the facts and circumstances, is reasonably expected to be paid) by the specified party pursuant to the hybrid transaction (such amount, the *principal payment*) is, to the extent included in the income of the specified recipient, treated as correspondingly reducing the specified recipient's no-inclusion with respect to the specified payment. For purposes of this paragraph (a)(4), whether the specified recipient in-

cludes the principal payment in income is determined under paragraph (a)(1) of this section, by treating the principal payment as the specified payment and the taxable year period described in paragraph (a)(1) as being composed of taxable years of the specified recipient ending no more than 36 months after the end of the specified party's taxable year during which the specified payment is made (as opposed to, for example, being composed of taxable years of the specified recipient ending no more than 36 months after the end of the specified party's taxable year during which the principal payment is reasonably expected to be made). Moreover, once a principal payment reduces a no-inclusion with respect to a specified payment, it is not again taken into account for purposes of applying this paragraph (a)(4) to another specified payment. See §1.267A-6(c)(1)(vi) for an example illustrating the application of this paragraph (a)(4).

(5) *Deemed full inclusions and de minimis inclusions.* A preferential rate, exemption, exclusion, deduction, credit, or similar relief particular to a type of payment that reduces or offsets 90 percent or more of the payment is considered to reduce or offset 100 percent of the payment. In addition, a preferential rate, exemption, exclusion, deduction, credit, or similar relief particular to a type of payment that reduces or offsets 10 percent or less of the payment is considered to reduce or offset none of the payment.

(b) *Certain amounts not treated as disqualified hybrid amounts to extent included or includible in income for U.S. tax purposes—(1) In general.* A specified payment, to the extent that but for this paragraph (b) it would be a disqualified hybrid amount (such amount, a *tentative disqualified hybrid amount*), is reduced under the rules of paragraphs (b)(2) through (4) of this section, as applicable. The tentative disqualified hybrid amount, as reduced under such rules, is the disqualified hybrid amount. See §1.267A-6(c)(3) and (7) for examples illustrating the application of paragraph (b) of this section.

(2) *Included in income of United States tax resident or U.S. taxable branch.* A tentative disqualified hybrid amount is reduced to the extent that a specified recipient that is a tax resident of the United States or a U.S. taxable branch takes the

tentative disqualified hybrid amount into account in determining its gross income.

(3) *Includible in income under section 951(a)(1)(A).* A tentative disqualified hybrid amount is reduced to the extent that the tentative disqualified hybrid amount is received by a CFC and includible under section 951(a)(1)(A) (determined without regard to properly allocable deductions of the CFC, qualified deficits under section 952(c)(1)(B), and the earnings and profits limitation under §1.952-1(c)) in the gross income of a United States shareholder of the CFC. However, if the United States shareholder is a domestic partnership, then the amount includible under section 951(a)(1)(A) in the gross income of the United States shareholder reduces the tentative disqualified hybrid amount only to the extent that a tax resident of the United States would take into account the amount.

(4) *Includible in income under section 951A(a).* A tentative disqualified hybrid amount is reduced to the extent that the tentative disqualified hybrid amount increases a United States shareholder's pro rata share of tested income (as determined under §§1.951A-1(d)(2) and 1.951A-2(b)(1)) with respect to a CFC, reduces the shareholder's pro rata share of tested loss (as determined under §§1.951A-1(d)(4) and 1.951A-2(b)(2)) of the CFC, or both. However, to the extent that a deduction for the tentative disqualified hybrid amount would be allowed to a tax resident of the United States or a U.S. taxable branch, or would be allowed to a CFC but would be allocated and apportioned to gross income of the CFC that is gross income taken into account in determining subpart F income (as described in section 952) or gross income that is effectively connected (or treated as effectively connected) with the conduct of a trade or business in the United States (as described in §1.882-4(a)(1)), the reduction provided under this paragraph (b)(4) is equal to the reduction that would be provided under this paragraph (b)(4) but for this sentence multiplied by the difference of 100 percent and the percentage described in section 250(a)(1)(B).

(5) *Includible in income under section 1293.* A tentative disqualified hybrid amount is reduced to the extent that the tentative disqualified hybrid amount is received by a qualified electing fund (as described in section 1295) and is includible

under section 1293 in the gross income of a United States person that owns stock of that fund. However, if the United States person is a domestic partnership, then the amount includible under section 1293 in the gross income of the United States person reduces the tentative disqualified hybrid amount only to the extent that a tax resident of the United States would take into account the amount.

*§1.267A-4 Disqualified imported mismatch amounts.*

(a) *Disqualified imported mismatch amounts*—(1) *Rule.* An imported mismatch payment is a disqualified imported mismatch amount to the extent that, under the set-off rules of paragraph (c) of this section, the income attributable to the payment is directly or indirectly offset by a hybrid deduction incurred by a foreign tax resident or foreign taxable branch that is related to the imported mismatch payer (or that is a party to a structured arrangement pursuant to which the payment is made). See §1.267A-6(c)(8) through (12) for examples illustrating the application of this section.

(2) *Definitions of certain terms.* The following definitions apply for purposes of this section:

(i) A *foreign tax resident* means a tax resident that is not a tax resident of the United States.

(ii) A *foreign taxable branch* means a taxable branch that is not a U.S. taxable branch.

(iii) An *imported mismatch payee* means, with respect to an imported mismatch payment, a foreign tax resident or foreign taxable branch that includes the payment in income, as determined under §1.267A-3(a).

(iv) An *imported mismatch payer* means, with respect to an imported mismatch payment, the specified party.

(v) An *imported mismatch payment* means a specified payment to the extent that it is neither a disqualified hybrid amount nor included or includible in income in the United States. For purposes of this paragraph (a)(2)(v), a specified payment is included or includible in income in the United States to the extent that, if the payment were a tentative disqualified hybrid amount (as described in

§1.267A-3(b)(1)), it would be reduced under the rules of §1.267A-3(b)(2) through (5).

(b) *Hybrid deduction*—(1) *In general.* A *hybrid deduction* means any of the following:

(i) A deduction allowed to a foreign tax resident or foreign taxable branch under its tax law for an amount paid or accrued that is interest (including an amount that would be a structured payment under the principles of §1.267A-5(b)(5)(ii)) or royalty under such tax law, to the extent that a deduction for the amount would be disallowed if such tax law contained rules substantially similar to those under §§1.267A-1 through 1.267A-3 and 1.267A-5. Such a deduction is a hybrid deduction regardless of whether or how the amount giving rise to the deduction would be recognized under U.S. tax law.

(ii) A deduction allowed to a foreign tax resident or foreign taxable branch under its tax law with respect to equity (including deemed equity), such as a notional interest deduction (or similar deduction determined with respect to the foreign tax resident's or foreign taxable branch's equity). However, a deduction allowed to a foreign tax resident or foreign taxable branch with respect to equity is a hybrid deduction only to the extent that an investor of the foreign tax resident, or the home office of the foreign taxable branch, would include the amount in income if, for purposes of the investor's or home office's tax law, the amount were interest paid by the foreign tax resident ratably (by value) with respect to the interests of the foreign tax resident, or interest paid by the foreign taxable branch to the home office. For purposes of this paragraph (b)(1)(ii), the rules of §1.267A-3(a) apply to determine the extent that an investor or home office would include an amount in income, by treating the amount as the specified payment.

(2) *Special rules*—(i) *Foreign tax law contains hybrid mismatch rules.* In the case of a foreign tax resident or foreign taxable branch the tax law of which contains hybrid mismatch rules, only the following deductions allowed to the foreign tax resident or foreign taxable branch under its tax law are hybrid deductions:

(A) A deduction described in paragraph (b)(1)(i) of this section, to the extent that

the deduction would be disallowed if the foreign tax resident's or foreign taxable branch's tax law—

(1) Contained a rule substantially similar to §1.267A-2(a)(4) (payments pursuant to interest-free loans and similar arrangements); or

(2) Did not permit an inclusion in income in a third country to discharge the application of its hybrid mismatch rules as to the amount giving rise to the deduction when the amount is not included in income in another country as a result of a hybrid or branch arrangement.

(B) A deduction described in paragraph (b)(1)(ii) of this section (deductions with respect to equity).

(ii) *Dual inclusion income used to determine hybrid deductions arising from deemed branch payments in certain cases.* In the case of a foreign taxable branch the tax law of which permits a loss of the foreign taxable branch to be shared with a tax resident or taxable branch (without regard to whether it is in fact so shared or whether there is a tax resident or taxable branch with which the loss can be shared), a deduction allowed to the foreign taxable branch for an amount that would be a deemed branch payment were such tax law to contain a provision substantially similar to §1.267A-2(c) is a hybrid deduction to the extent of the excess (if any) of the sum of all such amounts over the foreign taxable branch's dual inclusion income (as determined under the principles of §1.267A-2(b)(3)). The rule in this paragraph (b)(2)(ii) applies without regard to whether the tax law of the home office provides an exclusion or exemption for income attributable to the branch.

(iii) *Certain deductions are hybrid deductions only if allowed for an accounting period beginning on or after December 20, 2018.* A deduction described in paragraph (b)(1)(ii) of this section (deductions with respect to equity), or a deduction that would be disallowed if the foreign tax resident's or foreign taxable branch's tax law contained a rule substantially similar to §1.267A-2(a)(4) (payments pursuant to interest-free loans and similar arrangements), is a hybrid deduction only if allowed for an accounting period beginning on or after December 20, 2018.

(iv) *Certain deductions of a CFC are not hybrid deductions.* A deduction that

but for this paragraph (b)(2)(iv) would be a hybrid deduction is not a hybrid deduction to the extent that the amount paid or accrued giving rise to the deduction is—

(A) A disqualified hybrid amount (but subject to the special rule of paragraph (g) of this section); or

(B) Included or includible in income in the United States. For purposes of this paragraph (b)(2)(iv)(B), an amount is included or includible in income in the United States to the extent that, if the amount were a tentative disqualified hybrid amount (as described in §1.267A-3(b)(1)), it would be reduced under the rules of §1.267A-3(b)(2) through (5).

(v) *Loss carryovers.* A hybrid deduction for a particular accounting period includes a loss carryover from another accounting period, but only to the extent that a hybrid deduction incurred in an accounting period ending on or after December 20, 2018, comprises the loss carryover.

(c) *Set-off rules*—(1) *In general.* In the order described in paragraph (c)(2) of this section, a hybrid deduction directly or indirectly offsets the income attributable to an imported mismatch payment to the extent that, under paragraph (c)(3) of this section, the payment directly or indirectly funds the hybrid deduction. The rules of paragraphs (c)(2) and (3) of this section are applied by taking into account the application of paragraph (c)(4) of this section (adjustments to ensure that amounts not taken into account more than once).

(2) *Ordering rules.* The following ordering rules apply for purposes of determining the extent that a hybrid deduction directly or indirectly offsets income attributable to imported mismatch payments.

(i) First, the hybrid deduction offsets income attributable to a factually-related imported mismatch payment that directly or indirectly funds the hybrid deduction. For purposes of this paragraph (c)(2)(i), a *factually-related imported mismatch payment* means an imported mismatch payment that is made pursuant to a transaction, agreement, or instrument entered into pursuant to the same plan or series of related transactions that includes the transaction, agreement, or instrument pursuant to which the hybrid deduction is incurred, provided that a design of the plan or series of related transactions was for the hybrid deduction to offset income attrib-

utable to the payment (as determined under the principles of §1.267A-5(a)(20)(i), by treating the offset as the “hybrid mismatch” described in §1.267A-5(a)(20)(i)).

(ii) Second, to the extent remaining, the hybrid deduction offsets income attributable to an imported mismatch payment (other than a factually-related imported mismatch payment) that directly funds the hybrid deduction.

(iii) Third, to the extent remaining, the hybrid deduction offsets income attributable to an imported mismatch payment (other than a factually-related imported mismatch payment) that indirectly funds the hybrid deduction.

(3) *Funding rules.* The following funding rules apply for purposes of determining the extent that an imported mismatch payment directly or indirectly funds a hybrid deduction.

(i) The imported mismatch payment directly funds a hybrid deduction to the extent that the imported mismatch payee incurs the hybrid deduction.

(ii) The imported mismatch payment indirectly funds a hybrid deduction to the extent that the imported mismatch payee is allocated the hybrid deduction, and provided that the imported mismatch payee is related to the imported mismatch payer (or is a party to a structured arrangement pursuant to which the imported mismatch payment is made).

(iii) The imported mismatch payee is allocated a hybrid deduction to the extent that the imported mismatch payee directly or indirectly makes a funded taxable payment to the foreign tax resident or foreign taxable branch that incurs the hybrid deduction.

(iv) An imported mismatch payee indirectly makes a funded taxable payment to the foreign tax resident or foreign taxable branch that incurs a hybrid deduction to the extent that a chain of funded taxable payments connects the imported mismatch payee, each intermediary foreign tax resident or foreign taxable branch, and the foreign tax resident or foreign taxable branch that incurs the hybrid deduction, and provided that each intermediary foreign tax resident or foreign taxable branch is related to the imported mismatch payer (or is a party to a structured arrangement pursuant to which the imported mismatch payment is made).

(v) The term *funded taxable payment* means an amount paid or accrued by a foreign tax resident or foreign taxable branch under its tax law (other than an amount that gives rise to a hybrid deduction), to the extent that—

(A) The amount is deductible (but, if such tax law contains hybrid mismatch rules, determined without regard to a provision substantially similar to this section);

(B) Another foreign tax resident or foreign taxable branch includes the amount in income, as determined under §1.267A-3(a) (by treating the amount as the specified payment); and

(C) The amount is neither a disqualified hybrid amount (but subject to the special rule of paragraph (g) of this section) nor included or includible in income in the United States. For purposes of this paragraph (c)(3)(v)(C), an amount is included or includible in income in the United States to the extent that, if the amount were a tentative disqualified hybrid amount (as described in §1.267A-3(b)(1)), it would be reduced under the rules of §1.267A-3(b)(2) through (5).

(vi) If a deduction or loss that is not incurred by a foreign tax resident or foreign taxable branch is directly or indirectly made available to offset income of the foreign tax resident or foreign taxable branch under its tax law, then, for purposes of this paragraph (c), the foreign tax resident or foreign taxable branch to which the deduction or loss is made available and the foreign tax resident or foreign taxable branch that incurs the deduction or loss are treated as a single foreign tax resident or foreign taxable branch. For example, if a deduction or loss of one foreign tax resident is made available to offset income of another foreign tax resident under a tax consolidation, fiscal unity, group relief, loss sharing, or any similar regime, then the foreign tax residents are treated as a single foreign tax resident for purposes of this paragraph (c).

(vii) An imported mismatch payee that directly makes a funded taxable payment to the foreign tax resident or foreign taxable branch that incurs a hybrid deduction is allocated the hybrid deduction before the hybrid deduction (to the extent remaining) is allocated to an imported mismatch payee that indirectly makes a funded tax-



able payment to the foreign tax resident or foreign taxable branch that incurs the hybrid deduction.

(viii) An imported mismatch payee that, through a chain of funded taxable payments consisting of a particular number of funded taxable payments, indirectly makes a funded taxable payment to the foreign tax resident or foreign taxable branch that incurs a hybrid deduction is allocated the hybrid deduction before the hybrid deduction (to the extent remaining) is allocated to an imported mismatch payee that, through a chain of funded taxable payments consisting of a greater number of funded taxable payments, indirectly makes a funded taxable payment to the foreign tax resident or foreign taxable branch that incurs the hybrid deduction.

(4) *Adjustments to ensure amounts not taken into account more than once.* To the extent that the income attributable to an imported mismatch payment is directly or indirectly offset by a hybrid deduction, the imported mismatch payment, the hybrid deduction, and, if applicable, each funded taxable payment comprising the chain of funded taxable payments connecting the imported mismatch payee, each intermediary foreign tax resident or foreign taxable branch, and the foreign tax resident or foreign taxable branch that incurs the hybrid deduction is correspondingly reduced; as a result, such amounts are not again taken into account under this section.

(d) *Calculations based on aggregate amounts during accounting period.* For purposes of this section, amounts are determined on an accounting period basis. Thus, for example, the amount of imported mismatch payments made by an imported mismatch payer to a particular imported mismatch payee is equal to the aggregate amount of all such payments made by the imported mismatch payer during the accounting period.

(e) *Pro rata adjustments.* Amounts are allocated on a pro rata basis if there would otherwise be more than one permissible manner in which to allocate the amounts. Thus, for example, if multiple imported mismatch payers make an imported mismatch payment to a single imported mismatch payee, the sum of such payments exceeds the hybrid deduction incurred by the imported mismatch payee, and the payments are not factually-related import-

ed mismatch payments, then a pro rata portion of each imported mismatch payer's payment is considered to directly fund the hybrid deduction. See §1.267A-6(c)(9) and (12) for examples illustrating the application of this paragraph (e).

(f) *Special rules regarding manner in which this section is applied—(1) Initial application of this section.* This section is first applied without regard to paragraph (f)(2) of this section and by taking into account only the following hybrid deductions:

(i) A hybrid deduction described in paragraph (b)(1)(i) of this section, to the extent that—

(A) The deduction would be disallowed if the foreign tax resident's or foreign taxable branch's tax law contained a rule substantially similar to §1.267A-2(a)(4) (payments pursuant to interest-free loans and similar arrangements); or

(B) The paid or accrued amount giving rise to the deduction is included in income in a third country but is not included in income in another country as a result of a hybrid or branch arrangement.

(ii) A hybrid deduction described in paragraph (b)(1)(ii) of this section (deductions with respect to equity).

(2) *Subsequent application of this section takes into account certain amounts deemed to be imported mismatch payments.* After this section is applied pursuant to the rules of paragraph (f)(1) of this section, the section is then applied by taking into account only hybrid deductions other than those described in paragraph (f)(1) of this section. In addition, when applying this section in the manner described in the previous sentence, for purposes of determining the extent to which the income attributable to an imported mismatch payment is directly or indirectly offset by a hybrid deduction, an amount paid or accrued by a foreign tax resident or foreign taxable branch that is not a specified party is deemed to be an imported mismatch payment (and such foreign tax resident or foreign taxable branch and a foreign tax resident or foreign taxable branch that includes the amount in income, as determined under §1.267A-3(a), by treating the amount as the specified payment, are deemed to be an imported mismatch payer and an imported mismatch payee, respectively) to the extent that—

(i) The tax law of such foreign tax resident or foreign taxable branch contains hybrid mismatch rules; and

(ii) The amount is subject to disallowance under a provision of the hybrid mismatch rules substantially similar to this section. See §1.267A-6(c)(10) and (12) for examples illustrating the application of paragraph (f)(2) of this section.

(g) *Special rule regarding extent to which a disqualified hybrid amount of a CFC prevents a hybrid deduction or a funded taxable payment.* A disqualified hybrid amount of a CFC is taken into account for purposes of paragraph (b)(2)(iv)(A) or (c)(3)(v)(C) of this section (certain deductions not hybrid deductions or funded taxable payments to the extent the amount giving rise to the deduction is a disqualified hybrid amount) only to the extent of the excess (if any) of the disqualified hybrid amount over the sum of the amounts described in paragraphs (g)(1) through (3) of this section. See §1.267A-6(c)(11) for an example illustrating the application of this paragraph (g).

(1) The disqualified hybrid amount to the extent that, if allowed as a deduction, it would be allocated and apportioned to residual CFC gross income (as described in §1.951A-2(c)(5)(iii)(B)) of the CFC.

(2) The disqualified hybrid amount to the extent that, if allowed as a deduction, it would be allocated and apportioned (under the rules of section 954(b)(5)) to gross income that is taken into account in determining the CFC's subpart F income (as described in section 952 and §1.952-1), multiplied by the difference of 100 percent and the percentage of stock (by value) of the CFC that, for purposes of sections 951 and 951A, is owned (within the meaning of section 958(a), and determined by treating a domestic partnership as foreign) by one or more tax residents of the United States that are United States shareholders of the CFC.

(3) The disqualified hybrid amount to the extent that, if allowed as a deduction, it would be allocated and apportioned (under the rules of §1.951A-2(c)(3)) to gross tested income of the CFC (as described in section 951A(c)(2)(A) and §1.951A-2(c)(1)), multiplied by the difference of 100 percent and the percentage of stock (by value) of the CFC that, for purposes of

sections 951 and 951A, is owned (within the meaning of section 958(a), and determined by treating a domestic partnership as foreign) by one or more tax residents of the United States that are United States shareholders of the CFC.

*§1.267A-5 Definitions and special rules.*

(a) *Definitions.* For purposes of §§1.267A-1 through 1.267A-7 the following definitions apply.

(1) The term *accounting period* means a taxable year, or a period of similar length over which, under a provision of hybrid mismatch rules substantially similar to §1.267A-4, computations similar to those under §1.267A-4 are made under a foreign tax law.

(2) The term *branch* means a taxable presence of a tax resident in a country other than its country of residence as determined under either the tax resident's tax law or such other country's tax law.

(3) The term *branch mismatch payment* has the meaning provided in §1.267A-2(e)(2).

(4) The term *controlled foreign corporation* (or *CFC*) has the meaning provided in section 957.

(5) The term *deemed branch payment* has the meaning provided in §1.267A-2(c)(2).

(6) The term *disregarded payment* has the meaning provided in §1.267A-2(b)(2).

(7) The term *entity* means any person as described in section 7701(a)(1), including an entity that under §§301.7701-1 through 301.7701-3 of this chapter is disregarded as an entity separate from its owner, other than an individual.

(8) The term *fiscally transparent* means, with respect to an entity, fiscally transparent with respect to an item of income as determined under the principles of §1.894-1(d)(3)(ii) and (iii), without regard to whether a tax resident (either the entity or interest holder in the entity) that derives the item of income is a resident of a country that has an income tax treaty with the United States. In addition, the following special rules apply with respect to an item of income received by an entity:

(i) The entity is fiscally transparent with respect to the item under the tax law of the country in which the entity is created, organized, or otherwise established

if, under that tax law, the entity does not take the item into account in its income (without regard to whether such tax law requires an investor of the entity, wherever resident, to separately take into account on a current basis the investor's respective share of the item), and the effect under that tax law is that an investor of the entity is required to take the item into account in its income as if the item were realized directly from the source from which realized by the entity, whether or not distributed.

(ii) The entity is fiscally transparent with respect to the item under the tax law of an investor of the entity if, under that tax law, an investor of the entity takes the item into account in its income (without regard to whether such tax law requires the investor to separately take into account on a current basis the investor's respective share of the item) as if the item were realized directly from the source from which realized by the entity, whether or not distributed.

(iii) The entity is fiscally transparent with respect to the item under the tax law of the country in which the entity is created, organized, or otherwise established if—

(A) That tax law imposes a corporate income tax; and

(B) Under that tax law, neither the entity is required to take the item into account in its income nor an investor of the entity is required to take the item into account in its income as if the item were realized directly from the source from which realized by the entity, whether or not distributed.

(9) The term *home office* means a tax resident that has a branch.

(10) The term *hybrid mismatch rules* means rules, regulations, or other tax guidance substantially similar to section 267A, and includes rules the purpose of which is to neutralize the deduction/no-inclusion outcome of hybrid and branch mismatch arrangements. Examples of such rules would include rules based on, or substantially similar to, the recommendations contained in OECD/G-20, *Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2: 2015 Final Report* (October 2015), and OECD/G-20, *Neutralising the Effects of Branch Mismatch Arrangements, Action 2: Inclusive Framework on BEPS* (July 2017).

(11) The term *hybrid transaction* has the meaning provided in §1.267A-2(a)(2).

(12) The term *interest* means any amount described in paragraph (a)(12)(i) or (ii) of this section that is paid or accrued, or treated as paid or accrued, for the taxable year or that is otherwise designated as interest expense in paragraph (a)(12)(i) or (ii) of this section.

(i) *In general.* Interest is an amount paid, received, or accrued as compensation for the use or forbearance of money under the terms of an instrument or contractual arrangement, including a series of transactions, that is treated as a debt instrument for purposes of section 1275(a) and §1.1275-1(d), and not treated as stock under §1.385-3, or an amount that is treated as interest under other provisions of the Internal Revenue Code (Code) or the regulations in this part. Thus, interest includes, but is not limited to, the following—

(A) Original issue discount (OID);

(B) Qualified stated interest, as adjusted by the issuer for any bond issuance premium;

(C) OID on a synthetic debt instrument arising from an integrated transaction under §1.1275-6;

(D) Repurchase premium to the extent deductible by the issuer under §1.163-7(c);

(E) Deferred payments treated as interest under section 483;

(F) Amounts treated as interest under a section 467 rental agreement;

(G) Forgone interest under section 7872;

(H) De minimis OID taken into account by the issuer;

(I) Amounts paid in connection with a sale-repurchase agreement treated as indebtedness under Federal tax principles;

(J) Redeemable ground rent treated as interest under section 163(c); and

(K) Amounts treated as interest under section 636.

(ii) *Swaps with significant nonperiodic payments*—(A) *In general.* Except as provided in paragraphs (a)(12)(ii)(B) and (C) of this section, a swap with significant nonperiodic payments is treated as two separate transactions consisting of an on-market, level payment swap and a loan. The loan must be accounted for by the parties to the contract independently of the swap. The time value component

associated with the loan, determined in accordance with §1.446-3(f)(2)(iii)(A), is recognized as interest expense to the payor.

(B) *Exception for cleared swaps.* Paragraph (a)(12)(ii)(A) of this section does not apply to a cleared swap. The term *cleared swap* means a swap that is cleared by a derivatives clearing organization, as such term is defined in section 1a of the Commodity Exchange Act (7 U.S.C. 1a), or by a clearing agency, as such term is defined in section 3 of the Securities Exchange Act of 1934 (15 U.S.C. 78c), that is registered as a derivatives clearing organization under the Commodity Exchange Act or as a clearing agency under the Securities Exchange Act of 1934, respectively, if the derivatives clearing organization or clearing agency requires the parties to the swap to post and collect margin or collateral.

(C) *Exception for non-cleared swaps subject to margin or collateral requirements.* Paragraph (a)(12)(ii)(A) of this section does not apply to a non-cleared swap that requires the parties to meet the margin or collateral requirements of a Federal regulator or that provides for margin or collateral requirements that are substantially similar to a cleared swap or a non-cleared swap subject to the margin or collateral requirements of a Federal regulator. For purposes of this paragraph (a)(12)(ii)(C), the term *Federal regulator* means the Securities and Exchange Commission (SEC), the Commodity Futures Trading Commission (CFTC), or a prudential regulator, as defined in section 1a(39) of the Commodity Exchange Act (7 U.S.C. 1a), as amended by section 721 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Public Law No. 111-203, 124 Stat. 1376, Title VII.

(13) The term *investor* means, with respect to an entity, any tax resident or taxable branch that directly or indirectly (determined under the rules of section 958(a) without regard to whether an intermediate entity is foreign or domestic, or under substantially similar rules under a tax resident's or taxable branch's tax law) owns an interest in the entity.

(14) The term *related* has the meaning provided in this paragraph (a)(14). 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 section 954(d)(3) and the tax resident or taxable branch as the "person" referred to in section 954(d)(3). In addition, for the purposes of this paragraph (a)(14), a tax resident that under §§301.7701-1 through 301.7701-3 of this chapter is disregarded as an entity separate from its owner for U.S. tax purposes, as well as a taxable branch, is treated as a corporation. *See also* §1.954-1(f)(2)(iv)(B)(I) (neither section 318(a)(3), nor §1.958-2(d) or the principles thereof, applies to attribute stock or other interests).

(15) The term *reverse hybrid* has the meaning provided in §1.267A-2(d)(2).

(16) The term *royalty* includes amounts paid or accrued as consideration for the use of, or the right to use—

(i) Any copyright, including any copyright of any literary, artistic, scientific or other work (including cinematographic films and software);

(ii) Any patent, trademark, design or model, plan, secret formula or process, or other similar property (including goodwill); or

(iii) Any information concerning industrial, commercial or scientific experience, but does not include—

(A) Amounts paid or accrued for after-sales services;

(B) Amounts paid or accrued for services rendered by a seller to the purchaser under a warranty;

(C) Amounts paid or accrued for pure technical assistance; or

(D) Amounts paid or accrued for an opinion given by an engineer, lawyer or accountant.

(17) The term *specified party* means a tax resident of the United States, a CFC (other than a CFC with respect to which there is not a tax resident of the United States that, for purposes of sections 951 and 951A, owns (within the meaning of section 958(a), and determined by treating a domestic partnership as foreign) at least ten percent (by vote or value) of the stock of the CFC), and a U.S. taxable branch. Thus, an entity that is fiscally transparent for U.S. tax purposes is not a specified party, though an owner of the entity

may be a specified party. For example, in the case of a payment by a partnership, a domestic corporation that is a partner of the partnership is a specified party and a deduction for its allocable share of the payment is subject to disallowance under section 267A.

(18) The term *specified payment* has the meaning provided in §1.267A-1(b).

(19) The term *specified recipient* means, with respect to a specified payment, 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 (or any tax resident that, based on all the facts and circumstances, is reasonably expected to derive the payment under its tax law, or any taxable branch to which, based on all the facts and circumstances, the payment is reasonably expected to be attributable under its tax law). The principles of §1.894-1(d)(1) apply for purposes of determining whether a tax resident derives (or is reasonably expected to derive) 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.

(20) The terms *structured arrangement* and *party to a structured arrangement* have the meaning set forth in this paragraph (a)(20).

(i) *Structured arrangement.* A structured arrangement means an arrangement with respect to which one or more specified payments would be a disqualified hybrid amount (or a disqualified imported mismatch amount) without regard to the relatedness limitation in §1.267A-2(f) (or without regard to the phrase "that is related to the specified party" in §1.267A-4(a)) (either such outcome, a *hybrid mismatch*), provided that, based on all the facts and circumstances (including the terms of the arrangement), the arrangement is designed to produce the hybrid mismatch. Facts and circumstances that indicate the arrangement is designed to produce the hybrid mismatch include the following:

(A) The hybrid mismatch is priced into the terms of the arrangement, including—

(I) The pricing of the arrangement is different from what the pricing would have been absent the hybrid mismatch;

(2) Features that alter the terms of the arrangement, including its return if the hybrid mismatch is no longer available; or

(3) A below-market return absent the tax effects or benefits resulting from the hybrid mismatch.

(B) The arrangement is marketed as tax-advantaged where some or all of the tax advantage derives from the hybrid mismatch.

(C) The arrangement is marketed to tax residents of a country the tax law of which enables the hybrid mismatch.

(ii) *Party to a structured arrangement.* A party to a structured arrangement means a tax resident or taxable branch that participates in the structured arrangement. For purposes of this paragraph (a)(20)(ii), in the case of a tax resident or a taxable branch that is an entity, the tax resident's or taxable branch's participation in a structured arrangement is imputed to its investors. However, a tax resident or taxable branch is considered to participate in the structured arrangement only if—

(A) The tax resident or taxable branch (or a related tax resident or taxable branch) could, based on all the facts and circumstances, reasonably be expected to be aware of the hybrid mismatch; and

(B) The tax resident or taxable branch (or a related tax resident or taxable branch) shares in the value of the tax benefit resulting from the hybrid mismatch.

(21) The term *tax law* of a country includes statutes, regulations, administrative or judicial rulings, and income tax treaties of the country. If a country has an income tax treaty with the United States that applies to taxes imposed by a political subdivision or other local authority of that country, then the tax law of the political subdivision or other local authority is deemed to be a tax law of a country. When used with respect to a tax resident or branch, tax law refers to—

(i) In the case of a tax resident, the tax law of the country or countries where the tax resident is resident; and

(ii) In the case of a branch, the tax law of the country where the branch is located.

(22) The term *taxable branch* means a branch that has a taxable presence under its tax law.

(23) The term *tax resident* means either of the following:

(i) A body corporate or other entity or body of persons liable to tax under the tax law of a country as a resident. For purposes of this paragraph (a)(23)(i), an entity that is created, organized, or otherwise established under the tax law of a country that does not impose a corporate income tax is treated as liable to tax under the tax law of such country as a resident if under the corporate or commercial laws of such country the entity is treated as a body corporate or a company. A body corporate or other entity or body of persons may be a tax resident of more than one country.

(ii) An individual liable to tax under the tax law of a country as a resident. An individual may be a tax resident of more than one country.

(24) The term *United States shareholder* has the meaning provided in section 951(b).

(25) The term *U.S. taxable branch* means a trade or business carried on in the United States by a tax resident of another country, except that if an income tax treaty applies, the term means a permanent establishment of a tax treaty resident eligible for benefits under an income tax treaty between the United States and the treaty country. Thus, for example, a U.S. taxable branch includes a U.S. trade or business of a foreign corporation taxable under section 882(a) or a U.S. permanent establishment of a tax treaty resident.

(b) *Special rules.* For purposes of §§1.267A-1 through 1.267A-7, the following special rules apply.

(1) *Coordination with other provisions—*(i) *In general.* Except as provided in paragraph (b)(1)(ii) of this section, a specified payment is subject to section 267A after the application of any other applicable provisions of the Code and regulations in this part. Thus, the determination of whether a deduction for a specified payment is disallowed under section 267A is made with respect to the taxable year for which a deduction for the payment would otherwise be allowed for U.S. tax purposes. *See, for example,* sections 163(e)(3) and 267(a)(3) for rules that may defer the taxable year for which a deduction is allowed. *See also* §1.882-5(a)(5) (providing that provisions that disallow interest expense apply after the application of §1.882-5). In addition, provisions that characterize amounts paid or accrued

as something other than interest or royalties, such as §1.894-1(d)(2), govern the treatment of such amounts and therefore such amounts would not be treated as specified payments. Moreover, to the extent that a specified payment is not described in §1.267A-1(b) when it is subject to section 267A, the payment is not again subject to section 267A at a later time. For example, if for the taxable year in which a specified payment is paid the payment is not described in §1.267A-1(b) but under section 163(j) a deduction for the payment is deferred, the payment is not again subject to section 267A in the taxable year for which section 163(j) no longer defers the deduction.

(ii) *Section 267A applied before certain provisions.* In addition to the extent provided in any other applicable provision of the Code or regulations in this part, section 267A applies before the application of sections 163(j), 461(l), 465, and 469.

(iii) *Coordination with capitalization and recovery provisions.* To the extent a specified payment is described in §1.267A-1(b), a deduction for the payment is considered permanently disallowed for all purposes of the Code and regulations in this part and, therefore, the payment is not taken into account for purposes of computing costs that are required to be capitalized and recovered through depreciation, amortization, cost of goods sold, adjustment to basis, or similar forms of recovery under any applicable provision of the Code or in regulations in this part. Thus, for example, to the extent an interest or royalty payment is a specified payment described in §1.267A-1(b), the payment is not capitalized and included in inventory cost or added to basis under section 263A. As an additional example, to the extent that a debt issuance cost is a specified payment described in §1.267A-1(b), it is neither capitalized under section 263 or the regulations in this part under section 263 nor recoverable under §1.446-5.

(iv) *Specified payments arising in taxable years beginning before January 1, 2018.* Section 267A does not apply to a specified payment that is paid or accrued in a taxable year beginning before January 1, 2018, regardless of whether under a provision of the Code or regulations in this part (for example, section 267(a)(3)) a

deduction for the payment is deferred to a taxable year beginning after December 31, 2017, or whether the payment is carried over to another taxable year and under another provision of the Code (for example, section 163(j)) is considered paid or accrued in such taxable year.

(2) *Foreign currency gain or loss.* Except as set forth in this paragraph (b) (2), section 988 gain or loss is not taken into account under section 267A. Foreign currency gain or loss recognized with respect to a specified payment is taken into account under section 267A to the extent that a deduction for the specified payment is disallowed under section 267A, provided that the foreign currency gain or loss is described in §1.988-2(b)(4) (relating to exchange gain or loss recognized by the issuer of a debt instrument with respect to accrued interest) or §1.988-2(c) (relating to items of expense or gross income or receipts which are to be paid after the date accrued). If a deduction for a specified payment is disallowed under section 267A, then a proportionate amount of foreign currency loss under section 988 with respect to the specified payment is also disallowed, and a proportionate amount of foreign currency gain under section 988 with respect to the specified payment reduces the amount of the disallowance. For purposes of this paragraph (b)(2), the proportionate amount is the amount of the 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.

(3) *U.S. taxable branch payments—(i) Amounts considered paid or accrued by a U.S. taxable branch.* For purposes of section 267A, a U.S. taxable branch is considered to pay or accrue an amount of interest or royalty equal to either—

(A) The amount of interest or royalty allocable to effectively connected income of the U.S. taxable branch under section 873(a) or 882(c)(1), as applicable; or

(B) In the case of a U.S. taxable branch that is a U.S. permanent establishment of a treaty resident eligible for benefits under an income tax treaty between the United States and the treaty country, the amount

of interest or royalty allowable in computing the business profits attributable to the U.S. permanent establishment.

(ii) *Treatment of U.S. taxable branch payments—(A) Interest.* Interest considered paid or accrued by a U.S. taxable branch of a foreign corporation under paragraph (b)(3)(i) of this section (the “U.S. taxable branch interest payment”) is treated as a payment directly to the person to which the interest is payable, to the extent it is paid or accrued with respect to a liability described in §1.882-5(a)(1)(ii) (A) or (B) (resulting in directly allocable interest) or with respect to a U.S. booked liability, as described in §1.882-5(d)(2). If the U.S. taxable branch interest payment exceeds in the aggregate the interest paid or accrued on the U.S. taxable branch’s directly allocable interest and interest paid or accrued on U.S. booked liabilities, the excess amount is treated as paid or accrued by the U.S. taxable branch on a pro-rata basis to the same persons and pursuant to the same terms that the home office paid or accrued interest, excluding any directly allocable interest or interest paid or accrued on a U.S. booked liability. The rules of this paragraph (b)(3)(ii) for determining to whom interest is paid or accrued apply without regard to whether the U.S. taxable branch interest payment is determined under the method described in §1.882-5(b) through (d) or the method described in §1.882-5(e).

(B) *Royalties.* Royalties considered paid or accrued by a U.S. taxable branch under paragraph (b)(3)(i) of this section are treated solely for purposes of section 267A as paid or accrued on a pro-rata basis by the U.S. taxable branch to the same persons and pursuant to the same terms that the home office paid or accrued such royalties.

(C) *Permanent establishments and interbranch payments.* If a U.S. taxable branch is a permanent establishment in the United States, the principles of the rules in paragraphs (b)(3)(ii)(A) and (B) of this section apply with respect to interest and royalties allowed in computing the business profits of a treaty resident eligible for treaty benefits. This paragraph (b)(3)(ii) (C) does not apply to interbranch interest or royalty payments allowed as deduction under certain U.S. income tax treaties (as described in §1.267A-2(c)(2)).

(4) *Effect on earnings and profits.* The disallowance of a deduction under section 267A does not affect whether the amount paid or accrued that gave rise to the deduction reduces earnings and profits of a corporation. However, for purposes of section 952(c)(1) and §1.952-1(c), a CFC’s earnings and profits are not reduced by a specified payment a deduction for which is disallowed under section 267A, if a principal purpose of the transaction pursuant to which the payment is made is to reduce or limit the CFC’s subpart F income.

(5) *Application to structured payments—(i) In general.* For purposes of section 267A and the regulations in this part under section 267A, a structured payment (as defined in paragraph (b)(5)(ii) of this section) is treated as interest. Thus, a structured payment is treated as subject to section 267A and the regulations in this part under section 267A to the same extent as if the payment were an amount of interest paid or accrued.

(ii) *Structured payment.* A structured payment means any amount described in paragraph (b)(5)(ii)(A) or (B) of this section.

(A) *Substitute interest payments.* A substitute interest payment described in §1.861-2(a)(7) is treated as a structured payment for purposes of section 267A, unless the payment relates to a sale-repurchase agreement or a securities lending transaction that is entered into by the payor in the ordinary course of the payor’s business. This paragraph (b)(5)(ii)(A) does not apply to an amount described in paragraph (a)(12)(i)(I) of this section.

(B) *Amounts economically equivalent to interest—(1) Principal purpose to reduce interest expense.* Any expense or loss economically equivalent to interest is treated as a structured payment for purposes of section 267A if a principal purpose of structuring the transaction(s) is to reduce an amount incurred by the taxpayer that otherwise would have been described in paragraph (a)(12) or (b)(5)(ii)(A) of this section. For purposes of this paragraph (b) (5)(ii)(B)(1), the fact that the taxpayer has a business purpose for obtaining the use of funds does not affect the determination of whether the manner in which the taxpayer structures the transaction(s) is with a principal purpose of reducing the taxpayer’s interest expense. In addition, the fact that

the taxpayer has obtained funds at a lower pre-tax cost based on the structure of the transaction(s) does not affect the determination of whether the manner in which the taxpayer structures the transaction(s) is with a principal purpose of reducing the taxpayer's interest expense. For purposes of this paragraph (b)(5)(ii)(B), any expense or loss is economically equivalent to interest to the extent that the expense or loss is—

(i) Deductible by the taxpayer;

(ii) Incurred by the taxpayer in a transaction or series of integrated or related transactions in which the taxpayer secures the use of funds for a period of time;

(iii) Substantially incurred in consideration of the time value of money; and

(iv) Not described in paragraph (a)(12) or (b)(5)(ii)(A) of this section.

(2) *Principal purpose.* Whether a transaction or a series of integrated or related transactions is entered into with a principal purpose described in paragraph (b)(5)(ii)(B)(I) of this section depends on all the facts and circumstances related to the transaction(s). A purpose may be a principal purpose even though it is outweighed by other purposes (taken together or separately). Factors to be taken into account in determining whether one of the taxpayer's principal purposes for entering into the transaction(s) include the taxpayer's normal borrowing rate in the taxpayer's functional currency, whether the taxpayer would enter into the transaction(s) in the ordinary course of the taxpayer's trade or business, whether the parties to the transaction(s) are related persons (within the meaning of section 267(b) or 707(b)), whether there is a significant and bona fide business purpose for the structure of the transaction(s), whether the transactions are transitory, for example, due to a circular flow of cash or other property, and the substance of the transaction(s).

(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 deemed full inclusion rule in §1.267A-3(a)(5)).

(ii) A principal purpose of the terms or structure of the arrangement (including the form and the tax laws of the parties to the arrangement) is to avoid the application of the regulations in this part under section 267A in a manner that is contrary to the purposes of section 267A and the regulations in this part under section 267A.

#### §1.267A-6 Examples.

(a) *Scope.* This section provides examples that illustrate the application of §§1.267A-1 through 1.267A-5.

(b) *Presumed facts.* For purposes of the examples in this section, unless otherwise indicated, the following facts are presumed:

(1) US1, US2, and US3 are domestic corporations that are tax residents solely of the United States.

(2) FW, FX, and FZ are bodies corporate established in, and tax residents of, Country W, Country X, and Country Z, respectively. They are not fiscally transparent under the tax law of any country. They are not specified parties.

(3) Under the tax law of each country, interest and royalty payments are deductible.

(4) The tax law of each country provides a 100 percent participation exemption for dividends received from non-resident corporations.

(5) The tax law of each country, other than the United States, provides an exemption for income attributable to a branch.

(6) Except as provided in paragraphs (b)(4) and (5) of this section, all amounts derived (determined under the principles of §1.894-1(d)(1)) by a tax resident, or attributable to a taxable branch, are included in income, as determined under §1.267A-3(a).

(7) Only the tax law of the United States contains hybrid mismatch rules.

(c) *Examples—(1) Example 1. Payment pursuant to a hybrid financial instrument—(i) Facts.* FX holds all the interests of US1. FX also holds an instrument issued by US1 that is treated as equity for Country X tax purposes and indebtedness for U.S. tax purposes (the FX-US1 instrument). On date 1, US1 pays \$50x to FX pursuant to the instrument. The amount is treated as an excludible dividend for Country X tax purposes (by reason of the Country X participation exemption) and as interest for U.S. tax purposes.

(ii) *Analysis.* US1 is a specified party and thus a deduction for its \$50x specified payment is subject to disallowance under section 267A. As described in paragraphs (c)(1)(ii)(A) through (C) of this section, the entire \$50x payment is a disqualified hybrid amount under the hybrid transaction rule of

§1.267A-2(a) and, as a result, a deduction for the payment is disallowed under §1.267A-1(b)(1).

(A) US1's payment is made pursuant to a hybrid transaction because a payment with respect to the FX-US1 instrument is treated as interest for U.S. tax purposes but not for purposes of Country X tax law (the tax law of FX, a specified recipient that is related to US1). See §1.267A-2(a)(2) and (f). Therefore, §1.267A-2(a) applies to the payment.

(B) For US1's payment to be a disqualified hybrid amount under §1.267A-2(a), a no-inclusion must occur with respect to FX. See §1.267A-2(a)(1)(i). As a consequence of the Country X participation exemption, FX includes \$0 of the payment in income and therefore a \$50x no-inclusion occurs with respect to FX. See §1.267A-3(a)(1). The result is the same regardless of whether, under the Country X participation exemption, the \$50x payment is simply excluded from FX's taxable income or, instead, is reduced or offset by other means, such as a \$50x dividends received deduction. See §1.267A-3(a)(1).

(C) Pursuant to §1.267A-2(a)(1)(ii), FX's \$50x no-inclusion gives rise to a disqualified hybrid amount to the extent that it is a result of US1's payment being made pursuant to the hybrid transaction. FX's \$50x no-inclusion is a result of the payment being made pursuant to the hybrid transaction because, were the payment to be treated as interest for Country X tax purposes, FX would include \$50x in income and, consequently, the no-inclusion would not occur.

(iii) *Alternative facts – multiple specified recipients.* The facts are the same as in paragraph (c)(1)(i) of this section, except that FX holds all the interests of FZ, which is fiscally transparent for Country X tax purposes, and FZ holds all of the interests of US1. Moreover, the FX-US1 instrument is held by FZ (rather than by FX) and US1 makes its \$50x payment to FZ (rather than to FX); the payment is derived by FZ under its tax law and by FX under its tax law and, accordingly, both FZ and FX are specified recipients of the payment. Further, the payment is treated as interest for Country Z tax purposes and FZ includes it in income. For the reasons described in paragraph (c)(1)(ii) of this section, FX's no-inclusion causes the payment to be a disqualified hybrid amount. FZ's inclusion in income (regardless of whether Country Z has a low or high tax rate) does not affect the result, because the hybrid transaction rule of §1.267A-2(a) applies if any no-inclusion occurs with respect to a specified recipient of the payment as a result of the payment being made pursuant to the hybrid transaction.

(iv) *Alternative facts – preferential rate.* The facts are the same as in paragraph (c)(1)(i) of this section, except that for Country X tax purposes US1's payment is treated as a dividend subject to a 4% tax rate, whereas the marginal rate imposed on ordinary income is 20%. FX includes \$10x of the payment in income, calculated as \$50x multiplied by 0.2 (.04, the rate at which the particular type of payment (a dividend for Country X tax purposes) is subject to tax in Country X, divided by 0.2, the marginal tax rate imposed on ordinary income). See §1.267A-3(a)(1). Thus, a \$40x no-inclusion occurs with respect to FX (\$50x less \$10x). The \$40x no-inclusion is a result of the payment being made pursuant to the hybrid transaction because, were the payment to be treated as interest for Country X tax purposes, FX would include the entire \$50x in income at the full marginal rate imposed on ordinary income (20%)

and, consequently, the no-inclusion would not occur. Accordingly, \$40x of US1's payment is a disqualified hybrid amount.

(v) *Alternative facts – no-inclusion not the result of hybridity.* The facts are the same as in paragraph (c)(1)(i) of this section, except that Country X has a pure territorial regime (that is, Country X only taxes income with a domestic source). Although US1's payment is pursuant to a hybrid transaction and a \$50x no-inclusion occurs with respect to FX, FX's no-inclusion is not a result of the payment being made pursuant to the hybrid transaction. This is because if Country X tax law were to treat the payment as interest, FX would include \$0 in income and, consequently, the \$50x no-inclusion would still occur. Accordingly, US1's payment is not a disqualified hybrid amount. See §1.267A-2(a)(1)(ii). The result would be the same if Country X instead did not impose a corporate income tax.

(vi) *Alternative facts – indebtedness under both tax laws but different ordering rules give rise to hybrid transaction; reduction of no-inclusion by reason of inclusion of a principal payment.* The facts are the same as in paragraph (c)(1)(i) of this section, except that the FX-US1 instrument is indebtedness for both U.S. and Country X tax purposes. In addition, the \$50x date 1 payment is treated as interest for U.S. tax purposes and a repayment of principal for Country X tax purposes. On date 1, based on all the facts and circumstances (including the terms of the FX-US1 instrument, the tax laws of the United States and Country X, and an absence of a plan pursuant to which FX would dispose of the FX-US1 instrument), it is reasonably expected that on date 2 (a date that is within 36 months after the end of the taxable year of US1 that includes date 1), US1 will pay a total of \$200x to FX and that, for U.S. tax purposes, \$25x will be treated as interest and \$175x as a repayment of principal, and, for Country X tax purposes, \$75x will be treated as interest (and included in FX's income) and \$125x as a repayment of principal. US1's \$50x specified payment is made pursuant to a hybrid transaction and, but for §1.267A-3(a)(4), a \$50x no-inclusion would occur with respect to FX. See §§1.267A-2(a)(2) and 1.267A-3(a)(1). However, pursuant to §1.267A-3(a)(4), FX's inclusion in income with respect to \$50x of the date 2 amount that is a repayment of principal for U.S. tax purposes is treated as correspondingly reducing FX's no-inclusion with respect to the specified payment. As a result, as to US1's \$50x specified payment, a no-inclusion does not occur with respect to FX. See §1.267A-3(a)(4). Therefore, US1's \$50x specified payment is not a disqualified hybrid amount. See §1.267A-2(a)(1)(i).

(2) *Example 2. Payment pursuant to a repo transaction—(i) Facts.* FX holds all the interests of US1, and US1 holds all the interests of US2. On date 1, US1 and FX enter into a sale and repurchase transaction. Pursuant to the transaction, US1 transfers shares of preferred stock of US2 to FX in exchange for \$1,000x, subject to a binding commitment of US1 to reacquire those shares on date 3 for an agreed price, which represents a repayment of the \$1,000x plus a financing or time value of money return reduced by the amount of any distributions paid with respect to the preferred stock between dates 1 and 3 that are retained by FX. On date 2, US2 pays a \$100x dividend on its preferred stock to FX. For Country X

tax purposes, FX is treated as owning the US2 preferred stock and therefore is the beneficial owner of the dividend. For U.S. tax purposes, the transaction is treated as a loan from FX to US1 that is secured by the US2 preferred stock. Thus, for U.S. tax purposes, US1 is treated as owning the US2 preferred stock and is the beneficial owner of the dividend. In addition, for U.S. tax purposes, US1 is treated as paying \$100x of interest to FX (an amount corresponding to the \$100x dividend paid by US2 to FX). Further, the marginal tax rate imposed on ordinary income under Country X tax law is 25%. Moreover, instead of a participation exemption, Country X tax law provides its tax residents a credit for underlying foreign taxes paid by a non-resident corporation from which a dividend is received; with respect to the \$100x dividend received by FX from US2, the credit is \$10x.

(ii) *Analysis.* US1 is a specified party and thus a deduction for its \$100x specified payment is subject to disallowance under section 267A. As described in paragraphs (c)(2)(ii)(A) through (D) of this section, \$40x of the payment is a disqualified hybrid amount under the hybrid transaction rule of §1.267A-2(a) and, as a result, \$40x of the deduction is disallowed under §1.267A-1(b)(1).

(A) Although US1's \$100x interest payment is not regarded under Country X tax law, a connected amount (US2's dividend payment) is regarded and derived by FX under such tax law. Thus, FX is considered a specified recipient with respect to US1's interest payment. See §1.267A-2(a)(3).

(B) US1's payment is made pursuant to a hybrid transaction because a payment with respect to the sale and repurchase transaction is treated as interest for U.S. tax purposes but not for purposes of Country X tax law (the tax law of FX, a specified recipient that is related to US1), which does not regard the payment. See §1.267A-2(a)(2) and (f). Therefore, §1.267A-2(a) applies to the payment.

(C) For US1's payment to be a disqualified hybrid amount under §1.267A-2(a), a no-inclusion must occur with respect to FX. See §1.267A-2(a)(1)(i). As a consequence of Country X tax law not regarding US1's payment, FX includes \$0 of the payment in income and therefore a \$100x no-inclusion occurs with respect to FX. See §1.267A-3(a). However, FX includes \$60x of a connected amount (US2's dividend payment) in income, calculated as \$100x (the amount of the dividend) less \$40x (the portion of the connected amount that is not included in income in Country X due to the foreign tax credit, determined by dividing the amount of the credit, \$10x, by 0.25, the tax rate in Country X). See §1.267A-3(a). Pursuant to §1.267A-2(a)(3), FX's inclusion in income with respect to the connected amount correspondingly reduces the amount of its no-inclusion with respect to US1's payment. Therefore, for purposes of §1.267A-2(a), FX's no-inclusion with respect to US1's payment is \$40x (\$100x less \$60x). See §1.267A-2(a)(3).

(D) Pursuant to §1.267A-2(a)(1)(ii), FX's \$40x no-inclusion gives rise to a disqualified hybrid amount to the extent that FX's no-inclusion is a result of US1's payment being made pursuant to the hybrid transaction. FX's \$40x no-inclusion is a result of US1's payment being made pursuant to the hybrid transaction because, were the sale and repurchase transaction to be treated as a loan from FX to US1 for Country X tax purposes, FX would include US1's

\$100x interest payment in income (because it would not be entitled to a foreign tax credit) and, consequently, the no-inclusion would not occur.

(iii) *Alternative facts – structured arrangement.* The facts are the same as in paragraph (c)(2)(i) of this section, except that FX is a bank that is unrelated to US1. In addition, the sale and repurchase transaction is a structured arrangement and FX is a party to the structured arrangement. The result is the same as in paragraph (c)(2)(ii) of this section. That is, even though FX is not related to US1, it is taken into account with respect to the determinations under §1.267A-2(a) because it is a party to a structured arrangement pursuant to which the payment is made. See §1.267A-2(f).

(3) *Example 3. Disregarded payment—(i) Facts.* FX holds all the interests of US1. For Country X tax purposes, US1 is a disregarded entity of FX. During taxable year 1, US1 pays \$100x to FX pursuant to a debt instrument. The amount is treated as interest for U.S. tax purposes but is disregarded for Country X tax purposes as a transaction involving a single taxpayer. During taxable year 1, US1's only other items of income, gain, deduction, or loss are \$125x of gross income (the entire amount of which is included in US1's income) and a \$60x item of deductible expense. The \$125x item of gross income is included in FX's income, and the \$60x item of deductible expense is allowable for Country X tax purposes.

(ii) *Analysis.* US1 is a specified party and thus a deduction for its \$100x specified payment is subject to disallowance under section 267A. As described in paragraphs (c)(3)(ii)(A) and (B) of this section, \$35x of the payment is a disqualified hybrid amount under the disregarded payment rule of §1.267A-2(b) and, as a result, \$35x of the deduction is disallowed under §1.267A-1(b)(1).

(A) US1's \$100x payment is not regarded under the tax law of Country X (the tax law of FX, a related tax resident to which the payment is made) because under such tax law the payment involves a single taxpayer. See §1.267A-2(b)(2) and (f). In addition, were the tax law of Country X to regard the payment (and treat it as interest), FX would include it in income. Therefore, the payment is a disregarded payment to which §1.267A-2(b) applies. See §1.267A-2(b)(2).

(B) Under §1.267A-2(b)(1), the excess (if any) of US1's disregarded payments for taxable year 1 (\$100x) over its dual inclusion income for the taxable year is a disqualified hybrid amount. US1's dual inclusion income for taxable year 1 is \$65x, calculated as \$125x (the amount of US1's gross income that is included in FX's income) less \$60x (the amount of US1's deductible expenses, other than deductions for disregarded payments, that are allowable for Country X tax purposes). See §1.267A-2(b)(3). Therefore, \$35x is a disqualified hybrid amount (\$100x less \$65x). See §1.267A-2(b)(1).

(iii) *Alternative facts – non-dual inclusion income arising from hybrid transaction.* The facts are the same as in paragraph (c)(3)(i) of this section, except that US1 holds all the interests of FZ (a specified party that is a CFC) and US1's only item of income, gain, deduction, or loss during taxable year 1 (other than the \$100x payment to FX) is \$80x paid to US1 by FZ pursuant to an instrument treated as indebtedness for U.S. and Country Z tax purposes and equity for Country X tax purposes (the US1-FZ instrument). The \$80x is treated as interest for Country Z and U.S.

tax purposes (the entire amount of which is included in US1's income) and is treated as an excludible dividend for Country X tax purposes (by reason of the Country X participation exemption). Paragraphs (c)(3)(iii)(A) and (B) of this section describe the extent to which the specified payments by FZ and US1, each of which is a specified party, are disqualified hybrid amounts.

(A) The hybrid transaction rule of §1.267A-2(a) applies to FZ's payment because the payment is made pursuant to a hybrid transaction, as a payment with respect to the US1-FZ instrument is treated as interest for U.S. tax purposes but not for purposes of Country X's tax law (the tax law of FX, a specified recipient that is related to FZ). As a consequence of the Country X participation exemption, an \$80x no-inclusion occurs with respect to FX, and such no-inclusion is a result of the payment being made pursuant to the hybrid transaction. Thus, but for §1.267A-3(b), the entire \$80x of FZ's payment would be a disqualified hybrid amount. However, because US1 (a tax resident of the United States that is also a specified recipient of the payment) takes the entire \$80x payment into account in its gross income, no portion of the payment is a disqualified hybrid amount. See §1.267A-3(b)(2).

(B) The disregarded payment rule of §1.267A-2(b) applies to US1's \$100x payment to FX, for the reasons described in paragraph (c)(3)(ii)(A) of this section. In addition, US1 has no dual inclusion income for taxable year 1 because, as a result of the Country X participation exemption, no portion of FZ's \$80x payment to US1 (which is derived by FX under its tax law) is included in FX's income. See §§1.267A-2(b)(3) and 1.267A-3(a). Therefore, the entire \$100x payment from US1 to FX is a disqualified hybrid amount, calculated as \$100x (the amount of the payment) less \$0 (the amount of dual inclusion income). See §1.267A-2(b)(1).

(iv) *Alternative facts – dual inclusion income despite participation exemption.* The facts are the same as in paragraph (c)(3)(iii) of this section, except that the US1-FZ instrument is treated as indebtedness for U.S. tax purposes and equity for Country Z and Country X tax purposes. In addition, the \$80x paid to US1 by FZ is treated as interest for U.S. tax purposes (the entire amount of which is included in US1's income), a dividend for Country Z tax purposes (for which FZ is not allowed a deduction or other tax benefit), and an excludible dividend for Country X tax purposes (by reason of the Country X participation exemption). For the reasons described in paragraph (c)(3)(iii)(A) of this section, the hybrid transaction rule of §1.267A-2(a) applies to FZ's payment but no portion of the payment is a disqualified hybrid amount. In addition, the disregarded payment rule of §1.267A-2(b) applies to US1's \$100x payment to FX, for the reasons described in paragraph (c)(3)(ii)(B) of this section. US1's dual inclusion income for taxable year 1 is \$80x. This is because the \$80x paid to US1 by FZ is included in US1's income and, although not included in FX's income, it is a dividend for Country X tax purposes that would have been included in FX's income but for the Country X participation exemption, and FZ is not allowed a deduction or other tax benefit for it under Country Z tax law. See §1.267A-2(b)(3)(ii). Therefore, \$20x of US1's \$100x payment is a disqualified hybrid amount (\$100x less \$80x). See §1.267A-2(b)(1).

(4) *Example 4. Payment allocable to a U.S. taxable branch—(i) Facts.* FX1 and FX2 are foreign corporations that are bodies corporate established in and tax residents of Country X. FX1 holds all the interests of FX2, and FX1 and FX2 file a consolidated return under Country X tax law. FX2 has a U.S. taxable branch ("USB"). During taxable year 1, FX2 pays \$50x to FX1 pursuant to an instrument (the "FX1-FX2 instrument"). The amount paid pursuant to the instrument is treated as interest for U.S. tax purposes but, as a consequence of the Country X consolidation regime, is treated as a disregarded transaction between group members for Country X tax purposes. Also during taxable year 1, FX2 pays \$100x of interest to an unrelated bank that is not a party to a structured arrangement (the instrument pursuant to which the payment is made, the "bank-FX2 instrument"). FX2's only other item of income, gain, deduction, or loss for taxable year 1 is \$200x of gross income. Under Country X tax law, the \$200x of gross income is attributable to USB, but is not included in FX2's income because Country X tax law exempts income attributable to a branch. Under U.S. tax law, the \$200x of gross income is effectively connected income of USB. Further, under section 882(c)(1), \$75x of interest is, for taxable year 1, allocable to USB's effectively connected income. USB has neither liabilities that are directly allocable to it, as described in §1.882-5(a)(1)(ii)(A), nor U.S. booked liabilities, as defined in §1.882-5(d)(2).

(ii) *Analysis.* USB is a specified party and thus any interest or royalty allowable as a deduction in determining its effectively connected income is subject to disallowance under section 267A. Pursuant to §1.267A-5(b)(3)(i)(A), USB is treated as paying \$75x of interest, and such interest is thus a specified payment. Of that \$75x, \$25x is treated as paid to FX1, calculated as \$75x (the interest allocable to USB under section 882(c)(1)) multiplied by 1/3 (\$50x, FX2's payment to FX1, divided by \$150x, the total interest paid by FX2). See §1.267A-5(b)(3)(ii)(A). As described in paragraphs (c)(4)(ii)(A) and (B) of this section, the \$25x of the specified payment treated as paid by USB to FX1 is a disqualified hybrid amount under the disregarded payment rule of §1.267A-2(b) and, as a result, a deduction for that amount is disallowed under §1.267A-1(b)(1).

(A) USB's \$25x payment to FX1 is not regarded under the tax law of Country X (the tax law of FX1, a related tax resident to which the payment is made) because under such tax law it is a disregarded transaction between group members. See §1.267A-2(b)(2) and (f). In addition, were the tax law of Country X to regard the payment (and treat it as interest), FX1 would include it in income. Therefore, the payment is a disregarded payment to which §1.267A-2(b) applies. See §1.267A-2(b)(2).

(B) Under §1.267A-2(b)(1), the excess (if any) of USB's disregarded payments for taxable year 1 (\$25x) over its dual inclusion income for the taxable year is a disqualified hybrid amount. USB's dual inclusion income for taxable year 1 is \$0. This is because, as a result of the Country X exemption for income attributable to a branch, no portion of USB's \$200x item of gross income is included in FX2's income. See §1.267A-2(b)(3). Therefore, the entire \$25x of the specified payment treated as paid by USB to FX1 is a disqualified hybrid amount, calculated as \$25x (the amount of the payment)

less \$0 (the amount of dual inclusion income). See §1.267A-2(b)(1).

(iii) *Alternative facts – deemed branch payment.* The facts are the same as in paragraph (c)(4)(i) of this section, except that FX2 does not pay any amounts during taxable year 1 (thus, it does not pay the \$50x to FX1 or the \$100x to the bank). However, under an income tax treaty between the United States and Country X, USB is a U.S. permanent establishment and, for taxable year 1, \$25x of royalties is allowable as a deduction in computing the business profits of USB and is deemed paid to FX2. Under Country X tax law, the \$25x is not regarded. Accordingly, the \$25x is a specified payment that is a deemed branch payment. See §§1.267A-2(c)(2) and 1.267A-5(b)(3)(i)(B). In addition, the entire \$25x is a disqualified hybrid amount for which a deduction is disallowed because the tax law of Country X provides an exclusion or exemption for income attributable to a branch. See §1.267A-2(c)(1).

(5) *Example 5. Payment to a reverse hybrid—(i) Facts.* FX holds all the interests of US1 and FY, and FY holds all the interests of FV. FY is an entity established in Country Y, and FV is an entity established in Country V. FY is fiscally transparent for Country Y tax purposes but is not fiscally transparent for Country X tax purposes. FV is fiscally transparent for Country X tax purposes. On date 1, US1 pays \$100x to FY. The payment is treated as interest for U.S. tax purposes and Country X tax purposes.

(ii) *Analysis.* US1 is a specified party and thus a deduction for its \$100x specified payment is subject to disallowance under section 267A. As described in paragraphs (c)(5)(ii)(A) through (C) of this section, the entire \$100x payment is a disqualified hybrid amount under the reverse hybrid rule of §1.267A-2(d) and, as a result, a deduction for the payment is disallowed under §1.267A-1(b)(1).

(A) US1's payment is made to a reverse hybrid because FY is fiscally transparent under the tax law of Country Y (the tax law of the country in which it is established) but is not fiscally transparent under the tax law of Country X (the tax law of FX, an investor that is related to US1). See §1.267A-2(d)(2) and (f). Therefore, §1.267A-2(d) applies to the payment. The result would be the same if the payment were instead made to FV. See §1.267A-2(d)(3).

(B) For US1's payment to be a disqualified hybrid amount under §1.267A-2(d), a no-inclusion must occur with respect to FX, an investor the tax law of which treats FY as not fiscally transparent. See §1.267A-2(d)(1)(i). Because FX does not derive the \$100x payment under Country X tax law (as FY is not fiscally transparent under such tax law), FX includes \$0 of the payment in income and therefore a \$100x no-inclusion occurs with respect to FX. See §1.267A-3(a).

(C) Pursuant to §1.267A-2(d)(1)(ii), FX's \$100x no-inclusion gives rise to a disqualified hybrid amount to the extent that it is a result of US1's payment being made to the reverse hybrid. FX's \$100x no-inclusion is a result of the payment being made to the reverse hybrid because, were FY to be treated as fiscally transparent for Country X tax purposes, FX would include \$100x in income and, consequently, the no-inclusion would not occur. The result would be the same if Country X tax law instead viewed US1's payment as a dividend, rather than interest. See §1.267A-2(d)(1)(ii).



(iii) *Alternative facts – inclusion under anti-deferral regime.* The facts are the same as in paragraph (c)(5)(i) of this section, except that, under a Country X anti-deferral regime, FX takes into account \$100x attributable to the \$100x payment received by FY. If under the rules of §1.267A-3(a) FX includes the entire attributed amount in income (that is, if FX takes the amount into account in its income at the full marginal rate imposed on ordinary income and the amount is not reduced or offset by certain relief particular to the amount), then a no-inclusion does not occur with respect to FX. As a result, in such a case, no portion of US1's payment would be a disqualified hybrid amount under §1.267A-2(d).

(iv) *Alternative facts – multiple investors.* The facts are the same as in paragraph (c)(5)(i) of this section, except that FX holds all the interests of FZ, which is fiscally transparent for Country X tax purposes; FZ holds all the interests of FY, which is fiscally transparent for Country Z tax purposes; and FZ includes the \$100x payment in income. Thus, each of FZ and FX is an investor of FY, as each directly or indirectly holds an interest of FY. See §1.267A-5(a)(13). A \$100x no-inclusion occurs with respect to FX, an investor the tax law of which treats FY as not fiscally transparent. FX's no-inclusion is a result of the payment being made to the reverse hybrid because, were FY to be treated as fiscally transparent for Country X tax purposes, then FX would include \$100x in income (as FZ is fiscally transparent for Country X tax purposes). Accordingly, FX's no-inclusion is a result of US1's payment being made to the reverse hybrid and, consequently, the entire \$100x payment is a disqualified hybrid amount. However, if instead FZ were not fiscally transparent for Country X tax purposes, then FX's no-inclusion would not be a result of US1's payment being made to the reverse hybrid and, therefore, the payment would not be a disqualified hybrid amount under §1.267A-2(d).

(v) *Alternative facts – portion of no-inclusion not the result of hybridity.* The facts are the same as in paragraph (c)(5)(i) of this section, except that the \$100x is viewed as a royalty for U.S. tax purposes and Country X tax purposes, and Country X tax law contains a patent box regime that provides an 80% deduction with respect to certain royalty income. If the royalty payment would qualify for the Country X patent box deduction were FY to be treated as fiscally transparent for Country X tax purposes, then only \$20x of FX's \$100x no-inclusion would be the result of the payment being paid to a reverse hybrid, calculated as \$100x (the no-inclusion with respect to FX that actually occurs) less \$80x (the no-inclusion with respect to FX that would occur if FY were to be treated as fiscally transparent for Country X tax purposes). See §1.267A-2(d)(1)(ii) and 1.267A-3(a)(1)(ii). Accordingly, in such a case, only \$20x of US1's payment would be a disqualified hybrid amount under §1.267A-2(d).

(vi) *Alternative facts – payment to a discretionary trust—(A) Facts.* The facts are the same as in paragraph (c)(5)(i) of this section, except that FY is a discretionary trust established in, and a tax resident of, Country Y (and as a result, FY is generally not fiscally transparent for Country Y tax purposes under the principles of §1.894-1(d)(3)(ii)). In general, under Country Y tax law, FX, an investor of FY, is not required to separately take into account in its income

US1's \$100x payment received by FY; instead, FY is required to take the payment into account in its income. However, under the trust agreement, the trustee of FY may, with respect to certain items of income received by FY, allocate such an item to FY's beneficiary, FX. When this occurs, then, for Country Y tax purposes, FY does not take the item into account in its income, and FX is required to take the item into account in its income as if it received the item directly from the source from which realized by FY. For Country X tax purposes, FX in all cases does not take into account in its income any item of income received by FY. With respect to the \$100x paid from US1 to FY, the trustee allocates the \$100x to FX.

(B) *Analysis.* FY is fiscally transparent with respect to US1's \$100x payment under the tax law of Country Y (the tax law of the country in which FY is established). See §1.267A-5(a)(8)(i). In addition, FY is not fiscally transparent with respect to US1's \$100x payment under the tax law of Country X (the tax law of FX, the investor of FY). See §1.267A-5(a)(8)(ii). Thus, FY is a reverse hybrid with respect to the payment. See §1.267A-2(d)(2) and (f). Therefore, for reasons similar to those discussed in paragraphs (c)(5)(ii)(B) and (C) of this section, the entire \$100x payment is a disqualified hybrid amount.

(6) *Example 6. Branch mismatch payment—(i) Facts.* FX holds all the interests of US1 and FZ. FZ owns BB, a Country B branch that gives rise to a taxable presence in Country B under Country Z tax law but not under Country B tax law. On date 1, US1 pays \$50x to FZ. The amount is treated as a royalty for U.S. tax purposes and Country Z tax purposes. Under Country Z tax law, the amount is treated as income attributable to BB and, as a consequence of Country Z tax law exempting income attributable to a branch, is excluded from FZ's income.

(ii) *Analysis.* US1 is a specified party and thus a deduction for its \$50x specified payment is subject to disallowance under section 267A. As described in paragraphs (c)(6)(ii)(A) through (C) of this section, the entire \$50x payment is a disqualified hybrid amount under the branch mismatch rule of §1.267A-2(e) and, as a result, a deduction for the payment is disallowed under §1.267A-1(b)(1).

(A) US1's payment is a branch mismatch payment because under Country Z tax law (the tax law of FZ, a home office that is related to US1) the payment is treated as income attributable to BB, and BB is not a taxable branch (that is, under Country B tax law, BB does not give rise to a taxable presence). See §1.267A-2(e)(2) and (f). Therefore, §1.267A-2(e) applies to the payment. The result would be the same if instead BB were a taxable branch and, under Country B tax law, US1's payment were treated as income attributable to FZ, the home office, and not BB. See §1.267A-2(e)(2).

(B) For US1's payment to be a disqualified hybrid amount under §1.267A-2(e), a no-inclusion must occur with respect to FZ. See §1.267A-2(e)(1)(i). As a consequence of the Country Z branch exemption, FZ includes \$0 of the payment in income and therefore a \$50x no-inclusion occurs with respect to FZ. See §1.267A-3(a).

(C) Pursuant to §1.267A-2(e)(1)(ii), FZ's \$50x no-inclusion gives rise to a disqualified hybrid amount to the extent that it is a result of US1's payment being a branch mismatch payment. FZ's \$50x no-inclusion is a result of the payment being a branch

mismatch payment because, were the payment to not be treated as income attributable to BB for Country Z tax purposes, FZ would include \$50x in income and, consequently, the no-inclusion would not occur.

(7) *Example 7. Reduction of disqualified hybrid amount for certain amounts includible in income—(i) Facts.* US1 and FW hold 60% and 40%, respectively, of the interests of FX, and FX holds all the interests of FZ. Each of FX and FZ is a specified party that is a CFC. FX holds an instrument issued by FZ that it is treated as equity for Country X tax purposes and as indebtedness for U.S. tax purposes (the FX-FZ instrument). On date 1, FZ pays \$100x to FX pursuant to the FX-FZ instrument. The amount is treated as a dividend for Country X tax purposes and as interest for U.S. tax purposes. In addition, pursuant to section 954(c)(6), the amount is not foreign personal holding company income of FX and, under section 951A, the amount is gross tested income (as described in §1.951A-2(c)(1)) of FX. Further, were FZ allowed a deduction for the amount, it would be allocated and apportioned to gross tested income (as described in §1.951A-2(c)(1)) of FZ. Lastly, Country X tax law provides an 80% participation exemption for dividends received from nonresident corporations and, as a result of such participation exemption, FX includes \$20x of FZ's payment in income.

(ii) *Analysis.* FZ, a CFC, is a specified party and thus a deduction for its \$100x specified payment is subject to disallowance under section 267A. But for §1.267A-3(b), \$80x of FZ's payment would be a disqualified hybrid amount (such amount, a "tentative disqualified hybrid amount"). See §§1.267A-2(a) and 1.267A-3(b)(1). Pursuant to §1.267A-3(b), the tentative disqualified hybrid amount is reduced by \$48x. See §1.267A-3(b)(4). The \$48x is the tentative disqualified hybrid amount to the extent that it increases US1's pro rata share of tested income with respect to FX under section 951A (calculated as \$80x multiplied by 60%). See §1.267A-3(b)(4). Accordingly, \$32x of FZ's payment (\$80x less \$48x) is a disqualified hybrid amount under §1.267A-2(a) and, as a result, \$32x of the deduction is disallowed under §1.267A-1(b)(1).

(iii) *Alternative facts – United States shareholder is a domestic partnership.* The facts are the same as in paragraph (c)(7)(i) of this section, except that US1 is a domestic partnership, 90% of the interests of which are held by US2 and the remaining 10% of which are held by an individual that is a nonresident alien (as defined in section 7701(b)(1)(B)). Thus, although each of US1 and US2 is a United States shareholder of FX, only US2 has a pro rata share of any tested item of FX. See §1.951A-1(e). In addition, \$43.2x of the \$80x tentative disqualified hybrid amount increases US2's pro rata share of the tested income of FX (calculated as \$80x multiplied by 60% multiplied by 90%). Thus, \$36.8x of FZ's payment (\$80x less \$43.2x) is a disqualified hybrid amount under §1.267A-2(a). See §1.267A-3(b)(4).

(8) *Example 8. Imported mismatch rule – direct offset—(i) Facts.* FX holds all the interests of FW, and FW holds all the interests of US1. FX holds an instrument issued by FW that is treated as equity for Country X tax purposes and indebtedness for Country W tax purposes (the FX-FW instrument). FW holds an instrument issued by US1 that is treated as indebtedness for Country W and U.S. tax purposes (the FW-US1 instrument). In accounting period 1,

FW pays \$100x to FX pursuant to the FX-FW instrument. The amount is treated as an excludible dividend for Country X tax purposes (by reason of the Country X participation exemption) and as interest for Country W tax purposes. Also in accounting period 1, US1 pays \$100x to FW pursuant to the FW-US1 instrument. The amount is treated as interest for Country W and U.S. tax purposes and is included in FW's income. The FX-FW instrument was not entered into pursuant to the same plan or series of related transactions pursuant to which the FW-US1 instrument was entered into.

(ii) *Analysis.* US1 is a specified party and thus a deduction for its \$100x specified payment is subject to disallowance under section 267A. US1's \$100x payment is neither a disqualified hybrid amount nor included or includible in income in the United States. See §1.267A-4(a)(2)(v). In addition, FW's \$100x deduction is a hybrid deduction because it is a deduction allowed to FW that results from an amount paid that is interest under Country W tax law, and were Country W law to have rules substantially similar to those under §§1.267A-1 through 1.267A-3 and 1.267A-5, a deduction for the payment would be disallowed (because under such rules the payment would be pursuant to a hybrid transaction and FX's no-inclusion would be a result of the hybrid transaction). See §§1.267A-2(a) and 1.267A-4(b). Under §1.267A-4(a)(2), US1's payment is an imported mismatch payment, US1 is an imported mismatch payer, and FW (the foreign tax resident that includes the imported mismatch payment in income) is an imported mismatch payee. The imported mismatch payment is a disqualified imported mismatch amount to the extent that the income attributable to the payment is directly or indirectly offset by the hybrid deduction incurred by FW (a foreign tax resident that is related to US1). See §1.267A-4(a)(1). Under §1.267A-4(c)(1), the \$100x hybrid deduction directly or indirectly offsets the income attributable to US1's imported mismatch payment to the extent that the payment directly or indirectly funds the hybrid deduction. The entire \$100x of US1's payment directly funds the hybrid deduction because FW (the imported mismatch payee) incurs at least that amount of the hybrid deduction. See §1.267A-4(c)(3)(i). Accordingly, the entire \$100x payment is a disqualified imported mismatch amount under §1.267A-4(a)(1) and, as a result, a deduction for the payment is disallowed under §1.267A-1(b)(2).

(iii) *Alternative facts – long-term deferral.* The facts are the same as in paragraph (c)(8)(i) of this section, except that the FX-FW instrument is treated as indebtedness for Country X and Country W tax purposes, and FW does not pay any amounts pursuant to the instrument during accounting period 1. In addition, under Country W tax law, FW is allowed to deduct interest under the FX-FW instrument as it accrues, whereas under Country X tax law FX does not take into account in its income interest under the FX-FW instrument until the interest is paid. Further, FW accrues \$100x of interest during accounting period 1, and FW will not pay such amount to FX for more than 36 months after the end of accounting period 1. The results are the same as in paragraph (c)(8)(ii) of this section. That is, FW's \$100x deduction for the accrued interest is a hybrid deduction, see §§1.267A-2(a), 1.267A-3(a), and 1.267A-4(b), and the income attributable to US1's \$100x imported

mismatch payment is offset by the hybrid deduction for the reasons described in paragraph (c)(8)(ii) of this section. As a result, a deduction for the payment is disallowed under §1.267A-1(b)(2). The result would be the same even if the FX-FW instrument is expected to be redeemed or capitalized before the \$100x of interest is paid such that FX will never take into account in its income (and therefore will not include in income) the \$100x of interest.

(iv) *Alternative facts – notional interest deduction.* The facts are the same as in paragraph (c)(8)(i) of this section, except that there is no FX-FW instrument and thus FW does not pay any amounts to FX during accounting period 1. However, during accounting period 1, FW is allowed a \$100x notional interest deduction with respect to its equity under Country W tax law. Pursuant to §1.267A-4(b)(1)(ii), FW's notional interest deduction is a hybrid deduction. The results are the same as in paragraph (c)(8)(ii) of this section. That is, the income attributable to US1's \$100x imported mismatch payment is offset by FW's hybrid deduction for the reasons described in paragraph (c)(8)(ii) of this section. As a result, a deduction for the payment is disallowed under §1.267A-1(b)(2). The result would be the same if the tax law of Country W contains hybrid mismatch rules because FW's deduction is a deduction with respect to equity. See §1.267A-4(b)(2)(i).

(v) *Alternative facts – foreign hybrid mismatch rules prevent hybrid deduction.* The facts are the same as in paragraph (c)(8)(i) of this section, except that the tax law of Country W contains hybrid mismatch rules, and under such rules FW is not allowed a deduction for the \$100x that it pays to FX pursuant to the FX-FW instrument. The \$100x paid by FW therefore does not give rise to a hybrid deduction. See §1.267A-4(b). Accordingly, because the income attributable to US1's payment to FW is not directly or indirectly offset by a hybrid deduction, the payment is not a disqualified imported mismatch amount. Therefore, a deduction for the payment is not disallowed under §1.267A-1(b)(2).

(9) *Example 9. Imported mismatch rule – indirect offsets and pro rata allocations—(i) Facts.* FX holds all the interests of FZ, and FZ holds all the interests of US1 and US2. FX has a Country B branch that, for Country X and Country B tax purposes, gives rise to a taxable presence in Country B and is therefore a taxable branch ("BB"). Under the Country B-Country X income tax treaty, BB is a permanent establishment entitled to deduct expenses properly attributable to BB for purposes of computing its business profits under the treaty. In addition, BB is deemed to pay a royalty to FX for the right to use intangibles developed by FX equal to cost plus y%. The deemed royalty is a deductible expense properly attributable to BB under the Country B-Country X income tax treaty. For Country X tax purposes, any transactions between BB and X are disregarded. The deemed royalty is \$80x for accounting period 1. Country B tax law does not permit a loss of a taxable branch to be shared with a tax resident or another taxable branch. In addition, an instrument issued by FZ to FX is properly reflected as an asset on the books and records of BB (the FX-FZ instrument). The FX-FZ instrument is treated as indebtedness for Country X, Country Z, and Country B tax purposes. In accounting period 1, FZ pays \$80x to FX pursuant to the FX-FZ instrument; the

amount is treated as interest for Country X, Country Z, and Country B tax purposes, and is treated as income attributable to BB for Country X and Country B tax purposes (but, for Country X tax purposes, is excluded from FX's income as a consequence of the Country X exemption for income attributable to a branch). Further, in accounting period 1, US1 and US2 pay \$60x and \$40x, respectively, to FZ pursuant to instruments that are treated as indebtedness for Country Z and U.S. tax purposes; the amounts are treated as interest for Country Z and U.S. tax purposes and are included in FZ's income. Lastly, neither the instrument pursuant to which US1 pays the \$60x nor the instrument pursuant to which US2 pays the \$40x was entered into pursuant to a plan or series of related transactions that includes the transaction or agreement giving rise to BB's deduction for the deemed royalty.

(ii) *Analysis.* US1 and US2 are specified parties and thus deductions for their specified payments are subject to disallowance under section 267A. Neither of the payments is a disqualified hybrid amount, nor is either of the payments included or includible in income in the United States. See §1.267A-4(a)(2)(v). In addition, BB's \$80x deduction for the deemed royalty is a hybrid deduction because it is a deduction allowed to BB that results from an amount paid that is treated as a royalty under Country B tax law (regardless of whether a royalty deduction would be allowed under U.S. law), and were Country B tax law to have rules substantially similar to those under §§1.267A-1 through 1.267A-3 and 1.267A-5, a deduction for the payment would be disallowed because under such rules the payment would be a deemed branch payment and Country X has an exclusion for income attributable to a branch. See §§1.267A-2(c) and 1.267A-4(b). Under §1.267A-4(a)(2), each of US1's and US2's payments is an imported mismatch payment, US1 and US2 are imported mismatch payers, and FZ (the foreign tax resident that includes the imported mismatch payments in income) is an imported mismatch payee. The imported mismatch payments are disqualified imported mismatch amounts to the extent that the income attributable to the payments is directly or indirectly offset by the hybrid deduction incurred by BB (a foreign taxable branch that is related to US1 and US2). See §1.267A-4(a). Under §1.267A-4(c)(1), the \$80x hybrid deduction directly or indirectly offsets the income attributable to the imported mismatch payments to the extent that the payments directly or indirectly fund the hybrid deduction. Paragraphs (c)(9)(ii)(A) and (B) of this section describe the extent to which the imported mismatch payments directly or indirectly fund the hybrid deduction.

(A) Neither US1's nor US2's payment directly funds the hybrid deduction because FZ (the imported mismatch payee) does not incur the hybrid deduction. See §1.267A-4(c)(3)(i). To determine the extent to which the payments indirectly fund the hybrid deduction, the amount of the hybrid deduction that is allocated to FZ must be determined. See §1.267A-4(c)(3)(ii). FZ is allocated the hybrid deduction to the extent that it directly or indirectly makes a funded taxable payment to BB (the foreign taxable branch that incurs the hybrid deduction). See §1.267A-4(c)(3)(iii). The \$80x that FZ pays pursuant to the FX-FZ instrument is a funded taxable payment of FZ to BB. See §1.267A-4(c)(3)(v). Therefore, because FZ

makes a funded taxable payment to BB that is at least equal to the amount of the hybrid deduction, FZ is allocated the entire amount of the hybrid deduction. See §1.267A-4(c)(3)(iii).

(B) But for US2's imported mismatch payment, the entire \$60x of US1's imported mismatch payment would indirectly fund the hybrid deduction because FZ is allocated at least that amount of the hybrid deduction. See §1.267A-4(c)(3)(ii). Similarly, but for US1's imported mismatch payment, the entire \$40x of US2's imported mismatch payment would indirectly fund the hybrid deduction because FZ is allocated at least that amount of the hybrid deduction. See §1.267A-4(c)(3)(ii). However, because the sum of US1's and US2's imported mismatch payments to FZ (\$100x) exceeds the hybrid deduction allocated to FZ (\$80x), pro rata adjustments must be made. See §1.267A-4(e). Thus, \$48x of US1's imported mismatch payment is considered to indirectly fund the hybrid deduction, calculated as \$80x (the amount of the hybrid deduction) multiplied by 60% (\$60x, the amount of US1's imported mismatch payment to FZ, divided by \$100x, the sum of the imported mismatch payments that US1 and US2 make to FZ). Similarly, \$32x of US2's imported mismatch payment is considered to indirectly fund the hybrid deduction, calculated as \$80x (the amount of the hybrid deduction) multiplied by 40% (\$40x, the amount of US2's imported mismatch payment to FZ, divided by \$100x, the sum of the imported mismatch payments that US1 and US2 make to FZ). Accordingly, \$48x of US1's imported mismatch payment, and \$32x of US2's imported mismatch payment, are disqualified imported mismatch amounts under §1.267A-4(a)(1) and, as a result, deductions for such amounts are disallowed under §1.267A-1(b)(2).

(iii) *Alternative facts – loss made available through foreign group relief regime.* The facts are the same as in paragraph (c)(9)(i) of this section, except that FZ holds all the interests in FZ2, a body corporate that is a tax resident of Country Z, FZ2 (rather than FZ) holds all the interests of US1 and US2, and US1 and US2 make their respective \$60x and \$40x payments to FZ2 (rather than to FZ). Further, in accounting period 1, a \$10x loss of FZ is made available to offset income of FZ2 through a Country Z foreign group relief regime. Pursuant to §1.267A-4(c)(3)(vi), FZ and FZ2 are treated as a single foreign tax resident for purposes of §1.267A-4(c) because a loss that is not incurred by FZ2 (FZ's \$10x loss) is made available to offset income of FZ2 under the Country Z group relief regime. Accordingly, the results are the same as in paragraph (c)(9)(ii) of this section. That is, by treating FZ and FZ2 as a single foreign tax resident for purposes of §1.267A-4(c), BB's hybrid deduction offsets the income attributable to US1's and US2's imported mismatch payments to the same extent as described in paragraph (c)(9)(ii) of this section.

(10) *Example 10. Imported mismatch rule – ordering rules and rule deeming certain payments to be imported mismatch payments—(i) Facts.* FX holds all the interests of FW, and FW holds all the interests of US1, US2, and FZ. FZ holds all the interests of US3. FX transfers cash to FW in exchange for an instrument that is treated as equity for Country X tax purposes and indebtedness for Country W tax purposes (the FX-FW instrument). FW transfers cash to US1 in exchange for an instrument that is

treated as indebtedness for Country W and U.S. tax purposes (the FW-US1 instrument). The FX-FW instrument and the FW-US1 instrument were entered into pursuant to a plan a design of which was for deductions incurred by FW pursuant to the FX-FW instrument to offset income attributable to payments by US1 pursuant to the FW-US1 instrument. In accounting period 1, FW pays \$125x to FX pursuant to the FX-FW instrument; the amount is treated as an excludible dividend for Country X tax purposes (by reason of the Country X participation exemption regime) and as interest for Country W tax purposes. Also in accounting period 1, US1 pays \$50x to FW pursuant to the FW-US1 instrument; US2 pays \$50x to FW pursuant to an instrument treated as indebtedness for Country W and U.S. tax purposes (the FW-US2 instrument); US3 pays \$50x to FZ pursuant to an instrument treated as indebtedness for Country Z and U.S. tax purposes (the FZ-US3 instrument); and FZ pays \$50x to FW pursuant to an instrument treated as indebtedness for Country W and Country Z tax purposes (FW-FZ instrument). The amounts paid by US1, US2, US3, and FZ are treated as interest for purposes of the relevant tax laws and are included in the income of FW (in the case of US1's, US2's and FZ's payment) or FZ (in the case of US3's payment). Lastly, neither the FW-US2 instrument, the FW-FZ instrument, nor the FZ-US3 instrument was entered into pursuant to a plan or series of related transactions that includes the transaction pursuant to which the FX-FW instrument was entered into.

(ii) *Analysis.* US1, US2, and US3 are specified parties (but FZ is not a specified party, see §1.267A-5(a)(17)) and thus deductions for US1's, US2's, and US3's specified payments are subject to disallowance under section 267A. None of the specified payments is a disqualified hybrid amount, nor is any of the payments included or includible in income in the United States. See §1.267A-4(a)(2)(v). Under §1.267A-4(a)(2), each of the payments is an imported mismatch payment, US1, US2, and US3 are imported mismatch payers, and FW and FZ (the foreign tax residents that include the imported mismatch payments in income) are imported mismatch payees. The imported mismatch payments are disqualified imported mismatch amounts to the extent that the income attributable to the payments is directly or indirectly offset by FW's \$125x hybrid deduction. See §1.267A-4(a)(1) and (b). Under §1.267A-4(c)(1), the \$125x hybrid deduction directly or indirectly offsets the income attributable to the imported mismatch payments to the extent that the payments directly or indirectly fund the hybrid deduction. Paragraphs (c)(10)(ii)(A) through (C) of this section describe the extent to which the imported mismatch payments directly or indirectly fund the hybrid deduction and are therefore disqualified hybrid amounts for which a deduction is disallowed under §1.267A-1(b)(2).

(A) First, the \$125x hybrid deduction offsets the income attributable to US1's imported mismatch payment, a factually-related imported mismatch payment that directly funds the hybrid deduction. See §1.267A-4(c)(2)(i). The entire \$50x of US1's payment directly funds the hybrid deduction because FW (the imported mismatch payee) incurs at least that amount of the hybrid deduction. See §1.267A-4(c)(3)(i). Accordingly, the entire \$50x of the payment is a disqualified imported mismatch amount under §1.267A-4(a)(1).

(B) Second, the remaining \$75x hybrid deduction offsets the income attributable to US2's imported mismatch payment, a factually-unrelated imported mismatch payment that directly funds the remaining hybrid deduction. See §1.267A-4(c)(2)(ii). The entire \$50x of US2's payment directly funds the remaining hybrid deduction because FW (the imported mismatch payee) incurs at least that amount of the remaining hybrid deduction. See §1.267A-4(c)(3)(i). Accordingly, the entire \$50x of the payment is a disqualified imported mismatch amount under §1.267A-4(a)(1).

(C) Third, the remaining \$25x hybrid deduction offsets the income attributable to US3's imported mismatch payment, a factually-unrelated imported mismatch payment that indirectly funds the remaining hybrid deduction. See §1.267A-4(c)(2)(iii). The imported mismatch payment indirectly funds the remaining hybrid deduction to the extent that FZ (the imported mismatch payee) is allocated the remaining hybrid deduction. See §1.267A-4(c)(3)(ii). FZ is allocated the remaining hybrid deduction to the extent that it directly or indirectly makes a funded taxable payment to FW (the tax resident that incurs the hybrid deduction). See §1.267A-4(c)(3)(iii). The \$50x that FZ pays to FW pursuant to the FW-FZ instrument is a funded taxable payment of FZ to FW. See §1.267A-4(c)(3)(v). Therefore, because FZ makes a funded taxable payment to FW that is at least equal to the amount of the remaining hybrid deduction, FZ is allocated the remaining hybrid deduction. See §1.267A-4(c)(3)(iii). Accordingly, \$25x of US3's payment indirectly funds the \$25x remaining hybrid deduction and, consequently, \$25x of US3's payment is a disqualified imported mismatch amount under §1.267A-4(a)(2).

(iii) *Alternative facts – amount deemed to be an imported mismatch payment.* The facts are the same as in paragraph (c)(10)(i) of this section, except that US1 is not a domestic corporation but instead is a body corporate that is only a tax resident of Country E (hereinafter, "FE") (thus, for purposes of this paragraph (c)(10)(iii), the FW-US1 instrument is instead issued by FE and is the "FW-FE instrument"). In addition, the tax law of Country E contains hybrid mismatch rules and the \$50x FE pays to FW pursuant to the FW-FE instrument is subject to disallowance under a provision of the hybrid mismatch rules substantially similar to §1.267A-4. Pursuant to §1.267A-4(f)(2), the \$50x that FE pays to FW pursuant to the FW-FE instrument is deemed to be an imported mismatch payment for purposes of determining the extent to which the income attributable to an imported mismatch payment is offset by FW's hybrid deduction (a hybrid deduction other than one described in §1.267A-4(f)(1)). The results are the same as in paragraphs (c)(10)(ii)(B) and (C) of this section. That is, by treating the \$50x that FE pays to FW as an imported mismatch payment, and for reasons similar to those described in paragraphs (c)(10)(ii)(A) through (C) of this section, \$50x of FW's \$125x hybrid deduction offsets income attributable to FE's imported mismatch payment, \$50x of the remaining \$75x hybrid deduction offsets income attributable to US2's imported mismatch payment, and the remaining \$25x hybrid deduction offsets income attributable to US3's imported mismatch payment. Accordingly, the entire \$50x of US2's payment is a disqualified imported mismatch amount, and \$25x of

US3's payment is a disqualified imported mismatch amount.

(iv) *Alternative facts – amount deemed to be an imported mismatch payment and “waterfall” approach.* The facts are the same as in paragraph (c) (10)(i) of this section, except that FZ holds all of the interests of US3 indirectly through FE, a body corporate that is only a tax resident of Country E (hereinafter, “FE”), and US3 makes its \$50x payment to FE (rather than to FZ); such amount is treated as interest for Country E tax purposes and is included in FE's income. In addition, during accounting period 1, FE pays \$50x to FZ pursuant to an instrument; such amount is treated as interest for Country E and Country Z tax purposes, and is included in FZ's income. Further, the tax law of Country E contains hybrid mismatch rules and the \$50x FE pays to FZ pursuant to the instrument is subject to disallowance under a provision of the hybrid mismatch rules substantially similar to §1.267A-4. For purposes of determining the extent to which the income attributable to an imported mismatch payment is directly or indirectly offset by a hybrid deduction, the \$50x that FE pays to FZ is deemed to be an imported mismatch payment (and FE and FZ are deemed to be an imported mismatch payer and imported mismatch payee, respectively). See §1.267A-4(f)(2). With respect to US1 and US2, the results are the same as described in paragraphs (c)(10)(ii)(A) and (B) of this section. No portion of US3's payment is a disqualified imported mismatch amount because, by treating the \$50x that FE pays to FZ as an imported mismatch payment, the remaining \$25x of FW's hybrid deduction offsets income attributable to FE's imported mismatch payment. This is because the remaining \$25x of FW's hybrid deduction is indirectly funded solely by FE's imported mismatch payment (as opposed to also being funded by US3's imported mismatch payment), as FZ (the imported mismatch payee with respect to FE's payment) directly makes a funded taxable payment to FW, whereas FE (the imported mismatch payee with respect to US3's payment) indirectly makes a funded taxable payment to FW. See §1.267A-4(c) (3)(ii) through (v) and (vii).

(11) *Example 11. Imported mismatch rule – hybrid deduction of a CFC—(i) Facts.* FX holds all the interests of US1, and FX and US1 hold 80% and 20%, respectively, of the interests of FZ, a specified party that is a CFC. US1 also holds all the interests of US2, and FX also holds all the interests of FY. FY is an entity established in Country Y, and is fiscally transparent for Country Y tax purposes but is not fiscally transparent for Country X tax purposes. In accounting period 1, US2 pays \$100x to FZ pursuant to an instrument (the FZ-US2 instrument). The amount is treated as interest for U.S. tax purposes and Country Z tax purposes, and is included in FZ's income; in addition, for U.S. tax purposes, the amount is foreign personal holding company income of FZ. Also in accounting period 1, FZ pays \$100x to FY pursuant to an instrument (the FY-FZ instrument). The amount is treated as interest for U.S. tax purposes and Country Z tax purposes, and none of the amount is included in FX's income. Under Country Z tax law, FZ is allowed a deduction for its entire \$100x payment. Under §1.267A-2(d), the entire \$100x of FZ's payment is a disqualified hybrid amount (by reason of being made to a reverse hybrid) and, as

a result, a deduction for the payment is disallowed under §1.267A-1(b)(1); in addition, if a deduction were allowed for the \$100x, it would be allocated and apportioned (under the rules of section 954(b) (5)) to gross subpart F income of FZ. Lastly, the FZ-US2 instrument was not entered into pursuant to a plan or series of related transactions that includes the transaction pursuant to which the FY-FZ instrument was entered into.

(ii) *Analysis.* US2 is a specified party and thus a deduction for its \$100x specified payment is subject to disallowance under section 267A. As described in paragraphs (c)(11)(ii)(A) through (C) of this section, \$80x of US2's payment is a disqualified imported mismatch amount for which a deduction is disallowed under §1.267A-1(b)(2).

(A) \$80x of US2's specified payment is an imported mismatch payment, calculated as \$100x (the amount of the payment) less \$0 (the disqualified hybrid amount with respect to the payment) less \$20 (the amount of the payment that is included or includible in income in the United States). See §1.267A-4(a)(2)(v). US2 is an imported mismatch payer and FZ (a foreign tax resident that includes the imported mismatch in income) is an imported mismatch payee. See §1.267A-4(a)(2).

(B) But for §1.267A-4(b)(2)(iv), the entire \$100x deduction allowed to FZ under its tax law would be a hybrid deduction. See §§1.267A-2(d) and 1.267A-4(b)(1). However, pursuant to §1.267A-4(b) (2)(iv), only \$80x of the deduction is a hybrid deduction, calculated as \$100x (the deduction to the extent that it would be a hybrid deduction but for §1.267A-4(b)(2)(iv)) less \$20x (the extent that FZ's payment giving rise to the deduction is a disqualified hybrid amount that is taken into account for purposes of §1.267A-4(b)(2)(iv)(A)), less \$0 (the extent that FZ's payment giving rise to the deduction is included or includible in income in the United States). See §1.267A-4(b)(2)(iv). The \$20x disqualified hybrid amount that is taken into account for purposes of §1.267A-4(b)(2)(iv)(A) is calculated as \$100x (the extent that FZ's payment is a disqualified hybrid amount) less \$80x (\$100x, the disqualified hybrid amount to the extent that, if allowed as a deduction, it would be allocated and apportioned to gross subpart F income, multiplied by 80%, the difference of 100% and the percentage of the stock (by value) of FZ that is owned by US1)). See §1.267A-4(g).

(C) The \$80x hybrid deduction offsets the income attributable to US2's imported mismatch payment, an imported mismatch payment that directly funds the hybrid deduction. See §1.267A-4(c)(2)(ii). The entire \$80x of US2's imported mismatch payment directly funds the hybrid deduction because FZ (the imported mismatch payee) incurs at least that amount of the hybrid deduction. See §1.267A-4(c) (3)(i). Accordingly, the entire \$80x of US2's imported mismatch payment is a disqualified imported mismatch amount under §1.267A-4(a)(1).

(12) *Example 12. Imported mismatch rule – application first with respect to certain hybrid deductions, then with respect to other hybrid deductions—(i) Facts.* FX holds all the interests of FZ, and FZ holds all the interests of each of US1 and FE. The tax law of Country E contains hybrid mismatch rules. FX holds an instrument issued by FZ that is treated as equity for Country X tax purposes and indebtedness for Country Z tax purposes (the FX-FZ

instrument). In accounting period 1, FZ pays \$10x to FX pursuant to the FX-FZ instrument. The amount is treated as an excludible dividend for Country X tax purposes (by reason of the Country X participation exemption) and as interest for Country Z tax purposes. Also in accounting period 1, FZ is allowed a \$90x notional interest deduction with respect to its equity under Country Z tax law. In addition, in accounting period 1, US1 pays \$100x to FZ pursuant to an instrument (the FZ-US1 instrument); the amount is treated as interest for U.S. tax purposes and Country Z tax purposes, and is included in FZ's income. Further, in accounting period 1, FE pays \$40x to FZ pursuant to an instrument (the FZ-FE instrument); the amount is treated as interest for Country E and Country Z tax purposes, is included in FZ's income, and is subject to disallowance under a provision of Country E hybrid mismatch rules substantially similar to §1.267A-4. Lastly, neither the FZ-US1 instrument nor the FZ-FE instrument was entered into pursuant to a plan or series of related transactions that includes the transaction pursuant to which the FX-FZ instrument was entered into.

(ii) *Analysis.* US1 is a specified party and thus a deduction for its \$100x specified payment is subject to disallowance under section 267A. As described in paragraphs (c)(12)(ii)(A) through (D) of this section, \$92x of US1's payment is a disqualified imported mismatch amount for which a deduction is disallowed under §1.267A-1(b)(2).

(A) The entire \$100x of US1's specified payment is an imported mismatch payment. See §1.267A-4(a) (2)(v). US1 is an imported mismatch payer and FZ (a foreign tax resident that includes the imported mismatch payment in income) is an imported mismatch payee. See §1.267A-4(a)(2).

(B) FZ has \$100x of hybrid deductions (the \$10x deduction for the payment pursuant to the FX-FZ instrument plus the \$90x notional interest deduction). See §1.267A-4(b). Pursuant to §1.267A-4(f)(1), §1.267A-4 is first applied by taking into account only the \$90x hybrid deduction consisting of the notional interest deduction; in addition, for purposes of applying §1.267A-4 in this manner, FE's \$40x payment is not treated as an imported mismatch payment. Thus, the \$90x hybrid deduction offsets the income attributable to US1's imported mismatch payment, an imported mismatch payment that directly funds the hybrid deduction. See §1.267A-4(c)(2)(ii). Moreover, \$90x of US1's imported mismatch payment directly funds the hybrid deduction because FZ (the imported mismatch payee) incurs at least that amount of the hybrid deduction. See §1.267A-4(c)(3)(i).

(C) Section §1.267A-4 is next applied by taking into account only the \$10x hybrid deduction consisting of the deduction for the payment pursuant to the FX-FZ instrument. See §1.267A-4(f)(2). When applying §1.267A-4 in this manner, and for purposes of determining the extent to which the income attributable to an imported mismatch payment is directly or indirectly offset by a hybrid deduction, FE's \$40x payment is treated as an imported mismatch payment. See §1.267A-4(f)(2). In addition, US1's imported mismatch payment is reduced from \$100x to \$10x. See §1.267A-4(c)(4). But for FE's imported mismatch payment, the entire \$10x of US1's imported mismatch payment would directly fund the \$10x hybrid deduction because FZ incurred at least that amount of the hybrid deduction. See §1.267A-4(c)(3)(i). Similarly, but for

US1's imported mismatch payment, the entire \$40x of FE's imported mismatch payment would directly fund the \$10x hybrid deduction because FZ incurred at least that amount of the hybrid deduction. See §1.267A-4(c)(3)(i). However, because the sum of US1's and FE's imported mismatch payments to FZ (\$50x) exceeds the hybrid deduction incurred by FZ (\$10x), pro rata adjustments must be made. See §1.267A-4(e). Thus, \$2x of US1's imported mismatch payment is considered to directly fund the hybrid deduction, calculated as \$10x (the amount of the hybrid deduction) multiplied by 20% (\$10x, the amount of US1's imported mismatch payment to FZ, divided by \$50x, the sum of the imported mismatch payments that US1 and FE make to FZ). Similarly, \$8x of FE's imported mismatch payment is considered to directly fund the hybrid deduction, calculated as \$10x (the amount of the hybrid deduction) multiplied by 80% (\$40x, the amount of FE's imported mismatch payment to FZ, divided by \$50x, the sum of the imported mismatch payments that US1 and FE make to FZ). Accordingly, \$2x of FZ's \$10x hybrid deduction offsets income attributable to US1's \$10x imported mismatch payment, and \$8x of the hybrid deduction offsets income attributable to FE's \$40x imported mismatch payment.

(D) Therefore, \$92x of US1's imported mismatch payment is a disqualified imported mismatch amount, calculated as \$90x (the amount that is a disqualified imported mismatch amount determined by applying §1.267A-4 in the manner set forth in §1.267A-4(f)(1)) plus \$2x (the amount that is a disqualified imported mismatch amount determined by applying §1.267A-4 in the manner set forth in §1.267A-4(f)(2)). See §1.267A-4(a)(1) and (f).

(iii) *Alternative facts – amount deemed to be an imported mismatch payment solely funds hybrid instrument deduction.* The facts are the same as in paragraph (c)(12)(i) of this section, except that FZ holds all of the interests of US1 indirectly through FE, and US1 makes its \$100x payment to FE (rather than to FZ); such amount is treated as interest for U.S. and Country E tax purposes, and is included in FE's income. Moreover, FE pays \$100x to FZ (rather than \$40x); such amount is included in FZ's income, and is subject to disallowance under a provision of Country E hybrid mismatch rules substantially similar to §1.267A-4. As described in paragraphs (c)(12)(iii)(A) through (D) of this section, \$90x of US1's payment is a disqualified imported mismatch amount for which a deduction is disallowed under §1.267A-1(b)(2).

(A) The entire \$100x of US1's specified payment is an imported mismatch payment. See §1.267A-4(a)(2)(v). US1 is an imported mismatch payer and FE (a foreign tax resident that includes the imported mismatch payment in income) is an imported mismatch payee. See §1.267A-4(a)(2).

(B) FZ has \$100x of hybrid deductions. See §1.267A-4(b). Pursuant to §1.267A-4(f)(1), §1.267A-4 is first applied by taking into account only the \$90x hybrid deduction consisting of the notional interest deduction; in addition, for purposes of applying §1.267A-4 in this manner, FE's \$100x payment is not treated as an imported mismatch payment. Thus, the \$90x hybrid deduction offsets the income attributable to US1's imported mismatch payment, an imported mismatch payment that indirectly funds the hybrid deduction. See §1.267A-4(c)(2)(iii). The imported mismatch payment indirectly funds the hybrid deduction because FE (the imported mis-

match payee) is allocated the deduction, as FE makes a funded taxable payment (the \$100x payment to FZ) that is at least equal to the amount of the deduction. See §1.267A-4(c)(3)(ii), (iii), and (v).

(C) Section §1.267A-4 is next applied by taking into account only the \$10x hybrid deduction consisting of the deduction for the payment pursuant to the FX-FZ instrument. See §1.267A-4(f)(2). For purposes of applying §1.267A-4 in this manner, FE's \$100x payment is reduced from \$100x to \$10x, and similarly US1's imported mismatch payment is reduced from \$100x to \$10x. See §1.267A-4(c)(4). Further, FE's \$10x payment is treated as an imported mismatch payment. See §1.267A-4(f)(2). The entire \$10x of FE's imported mismatch payment directly funds the hybrid deduction because FZ (the imported mismatch payee with respect to FE's imported mismatch payment) incurs at least that amount of the hybrid deduction. See §1.267A-4(c)(3)(i). Accordingly, the \$10x hybrid deduction offsets the income attributable to FE's imported mismatch payment, and none of the income attributable to US1's imported mismatch payment.

(D) Therefore, \$90x of US1's imported mismatch payment is a disqualified imported mismatch amount, calculated as \$90x (the amount that is a disqualified imported mismatch amount determined by applying §1.267A-4 in the manner set forth in §1.267A-4(f)(1)) plus \$0 (the amount that is a disqualified imported mismatch amount determined by applying §1.267A-4 in the manner set forth in §1.267A-4(f)(2)). See §1.267A-4(a)(1) and (f).

#### §1.267A-7 Applicability dates.

(a) *General rule.* Except as provided in paragraph (b) of this section, §§1.267A-1 through 1.267A-6 apply to taxable years ending on or after December 20, 2018, provided that such taxable years begin after December 31, 2017. However, taxpayers may apply the regulations in §§1.267A-1 through 1.267A-6 in their entirety for taxable years beginning after December 31, 2017, and ending before December 20, 2018. In lieu of applying the regulations in §§1.267A-1 through 1.267A-6, taxpayers may apply the provisions matching §§1.267A-1 through 1.267A-6 from the Internal Revenue Bulletin (IRB) 2019-03 (<https://www.irs.gov/pub/irs-irbs/irb19-03.pdf>) in their entirety for all taxable years ending on or before April 8, 2020.

(b) *Special rules.* The following special rules apply regarding applicability dates:

(1) Sections 1.267A-2(a)(4) (payments pursuant to interest-free loans and similar arrangements), (b) (disregarded payments), (c) (deemed branch payments), and (e) (branch mismatch transactions), 1.267A-4 (imported mismatch rule), and 1.267A-5(b)(5) (structured payments), except as provided in paragraph (b)(5) of this section, apply to taxable years beginning on or after December 20, 2018.

(2) Section 1.267A-5(a)(20) (defining structured arrangement), as well as the portions of §§1.267A-1 through 1.267A-3 that relate to structured arrangements and that are not otherwise described in paragraph (b) of this section, apply to taxable years beginning on or after December 20, 2018. However, in the case of a specified payment made pursuant to an arrangement entered into before December 22, 2017, §1.267A-5(a)(20), and the portions of §§1.267A-1 through 1.267A-3 that relate to structured arrangements and that are not otherwise described in paragraph (b) of this section, apply to taxable years beginning after December 31, 2020.

(3) Except as provided in paragraph (b)(4) of this section, the rules provided in §1.267A-5(a)(12)(ii) (swaps with significant nonperiodic payments) apply to notional principal contracts entered into on or after April 8, 2021. However, taxpayers may apply the rules provided in §1.267A-5(a)(12)(ii) to notional principal contracts entered into before April 8, 2021.

(4) For a notional principal contract entered into before April 8, 2021, the interest equivalent rules provided in §1.267A-5(b)(5)(ii)(B) (applied without regard to the references to §1.267A-5(a)(12)(ii)) apply to a notional principal contract entered into on or after April 8, 2020.

(5) Section 1.267A-5(b)(5)(ii)(B) (interest equivalent rules) applies to transactions entered into on or after April 8, 2020.

Par. 4 Section 1.1503(d)-1 is amended by:

1. In paragraph (b)(2)(i), removing the word “and”.

2. In paragraph (b)(2)(ii), removing the second period and adding in its place “; and”.

3. Adding paragraph (b)(2)(iii).

4. Redesignating paragraph (c) as paragraph (d).

5. Adding new paragraph (c).

6. In newly redesignated paragraph (d)(1), removing the language “(c)” and “(c)(2)” and adding the language “(d)” and “(d)(2)” in their places, respectively.

7. In the first sentence of newly redesignated paragraph (d)(2)(ii) introductory text, removing the language “(c)(2)(i)” and adding the language “(d)(2)(i)” in its place.

The additions read as follows:

§1.1503(d)-1 *Definitions and special rules for filings under section 1503(d).*

\*\*\*\*\*

(b)\*\*\*

(2)\*\*\*

(iii) A domestic consenting corporation (as defined in §301.7701-3(c)(3)(i) of this chapter), as provided in paragraph (c)(1) of this section. See §1.1503(d)-7(c)(41) for an example illustrating the application of section 1503(d) to a domestic consenting corporation.

\*\*\*\*\*

(c) *Treatment of domestic consenting corporation as a dual resident corporation*—(1) *Rule.* A domestic consenting corporation is treated as a dual resident corporation under paragraph (b)(2)(iii) of this section for a taxable year if, on any day during the taxable year, the following requirements are satisfied:

(i) Under the tax law of a foreign country where a specified foreign tax resident is tax resident, the specified foreign tax resident derives or incurs (or would derive or incur) items of income, gain, deduction, or loss of the domestic consenting corporation (because, for example, the domestic consenting corporation is fiscally transparent under such tax law).

(ii) The specified foreign tax resident bears a relationship to the domestic consenting corporation that is described in section 267(b) or 707(b). See §1.1503(d)-

7(c)(41) for an example illustrating the application of paragraph (c) of this section.

(2) *Definitions.* The following definitions apply for purposes of this paragraph (c).

(i) The term *fiscally transparent* means, with respect to a domestic consenting corporation or an intermediate entity, fiscally transparent as determined under the principles of §1.894-1(d)(3)(ii) and (iii), without regard to whether a specified foreign tax resident is a resident of a country that has an income tax treaty with the United States.

(ii) The term *specified foreign tax resident* means a body corporate or other entity or body of persons liable to tax under the tax law of a foreign country as a resident.

\*\*\*\*\*

Par. 5. Section 1.1503(d)-3 is amended by adding the language “or (3)” after the language “paragraph (e)(2)” in paragraph (e)(1) introductory text and adding paragraph (e)(3) to read as follows:

§1.1503(d)-3 *Foreign use.*

\*\*\*\*\*

(e)\*\*\*

(3) *Exception for domestic consenting corporations.* Paragraph (e)(1) of this section will not apply so as to deem a foreign use of a dual consolidated loss incurred

by a domestic consenting corporation that is a dual resident corporation under §1.1503(d)-1(b)(2)(iii).

§1.1503(d)-6 [Amended]

Par. 6. Section 1.1503(d)-6 is amended by:

1. Removing the language “a foreign government” and “a foreign country” in paragraph (f)(5)(i) and adding the language “a government of a country” and “the country” in their places, respectively.

2. Removing the language “a foreign government” in paragraph (f)(5)(ii) and adding the language “a government of a country” in its place.

3. Removing the language “the foreign government” in paragraph (f)(5)(iii) and adding the language “a government of a country” in its place.

Par. 7. Section 1.1503(d)-7 is amended by:

1. Designating *Examples 1* through *40* of paragraph (c) as paragraphs (c)(1) through (40), respectively.

2. In newly designated paragraphs (c)(1) through (40), removing “Alternative Facts” and adding “Alternative facts” in its place wherever it appears.

3. For each newly designated paragraph listed in the table, remove the language in the “Remove” column and add in its place the language in the “Add” column:

Paragraph	Remove	Add
(c)(2)(iii)	paragraph (i) of this <i>Example 2</i>	paragraph (c)(2)(i) of this section
(c)(5)(iii)	paragraph (i) of this <i>Example 5</i>	paragraph (c)(5)(i) of this section
(c)(5)(iv)	paragraph (iii), of this <i>Example 5</i>	paragraph (c)(5)(iii) of this section
(c)(6)(iii)	paragraph (i) of this <i>Example 6</i>	paragraphs (c)(6)(i) of this section
(c)(10)(iii)	paragraph (i) of this <i>Example 10</i>	paragraph (c)(10)(i) of this section
(c)(10)(iii)	paragraph (ii) of this <i>Example 10</i>	paragraph (c)(10)(ii) of this section
(c)(11)(iii)	paragraph (i) of this <i>Example 11</i>	paragraph (c)(11)(i) of this section
(c)(13)(iii) and (iv)	paragraph (i) of this <i>Example 13</i>	paragraph (c)(13)(i) of this section
(c)(17)(iii)	paragraph (i) of this <i>Example 17</i>	paragraph (c)(17)(i) of this section
(c)(18)(iii)	paragraph (i) of this <i>Example 18</i>	paragraph (c)(18)(i) of this section
(c)(19)(iii)	paragraph (i) of this <i>Example 19</i>	paragraph (c)(19)(i) of this section
(c)(21)(iii)	paragraph (i) of this <i>Example 21</i>	paragraph (c)(21)(i) of this section
(c)(21)(iv)	paragraph (iii) of this <i>Example 21</i>	paragraph (c)(21)(iii) of this section
(c)(21)(v)	paragraph (iv) of this <i>Example 21</i>	paragraph (c)(21)(iv) of this section
(c)(31)(iii)	paragraph (i) of this <i>Example 31</i>	paragraph (c)(31)(i) of this section
(c)(33)(iii)	paragraph (i) of this <i>Example 33</i>	paragraph (c)(33)(i) of this section
(c)(35)(iii)	paragraph (i) of this <i>Example 35</i>	paragraph (c)(35)(i) of this section
(c)(40)(iii)	paragraph (i) of this <i>Example 40</i>	paragraph (c)(40)(i) of this section
(c)(40)(iii)	paragraph (ii) of this <i>Example 40</i>	paragraph (c)(40)(ii) of this section

4. In newly designated paragraphs (c)(29)(i)(A) and (c)(38)(i)(A), adding headings to the tables.

5. Adding paragraph (c)(41).

The additions read as follows:

*§1.1503(d)-7 Examples.*

\* \* \* \* \*

(c) \* \* \*

(29) \* \* \*

(i) \* \* \*

(A) \* \* \*

Table 1 to paragraph (c)(29)(i)(A)

\* \* \* \* \*

(38) \* \* \*

(i) \* \* \*

(A)

Table 2 to paragraph (c)(38)(i)(A)

\* \* \* \* \*

(41) *Example 41. Domestic consenting corporation—treated as dual resident corporation—(i) Facts.* FSZ1, a Country Z entity that is subject to Country Z tax on its worldwide income or on a residence basis and is classified as a foreign corporation for U.S. tax purposes, owns all the interests in DCC, a domestic eligible entity that has filed an election to be classified as an association. Under Country Z tax law, DCC is fiscally transparent. For taxable year 1, DCC's only item of income, gain, deduction, or loss is a \$100x deduction and such deduction comprises a \$100x net operating loss of DCC. For Country Z tax purposes, FSZ1's only item of income, gain, deduction, or loss, other than the \$100x loss attributable to DCC, is \$60x of operating income.

(ii) *Result.* DCC is a domestic consenting corporation because by electing to be classified as an association, it consents to be treated as a dual resident corporation for purposes of section 1503(d). See §301.7701-3(c)(3) of this chapter. For taxable year 1, DCC is treated as a dual resident corporation under §1.1503(d)-1(b)(2)(iii) because FSZ1 (a specified foreign tax resident that bears a relationship to DCC that is described in section 267(b) or 707(b)) derives or incurs items of income, gain, deduction, or loss of DCC. See §1.1503(d)-1(c). FSZ1 derives or incurs items of income, gain, deduction, or loss of DCC because, under Country Z tax law, DCC is fiscally transparent. Thus, DCC has a \$100x dual consolidated loss for taxable year 1. See §1.1503(d)-1(b)(5). Because the loss is available to, and in fact does, offset income of FSZ1 under Country Z tax law, there is a foreign use of the dual consolidated loss in year 1. Accordingly, the dual consolidated loss is subject to the domestic use limitation rule of §1.1503(d)-4(b). The result would be the same if FSZ1 were to indirectly own its DCC stock through an intermediate entity that is fiscally transparent under Country Z tax law, or if an individual were to wholly own FSZ1 and FSZ1 were a disregarded entity. In addition, the result would be the same if FSZ1 had no items of income, gain, deduction, or loss, other than the \$100x loss attributable to DCC.

(iii) *Alternative facts – DCC not treated as a dual resident corporation.* The facts are the same as in paragraph (c)(41)(i) of this section, except that DCC is not fiscally transparent under Country Z tax

law and thus under Country Z tax law FSZ1 does not derive or incur items of income, gain, deduction, or loss of DCC. Accordingly, DCC is not treated as a dual resident corporation under §1.1503(d)-1(b)(2)(iii) for year 1 and, consequently, its \$100x net operating loss in that year is not a dual consolidated loss.

(iv) *Alternative facts – mirror legislation.* The facts are the same as in paragraph (c)(41)(i) of this section, except that, under provisions of Country Z tax law that constitute mirror legislation under §1.1503(d)-3(e)(1) and that are substantially similar to the recommendations in Chapter 6 of OECD/G-20, *Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2: 2015 Final Report* (October 2015), Country Z tax law prohibits the \$100x loss attributable to DCC from offsetting FSZ1's income that is not also subject to U.S. tax. As is the case in paragraph (c)(41)(ii) of this section, DCC is treated as a dual resident corporation under §1.1503(d)-1(b)(2)(iii) for year 1 and its \$100x net operating loss is a dual consolidated loss. Pursuant to §1.1503(d)-3(e)(3), however, the dual consolidated loss is not deemed to be put to a foreign use by virtue of the Country Z mirror legislation. Therefore, DCC is eligible to make a domestic use election for the dual consolidated loss.

Par. 8. Section 1.1503(d)-8 is amended by removing the language “§1.1503(d)-1(c)” and adding in its place the language “§1.1503(d)-1(d)” wherever it appears in paragraphs (b)(3)(i) and (iii) and adding paragraphs (b)(6) and (7) to read as follows:

*§1.1503(d)-8 Effective dates.*

\* \* \* \* \*

(b) \* \* \*

(6) *Rules regarding domestic consenting corporations.* Section 1.1503(d)-1(b)(2)(iii) and (c), as well as §1.1503(d)-3(e)(1) and (3), apply to determinations under §§1.1503(d)-1 through 1.1503(d)-7 relating to taxable years ending on or after December 20, 2018. For taxable years ending before December 20, 2018, see §1.1503(d)-3(e)(1) as contained in 26 CFR part 1 revised as of April 1, 2018.

(7) *Compulsory transfer triggering event exception.* Section 1.1503(d)-6(f)(5)(i) through (iii) applies to transfers that occur on or after December 20, 2018. For transfers occurring before December 20, 2018, see §1.1503(d)-6(f)(5)(i) through (iii) as contained in 26 CFR part 1 revised as of April 1, 2018. However, taxpayers may consistently apply §1.1503(d)-6(f)(5)(i) through (iii) to transfers occurring before December 20, 2018.

Par. 9. Section 1.6038-2 is amended by adding paragraphs (f)(13) and (14) and (m)(3) to read as follows:

*§1.6038-2 Information returns required of United States persons with respect to annual accounting periods of certain foreign corporations.*

\* \* \* \* \*

(f) \* \* \*

(13) *Amounts involving hybrid transactions or hybrid entities under section 267A.* If for the annual accounting period, the corporation pays or accrues interest or royalties for which a deduction is disallowed under section 267A and the regulations in this part under section 267A of the Internal Revenue Code, then Form 5471 (or successor form) must contain such information about the disallowance in the form and manner and to the extent prescribed by the form, instruction, publication, or other guidance.

(14) *Hybrid dividends under section 245A(e).* If for the annual accounting period, the corporation pays or receives a hybrid dividend or a tiered hybrid dividend under section 245A(e) and the regulations in this part under section 245A(e) of the Internal Revenue Code, then Form 5471 (or successor form) must contain such information about the hybrid dividend or tiered hybrid dividend in the form and manner and to the extent prescribed by the form, instruction, publication, or other guidance. Form 5471 (or successor form) must also contain any other information relating to the rules of section 245A(e) and the regulations in this part under section 245A(e) of the Internal Revenue Code (including information related to a specified owner's hybrid deduction account), as prescribed by the form, instruction, publication, or other guidance.

\* \* \* \* \*

(m) \* \* \*

(3) *Rules relating to certain hybrid arrangements.* Paragraphs (f)(13) and (14) of this section apply with respect to information for annual accounting periods beginning on or after December 20, 2018.

Par. 10. Section 1.6038-3 is amended by:

1. Adding paragraph (g)(3).
2. Redesignating paragraph (1) at the end of the section as paragraph (l).
3. In newly redesignated paragraph (l), revising the heading and adding a sentence at the end.

The additions and revision read as follows:

§1.6038-3 Information returns required of certain United States persons with respect to controlled foreign partnerships (CFPs).

\*\*\*\*\*

(g)\*\*\*

(3) Amounts involving hybrid transactions or hybrid entities under section 267A. In addition to the information required pursuant to paragraphs (g)(1) and (2) of this section, if, during the partnership's taxable year for which the Form 8865 is being filed, the partnership paid or accrued interest or royalties for which a deduction is disallowed under section 267A and the regulations in this part under section 267A, the controlling fifty-percent partners must provide information about the disallowance in the form and manner and to the extent prescribed by Form 8865 (or successor form), instruction, publication, or other guidance.

\*\*\*\*\*

(1) *Applicability dates.* \*\*\* Paragraph (g)(3) of this section applies for taxable years of a foreign partnership beginning on or after December 20, 2018.

Par. 11. Section 1.6038A-2 is amended by adding paragraph (b)(5)(iii) and adding a sentence at the end of paragraph (g) to read as follows:

§1.6038A-2 Requirement of return.

\*\*\*\*\*

(b)\*\*\*

(5)\*\*\*

(iii) If, for the taxable year, a reporting corporation pays or accrues interest or royalties for which a deduction is disallowed under section 267A and the regulations in this part under section 267A, then the reporting corporation must provide such information about the disallowance in the form and manner and to the extent prescribed by Form 5472 (or successor

form), instruction, publication, or other guidance.

\*\*\*\*\*

(g)\*\*\* Paragraph (b)(5)(iii) of this section applies with respect to information for annual accounting periods beginning on or after December 20, 2018.

#### PART 301—PROCEDURE AND ADMINISTRATION

Paragraph 12. The authority citation for part 301 continues to read in part as follows:

Authority: 26 U.S.C. 7805 \*\*\*

Par. 13. Section 301.7701-3 is amended by revising the sixth sentence of paragraph (a) and adding paragraph (c)(3) to read as follows:

§301.7701-3 Classification of certain business entities.

(a) *In general.* \*\*\* Paragraph (c) of this section provides rules for making express elections, including a rule under which a domestic eligible entity that elects to be classified as an association consents to be subject to the dual consolidated loss rules of section 1503(d). \*\*\*

\*\*\*\*\*

(c)\*\*\*

(3) *Consent to be subject to section 1503(d)*—(i) *Rule.* A domestic eligible entity that elects to be classified as an association consents to be treated as a dual resident corporation for purposes of section 1503(d) (such an entity, a *domestic consenting corporation*), for any taxable year for which it is classified as an association and the condition set forth in §1.1503(d)-1(c)(1) of this chapter is satisfied.

(ii) *Transition rule — deemed consent.* If, as a result of the applicability date (see paragraph (c)(3)(iii) of this section) relating to paragraph (c)(3)(i) of this section,

a domestic eligible entity that is classified as an association has not consented to be treated as a domestic consenting corporation pursuant to paragraph (c)(3)(i) of this section, then the domestic eligible entity is deemed to consent to be so treated as of its first taxable year beginning on or after December 20, 2019. The first sentence of this paragraph (c)(3)(ii) does not apply if the domestic eligible entity elects, on or after December 20, 2018 and effective before its first taxable year beginning on or after December 20, 2019, to be classified as a partnership or disregarded entity such that it ceases to be a domestic eligible entity that is classified as an association. For purposes of the election described in the second sentence of this paragraph (c)(3)(ii), the sixty month limitation under paragraph (c)(1)(iv) of this section is waived.

(iii) *Applicability date.* The sixth sentence of paragraph (a) of this section and paragraph (c)(3)(i) of this section apply to a domestic eligible entity that on or after December 20, 2018 files an election to be classified as an association (regardless of whether the election is effective before December 20, 2018). Paragraph (c)(3)(ii) of this section applies as of December 20, 2018.

\*\*\*\*\*

Sunita Lough,  
Deputy Commissioner for Services  
and Enforcement.

Approved: February 26, 2020.

David J. Kautter,  
Assistant Secretary of the Treasury  
(Tax Policy).

(Filed by the Office of the Federal Register on April 7, 2020, 8:45 a.m., and published in the issue of the Federal Register for April 8, 2020, 85 F.R. 19802)



# Part III

## Update to Notice 2020-18, Additional Relief for Taxpayers Affected by Ongoing Coronavirus Disease 2019 Pandemic

### Notice 2020-23

#### I. PURPOSE

On March 13, 2020, the President of the United States issued an emergency declaration under the Robert T. Stafford Disaster Relief and Emergency Assistance Act in response to the ongoing Coronavirus Disease 2019 (COVID-19) pandemic (Emergency Declaration). The Emergency Declaration instructed the Secretary of the Treasury “to provide relief from tax deadlines to Americans who have been adversely affected by the COVID-19 emergency, as appropriate, pursuant to 26 U.S.C. 7508A(a).” Pursuant to the Emergency Declaration, this notice provides relief under section 7508A(a) of the Internal Revenue Code (Code) for the persons described in section III.A of this notice that the Secretary of the Treasury has determined to be affected by the COVID-19 emergency. This notice amplifies Notice 2020-18, 2020-15 IRB 590 (April 6, 2020), and Notice 2020-20, 2020-16 IRB 660 (April 13, 2020).

#### II. BACKGROUND

Section 7508A of the Code provides the Secretary of the Treasury or his delegate (Secretary) with authority to postpone the time for performing certain acts under the internal revenue laws for a taxpayer determined by the Secretary to be affected by a Federally declared disaster as defined in section 165(i)(5)(A). Pursuant to section 7508A(a), a period of up to one year may be disregarded in determining whether the performance of certain acts is timely under the internal revenue laws.

On March 18, 2020, the Department of the Treasury (Treasury Department) and the Internal Revenue Service (IRS)

issued Notice 2020-17 providing relief under section 7508A(a), which postponed the due date for certain Federal income tax payments from April 15, 2020, until July 15, 2020. On March 20, 2020, the Treasury Department and the IRS issued Notice 2020-18, which superseded Notice 2020-17 and provided expanded relief, postponing the due date from April 15, 2020, until July 15, 2020, for filing Federal income tax returns and making Federal income tax payments due April 15, 2020. On March 27, 2020, the Treasury Department and the IRS issued Notice 2020-20, which amplified Notice 2020-18 and provided additional relief, postponing certain Federal gift (and generation-skipping transfer) tax return filings and payments.

This notice further amplifies the relief provided in Notice 2020-18 and Notice 2020-20, providing additional relief to affected taxpayers as described in section III. In addition, section III.D of this notice postpones due dates with respect to certain government acts, and section III.E of this notice postpones the application date to participate in the Annual Filing Season Program.

The relief provided under section 7508A in this notice, Notice 2020-18, and Notice 2020-20, is limited to the relief explicitly provided in these notices and does not apply with respect to any other type of Federal tax, any other type of Federal tax return, or any other time-sensitive act. For information about additional relief that may be available in connection with the COVID-19 emergency, including relief provided to employers that allows them to delay the deposit of certain employment taxes, go to *IRS.gov/Coronavirus*.

#### III. GRANT OF RELIEF

##### A. Taxpayers Affected by COVID-19 Emergency

The Secretary of the Treasury has determined that any person (as defined in section 7701(a)(1) of the Code) with a Federal tax payment obligation specified in this section III.A (Specified Payment),

or a Federal tax return or other form filing obligation specified in this section III.A (Specified Form), which is due to be performed (originally or pursuant to a valid extension) on or after April 1, 2020, and before July 15, 2020, is affected by the COVID-19 emergency for purposes of the relief described in this section III (Affected Taxpayer). The payment obligations and filing obligations specified in this section III.A (Specified Filing and Payment Obligations) are as follows:

- Individual income tax payments and return filings on Form 1040, U.S. Individual Income Tax Return, 1040-SR, U.S. Tax Return for Seniors, 1040-NR, U.S. Nonresident Alien Income Tax Return, 1040-NR-EZ, U.S. Income Tax Return for Certain Nonresident Aliens With No Dependents, 1040-PR, Self-Employment Tax Return - Puerto Rico, and 1040-SS, U.S. Self-Employment Tax Return (Including the Additional Child Tax Credit for Bona Fide Residents of Puerto Rico);
- Calendar year or fiscal year corporate income tax payments and return filings on Form 1120, U.S. Corporation Income Tax Return, 1120-C, U.S. Income Tax Return for Cooperative Associations, 1120-F, U.S. Income Tax Return of a Foreign Corporation, 1120-FSC, U.S. Income Tax Return of a Foreign Sales Corporation, 1120-H, U.S. Income Tax Return for Homeowners Associations, 1120-L, U.S. Life Insurance Company Income Tax Return, 1120-ND, Return for Nuclear Decommissioning Funds and Certain Related Persons, 1120-PC, U.S. Property and Casualty Insurance Company Income Tax Return, 1120-POL, U.S. Income Tax Return for Certain Political Organizations, 1120-REIT, U.S. Income Tax Return for Real Estate Investment Trusts, 1120-RIC, U.S. Income Tax Return for Regulated Investment Companies, 1120-S, U.S. Income Tax Return for an S Corporation, and 1120-SF, U.S. Income Tax Return for Settlement Funds (Under Section 468B);

- Calendar year or fiscal year partnership return filings on Form 1065, U.S. Return of Partnership Income, and Form 1066, U.S. Real Estate Mortgage Investment Conduit (REMIC) Income Tax Return;
- Estate and trust income tax payments and return filings on Form 1041, U.S. Income Tax Return for Estates and Trusts, 1041-N, U.S. Income Tax Return for Electing Alaska Native Settlement Trusts, and 1041-QFT, U.S. Income Tax Return for Qualified Funeral Trusts;
- Estate and generation-skipping transfer tax payments and return filings on Form 706, United States Estate (and Generation-Skipping Transfer) Tax Return, 706-NA, United States Estate (and Generation-Skipping Transfer) Tax Return, 706-A, United States Additional Estate Tax Return, 706-QDT, U.S. Estate Tax Return for Qualified Domestic Trusts, 706-GS(T), Generation-Skipping Transfer Tax Return for Terminations, 706-GS(D), Generation-Skipping Transfer Tax Return for Distributions, and 706-GS(D-1), Notification of Distribution from a Generation-Skipping Trust (including the due date for providing such form to a beneficiary);
- Form 706, United States Estate (and Generation-Skipping Transfer) Tax Return, filed pursuant to Revenue Procedure 2017-34;
- Form 8971, Information Regarding Beneficiaries Acquiring Property from a Decedent and any supplemental Form 8971, including all requirements contained in section 6035(a) of the Code;
- Gift and generation-skipping transfer tax payments and return filings on Form 709, United States Gift (and Generation-Skipping Transfer) Tax Return that are due on the date an estate is required to file Form 706 or Form 706-NA;
- Estate tax payments of principal or interest due as a result of an election made under sections 6166, 6161, or 6163 and annual recertification requirements under section 6166 of the Code;
- Exempt organization business income tax and other payments and re-

turn filings on Form 990-T, Exempt Organization Business Income Tax Return (and proxy tax under section 6033(e) of the Code);

- Excise tax payments on investment income and return filings on Form 990-PF, Return of Private Foundation or Section 4947(a)(1) Trust Treated as Private Foundation, and excise tax payments and return filings on Form 4720, Return of Certain Excise Taxes under Chapters 41 and 42 of the Internal Revenue Code; and
- Quarterly estimated income tax payments calculated on or submitted with Form 990-W, Estimated Tax on Unrelated Business Taxable Income for Tax-Exempt Organizations, 1040-ES, Estimated Tax for Individuals, 1040-ES (NR), U.S. Estimated Tax for Nonresident Alien Individuals, 1040-ES (PR), Estimated Federal Tax on Self Employment Income and on Household Employees (Residents of Puerto Rico), 1041-ES, Estimated Income Tax for Estates and Trusts, and 1120-W, Estimated Tax for Corporations.

The Secretary of the Treasury has also determined that any person performing a time-sensitive action listed in either § 301.7508A-1(c)(1)(iv) – (vi) of the Procedure and Administration Regulations or Revenue Procedure 2018-58, 2018-50 IRB 990 (December 10, 2018), which is due to be performed on or after April 1, 2020, and before July 15, 2020 (Specified Time-Sensitive Action), is an Affected Taxpayer. For purposes of this notice, the term Specified Time-Sensitive Action also includes an investment at the election of a taxpayer due to be made during the 180-day period described in section 1400Z-2(a)(1)(A) of the Code.

#### **B. Postponement of Due Dates with Respect to Certain Federal Tax Returns and Federal Tax Payments**

For an Affected Taxpayer with respect to Specified Filing and Payment Obligations, the due date for filing Specified Forms and making Specified Payments is automatically postponed to July 15, 2020.

This relief is automatic; Affected Taxpayers do not have to call the IRS or file any extension forms, or send letters or

other documents to receive this relief. However, Affected Taxpayers who need additional time to file may choose to file the appropriate extension form by July 15, 2020, to obtain an extension to file their return, but the extension date may not go beyond the original statutory or regulatory extension date. For example, a Form 4868, Application for Automatic Extension of Time to File U.S. Individual Income Tax Return, may be filed by July 15, 2020, to extend the time to file an individual income tax return, but that extension will only be to October 15, 2020. That extension will not extend the time to pay federal income tax beyond July 15, 2020.

This relief includes not just the filing of Specified Forms, but also all schedules, returns, and other forms that are filed as attachments to Specified Forms or are required to be filed by the due date of Specified Forms, including, for example, Schedule H and Schedule SE, as well as Forms 3520, 5471, 5472, 8621, 8858, 8865, and 8938. This relief also includes any installment payments under section 965(h) due on or after April 1, 2020, and before July 15, 2020. Finally, elections that are made or required to be made on a timely filed Specified Form (or attachment to a Specified Form) shall be timely made if filed on such Specified Form or attachment, as appropriate, on or before July 15, 2020.

As a result of the postponement of the due date for filing Specified Forms and making Specified Payments, the period beginning on April 1, 2020, and ending on July 15, 2020, will be disregarded in the calculation of any interest, penalty, or addition to tax for failure to file the Specified Forms or to pay the Specified Payments postponed by this notice. Interest, penalties, and additions to tax with respect to such postponed Specified Filing and Payment Obligations will begin to accrue on July 16, 2020.

#### **C. Relief With Respect to Specified Time-Sensitive Actions**

Affected Taxpayers also have until July 15, 2020, to perform all Specified Time-Sensitive Actions, that are due to be performed on or after April 1, 2020, and before July 15, 2020. This relief includes the time for filing all petitions

with the Tax Court, or for review of a decision rendered by the Tax Court, filing a claim for credit or refund of any tax, and bringing suit upon a claim for credit or refund of any tax. This notice does not provide relief for the time period for filing a petition with the Tax Court, or for filing a claim or bringing a suit for credit or refund if that period expired before April 1, 2020.

#### **D. Postponement of Due Dates with Respect to Certain Government Acts**

This notice also provides the IRS with additional time to perform the time-sensitive actions described in § 301.7508A-1(c) (2) as provided in this section III.D (Time-Sensitive IRS Action). Due to the COVID-19 emergency, IRS employees, taxpayers, and other persons may be unable to access documents, systems, or other resources necessary to perform certain time-sensitive actions due to office closures or state and local government executive orders restricting activities. The lack of access to those documents, systems, or resources will materially interfere with the IRS's ability to timely administer the Code. As a result, IRS employees will require additional time to perform time-sensitive actions.

Accordingly, the following persons (as defined in section 7701(a)(1) of the Code) are "Affected Taxpayers" for the limited purpose of this section III.D:

- persons who are currently under examination (including an investigation to determine liability for an assessable penalty under subchapter B of Chapter 68);
- persons whose cases are with the Independent Office of Appeals; and
- persons who, during the period beginning on or after April 6, 2020 and ending before July 15, 2020, file written documents described in section 6501(c)(7) of the Code (amended returns) or submit payments with respect to a tax for which the time for assessment would otherwise expire during this period.

With respect to those Affected Taxpayers, a 30-day postponement is granted for Time-Sensitive IRS Actions if the last date for performance of the action is on or after April 6, 2020, and before July 15, 2020.

As a result of the postponement of the time to perform Time-Sensitive IRS Actions, the 30-day period following the last date for the performance of Time-Sensitive IRS Actions will be disregarded in determining whether the performance of those actions is timely.

This section III.D is subject to review and further postponement, as appropriate.

#### **E. Extension of Time to Participate in the Annual Filing Season Program**

Revenue Procedure 2014-42, 2014-29 IRB 192, created a voluntary Annual Filing Season Program to encourage tax return preparers who do not have credentials as practitioners under Treasury Department Circular No. 230 (*Regulations Governing Practice before the Internal Revenue Service*) to complete continuing education courses for the purpose of increasing their knowledge of the law relevant to federal tax returns. Tax return preparers who complete the requirements in Rev. Proc. 2014-42 receive an annual Record of Completion. Under Rev. Proc. 2014-42, applications to participate in the Annual Filing Season Program for the 2020 calendar year must be received by April 15, 2020. The 2020 calendar year application deadline is postponed to July 15, 2020.

#### **IV. EFFECT ON OTHER DOCUMENTS**

Notice 2020-18 and Notice 2020-20 are amplified. Rev. Proc. 2014-42 is modified, applicable for calendar year 2020.

#### **V. DRAFTING INFORMATION**

The principal author of this notice is Jennifer Auchterlonie of the Office of Associate Chief Counsel, Procedure and Administration. For further information regarding this notice, you may call the COVID-19 Disaster Relief Hotline at (202) 317-5436 (not a toll-free number). For further information regarding estate, gift, trust, and generation-skipping transfer tax issues related to this notice, please contact Daniel Gespass, of CC:PSI: Br. 4 at (202) 317-6859 (not a toll-free number).

## **Extension of Time to File Application for Tentative Carryback Adjustment**

### **Notice 2020-26**

#### **SECTION 1. PURPOSE**

This notice provides relief for certain taxpayers to allow them to take advantage of amendments made to the net operating loss (NOL) provisions set forth in § 172 of the Internal Revenue Code (Code) by section 2303 of the Coronavirus Aid, Relief, and Economic Security Act (CARES Act), Public Law 116-136, 134 Stat. 281 (March 27, 2020). Specifically, this notice extends the deadline for filing an application for a tentative carryback adjustment under § 6411 of the Code with respect to the carryback of an NOL that arose in any taxable year that began during calendar year 2018 and that ended on or before June 30, 2019.

#### **SECTION 2. BACKGROUND**

Section 2303(b) of the CARES Act amends § 172(b)(1) to carry back any NOL arising in a taxable year beginning after December 31, 2017, and before January 1, 2021, to each of the five taxable years preceding the taxable year in which the NOL arises (carryback period). As a result of that amendment, taxpayers take into account such NOLs in the earliest taxable year in the carryback period, carrying forward unused amounts to each succeeding taxable year. Section 2303(a) of the CARES Act amends § 172(a) to allow a deduction for a taxable year beginning before January 1, 2021, in an amount equal to the aggregate of the NOL carryovers and carrybacks to such year.

Section 2305(a) of the CARES Act amended § 53(e) of the Code to accelerate the recovery of 100 percent of any remaining minimum tax credits of a corporation in its taxable year beginning in 2019, as opposed to its taxable year beginning in 2021. Section 2305(b) of the CARES Act added § 53(e)(5) to the Code to permit a corporation to elect instead to recover 100 percent of any of its remaining minimum tax credits in its taxable year beginning in 2018.

Section 6411 allows a taxpayer to file an application for a tentative carryback adjustment of the tax liability for a prior taxable year that is affected by an NOL carryback provided in § 172(b) or by carrybacks provided for in other Code sections. Under § 1.6411-1(b)(1) of the Income Tax Regulations, taxpayers that are corporations must make the application on Form 1139, *Corporation Application for Tentative Refund*, and taxpayers other than corporations must make the application on Form 1045, *Application for Tentative Refund*. The Code and regulations require that an application must be filed within 12 months of the close of the taxable year in which the NOL arose. Section 6411(a); § 1.6411-1(c). The tentative carryback adjustment procedure allows a taxpayer to obtain a quick tentative tax refund based on an NOL carryback. Under § 6411(b), the Internal Revenue Service (IRS) conducts a limited examination of the application and makes the resulting credit or refund within 90 days of the filing of the application.

Section 2305(d) of the CARES Act permits a corporation to file an application for a tentative refund of any amount for which a refund with respect to its taxable year beginning in 2018 is due by reason of an election under § 53(e)(5), and provides generally that such application is to be treated and processed as an application made under § 6411 of the Code, provided the application is filed prior to December 31, 2020.

The CARES Act did not provide additional time to file tentative carryback adjustment applications with respect to NOLs arising in a taxable year beginning on or after January 1, 2018, and ending before March 27, 2019, even though the time to file those applications had expired as of the date of enactment. Taxpayers whose losses in these taxable years may now be carried back to an earlier taxable year due to application of section 2303 of the CARES Act will generally be able to file amended returns to claim refunds or credits resulting from the change in the law. These taxpayers, however, would not be able to take advantage of the expedited § 6411 tentative carryback adjustment procedure without an extension of time to file Form 1139 or Form 1045.

Section 6081 of the Code provides that the Secretary of the Treasury or his delegate may grant a reasonable extension of time (generally not to exceed six months) for filing any return, declaration, statement, or other document required by the Code or by regulations thereunder.

### SECTION 3. EXTENSION OF TIME TO FILE

The Department of the Treasury and the IRS grant a six-month extension of time to file Form 1045 or Form 1139, as applicable, to taxpayers that have an NOL that arose in a taxable year that began during calendar year 2018 and that ended on or before June 30, 2019. This extension of time is limited to requesting a tentative refund to carry back an NOL and does not extend the time to carry back any other item.

For example, in the case of an NOL that arose in a taxable year ending on December 31, 2018, a taxpayer normally would have until December 31, 2019, to file the Form 1045 or Form 1139, as applicable, but due to this relief, will now have until June 30, 2020, to file the Form 1045 or Form 1139, as applicable. For this same taxpayer, if the taxpayer is a corporation, the deadline to claim a minimum tax credit described in § 53(e)(5) is December 30, 2020, but in order to file one application for a tentative refund and claim both the NOL carryback and the minimum tax credit at the same time, the taxpayer must do so by the earlier of the two deadlines.

To take advantage of the extension of time for requesting a tentative refund based on an NOL carryback, the taxpayer must perform the following actions:

- (a) File the applicable form no later than 18 months after the close of the taxable year in which the NOL arose (that is, no later than June 30, 2020, for a taxable year ending December 31, 2018); and
- (b) Include on the top of the applicable form “Notice 2020-26, Extension of Time to File Application for Tentative Carryback Adjustment.”

For instructions and additional information, visit [IRS.gov/Form1045](https://www.irs.gov/Form1045) or [IRS.gov/Form1139](https://www.irs.gov/Form1139), as applicable.

### SECTION 4. CONTACT INFORMATION

The principal author of this notice is Alexander Wu of the Office of the Associate Chief Counsel (Procedure and Administration). For further information, please contact Mr. Wu at (202) 317-5436 (not a toll-free number).

*26 CFR 601.601. Rules and regulations. (Also Part I, §§ 163, 168.)*

## Rev. Proc. 2020-22

### SECTION 1. PURPOSE

.01 This revenue procedure provides guidance regarding the election under section 163(j)(7)(B) of the Internal Revenue Code (Code) to be an electing real property trade or business and the election under section 163(j)(7)(C) to be an electing farming business for purposes of the business interest expense deduction limitation under section 163(j) of the Code. This revenue procedure allows certain taxpayers to make a late election, or to withdraw an election, under section 163(j)(7)(B) or 163(j)(7)(C), as applicable, on an amended Federal income tax return, an amended Form 1065, or an administrative adjustment request under section 6227 of the Code (AAR).

.02 This revenue procedure also provides guidance regarding recent changes made to section 163(j)(10) of the Code. This revenue procedure describes the time and manner in which certain taxpayers can elect (1) out of the 50 percent adjusted taxable income (ATI) limitation for taxable years beginning in 2019 and 2020, (2) to use the taxpayer’s ATI for the last taxable year beginning in 2019 to calculate the taxpayer’s section 163(j) limitation for taxable year 2020, and (3) out of deducting 50 percent of excess business interest expense (EBIE) for taxable years beginning in 2020 without limitation.

### SECTION 2. BACKGROUND

.01 On December 22, 2017, section 163(j) was amended by Public Law 115-97, 131 Stat. 2054, commonly referred to

as the Tax Cuts and Jobs Act (TCJA). Section 163(j), as amended by § 13301(a) of the TCJA, provides new rules limiting the amount of business interest expense that can be deducted for taxable years beginning after December 31, 2017.

.02 On March 27, 2020, section 163(j) was further amended by § 2306 of the Coronavirus Aid, Relief, and Economic Security Act, Public Law 116-136, 134 Stat. 281 (CARES Act). The CARES Act amended section 163(j) by redesignating section 163(j)(10), as amended by the TCJA, as new section 163(j)(11), and adding a new section 163(j)(10) providing special rules for applying section 163(j) to taxable years beginning in 2019 and 2020.

.03 Under section 163(j)(1), as in effect prior to the enactment of the CARES Act, the business interest expense deduction is limited to the sum of: (1) the taxpayer's business interest income, as defined in section 163(j)(6), for the taxable year; (2) 30 percent of the taxpayer's ATI, as defined in section 163(j)(8) (30 percent ATI limitation), for such taxable year; and (3) the taxpayer's floor plan financing interest, as defined in section 163(j)(9), for such taxable year (collectively, section 163(j) limitation).

.04 The section 163(j) limitation applies to all taxpayers with "business interest," as defined in section 163(j)(5), except for taxpayers, other than tax shelters under section 448(a)(3), that meet the gross receipts test in section 448(c).

.05 Section 163(j)(5) generally provides that the term "business interest" means any interest expense properly allocable to a trade or business. Section 163(j)(7)(A)(ii) provides that, under the limitation, the term "trade or business" does not include an "electing real property trade or business." Section 163(j)(7)(A)(iii) provides that, under the limitation, the term "trade or business" does not include an "electing farming business." Thus, interest expense that is properly allocable to an electing real property trade or business or an electing farming business is not properly allocable to a trade or business under section 163(j) and therefore is not business interest expense that is subject to section 163(j)(1).

.06 The CARES Act retroactively increases the amount of business interest expense that may be deductible for taxable

years beginning in 2019 and 2020 by computing the section 163(j) limitation using 50 percent, rather than 30 percent, of the taxpayer's ATI (50 percent ATI limitation). The 50 percent ATI limitation does not apply to partnerships for taxable years beginning in 2019. *See* section 163(j)(10)(A)(i).

.07 Under the CARES Act, a taxpayer can elect not to apply the 50 percent ATI limitation to any taxable year beginning in 2019 or 2020, and instead apply the 30 percent ATI limitation. In the case of a partnership, the election must be made by the partnership and may be made only for taxable years beginning in 2020. The election, once made, cannot be revoked without the consent of the Secretary of the Treasury or his delegate. *See* section 163(j)(10)(A)(iii).

.08 The CARES Act provides special rules for partnerships and partners for taxable years beginning in 2019. Under section 163(j)(10)(A)(ii), a partner treats 50 percent of its allocable share of a partnership's EBIE for 2019 (2019 EBIE) as an interest deduction in the partner's first taxable year beginning in 2020 without limitation (50 percent EBIE rule). The remaining 50 percent of such EBIE remains subject to the section 163(j) limitation applicable to EBIE carried forward at the partner level. A partner may elect out of the 50 percent EBIE rule. *See* section 163(j)(10)(A)(ii)(II).

.09 The CARES Act allows a taxpayer to elect to substitute its ATI for the last taxable year beginning in 2019 (2019 ATI) for the taxpayer's ATI in determining the taxpayer's section 163(j) limitation for any taxable year beginning in 2020. *See* section 163(j)(10)(B)(i).

.10 On December 28, 2018, the Department of the Treasury (Treasury Department) and the Internal Revenue Service (IRS) published a notice of proposed rulemaking in the Federal Register (REG-106089-18; 83 FR 67490) containing proposed regulations under section 163(j) (2018 proposed regulations) to amend the Income Tax Regulations (26 CFR Part 1).

.11 Proposed § 1.163(j)-9 provides the rules and procedures for making an election under section 163(j)(7)(B) to be an electing real property trade or business, as defined in proposed § 1.163(j)-1(b)(12), and an election under section 163(j)(7)(C)

to be an electing farming business, as defined in proposed § 1.163(j)-1(b)(11). Proposed § 1.163(j)-9(b)(2) provides that the election described in proposed § 1.163(j)-9 is irrevocable.

.12 Proposed § 1.163(j)-9(c)(1) provides that a taxpayer makes an election under section 163(j)(7)(B) or 163(j)(7)(C) by attaching an election statement with the information specified in proposed § 1.163(j)-9(c)(2) to the taxpayer's timely filed original Federal income tax return, including extensions.

.13 The Treasury Department and the IRS intend to publish final regulations as well as additional proposed regulations under section 163(j).

.14 With the enactment of the CARES Act, and prior to publication of the final and additional proposed regulations, immediate transition guidance is needed under section 163(j) for taxpayers who are affected by the various amendments to the Code made by the CARES Act, including, for example, the technical corrections to section 168(e) of the Code relating to the classification of qualified improvement property. Immediate transition guidance is also needed to provide the time and manner of making or revoking the elections provided for under section 163(j)(10) as amended by the CARES Act.

.15 Section 4 of this revenue procedure provides an automatic extension of time for certain taxpayers to file an election under section 163(j)(7)(B) to be an electing real property trade or business or under section 163(j)(7)(C) to be an electing farming business for taxable years 2018, 2019, or 2020. Section 5 of this revenue procedure also provides an opportunity for certain taxpayers to withdraw a prior election under section 163(j)(7)(B) to be an electing real property trade or business or under section 163(j)(7)(C) to be an electing farming business. If a taxpayer withdraws an election within the manner outlined in section 5 of this revenue procedure, the taxpayer will be treated as if the election was never made.

.16 Section 6 of this revenue procedure provides the time and manner by which certain taxpayers can make or revoke elections under new section 163(j)(10). Specifically, these elections are: (1) under section 163(j)(10)(A)(iii), to not

apply the 50 percent ATI limitation; (2) under section 163(j)(10)(B), to use the taxpayer's ATI for the last taxable year beginning in 2019 to calculate the taxpayer's section 163(j) limitation in 2020; and (3) under section 163(j)(10)(A)(ii) (II), for a partner to elect out of the 50 percent EBIE rule.

### SECTION 3. SCOPE

.01 *Section 163(j)(7) elections.* Sections 4 and 5 of this revenue procedure apply to a taxpayer described in section 3.01(1) or (2) of this revenue procedure with respect to an election under section 163(j)(7)(B) to be an electing real property trade or business or under section 163(j)(7)(C) to be an electing farming business (collectively, section 163(j)(7) election). The fact that a taxpayer satisfies the scope requirement of this section 3.01 is not a determination that the taxpayer is a real property trade or business under section 162, 212, or 469 of the Code, or a farming business under section 162, 199A, or 263A of the Code.

(1) A taxpayer is described in this section 3.01(1) if the taxpayer did not file a section 163(j)(7) election with its timely filed original Federal income tax return or Form 1065, including extensions, or withdrew an election under section 5 of this revenue procedure, for a taxable year beginning in 2018 (2018 taxable year), 2019 (2019 taxable year), or 2020 (2020 taxable year), was otherwise qualified to make an election when the return was filed, and now wants to make an election for one of those taxable years.

(2) A taxpayer is described in this section 3.01(2) if the taxpayer filed a section 163(j)(7) election with its timely filed original Federal income tax return or Form 1065, including extensions, or made a late election under section 4 of this revenue procedure, for a 2018, 2019, or 2020 taxable year and now wants to withdraw the election.

.02 *Section 163(j)(10) elections.* Section 6 of this revenue procedure provides the time and manner of making or revoking elections under new section 163(j)(10) applicable to a taxpayer that has timely filed, or will timely file, an original Federal income tax return or Form 1065 for a taxpayer's 2019 or 2020 taxable year.

### SECTION 4. AUTOMATIC EXTENSION OF TIME TO FILE A SECTION 163(j)(7) ELECTION

.01 *In general.* A taxpayer within the scope of section 3.01(1) of this revenue procedure has properly made the section 163(j)(7) election if the taxpayer made the section 163(j)(7) election under the 2018 proposed regulations or under section 4.02 of this revenue procedure.

.02 *Time for making a late section 163(j)(7) election.* A taxpayer within the scope of section 3.01(1) of this revenue procedure may make the section 163(j)(7) election for a 2018, 2019, or 2020 taxable year by filing an amended Federal income tax return, amended Form 1065, or AAR, as applicable. Except as provided in Rev. Proc. 2020-23, 2020-18 I.R.B. 749 (April 27, 2020), released on www.irs.gov on April 8, 2020, regarding the time to file an amended return by a partnership subject to the centralized partnership audit regime enacted as part of the Bipartisan Budget Act of 2015 (BBA partnership) for 2018 and 2019 taxable years, the amended Federal income tax return or amended Form 1065 must be filed on or before October 15, 2021, but in no event later than the applicable period of limitations on assessment for the taxable year for which the amended return is being filed. In the case of a BBA partnership that chooses not to file an amended Form 1065 as permitted under Rev. Proc. 2020-23, the BBA partnership may make a late section 163(j)(7) election by filing an AAR on or before October 15, 2021, but in no event later than the applicable period of limitations on making adjustments under section 6235 for the reviewed year, as defined in § 301.6241-1(a)(8) of the Procedure and Administration Regulations (26 CFR Part 301).

.03 *Manner of making a late section 163(j)(7) election.* A taxpayer described in section 4.02 of this revenue procedure must make the election on a timely filed amended Federal income tax return, amended Form 1065, or an AAR, as applicable, with the election statement in accordance with the rules and procedures contained in proposed § 1.163(j)-9 of the 2018 proposed regulations and this section 4. The amended Federal income tax return, amended Form 1065, or AAR, as

applicable, must include the adjustment to taxable income for the late section 163(j)(7) election and any collateral adjustments to taxable income or to tax liability. Such collateral adjustments also must be made on amended Federal income tax returns, amended Forms 1065, or AARs, as applicable, for any affected succeeding taxable year. An example of such collateral adjustments is the amount of depreciation allowed or allowable in the applicable taxable year for the property to which the late election applies. The taxpayer is subject to all of the other rules and requirements in section 163(j), except as otherwise provided in this revenue procedure. The Treasury Department and the IRS have provided guidance under section 163(j) in the 2018 proposed regulations and will provide additional guidance in forthcoming final regulations and additional proposed regulations under section 163(j). The additional proposed regulations will address issues arising under the CARES Act as well as certain other issues.

.04 *Late section 163(j)(7) election statement contents.* The election statement must be titled, "Revenue Procedure 2020-22 Late Section 163(j)(7) Election." The election statement must contain:

- (1) The taxpayer's name;
- (2) The taxpayer's address;
- (3) The taxpayer's social security number (SSN) or employer identification number (EIN);
- (4) A description of the taxpayer's electing trade or business, including the principal business activity code; and
- (5) A statement that the taxpayer is making an election under section 163(j)(7)(B) or 163(j)(7)(C), as applicable.

.05 *Depreciation.* A taxpayer within the scope of section 3.01(1) of this revenue procedure that is making a section 163(j)(7) election must determine its depreciation on the amended Federal income tax returns, amended Forms 1065, or AARs, as applicable, for the property that is affected by the late election using the alternative depreciation system of section 168(g), pursuant to section 168(g)(1)(F) or (G). *See also* section 163(j)(11). Section 4.02 of Rev. Proc. 2019-8, 2019-3 I.R.B. 347, explains how to change to the alternative depreciation system for existing property that is affected by the late election.

## SECTION 5. OPPORTUNITY TO WITHDRAW A SECTION 163(j)(7) ELECTION

.01 *In general.* A taxpayer within the scope of section 3.01(2) of this revenue procedure will be treated as if the section 163(j)(7) election was never made if the taxpayer withdraws the election as provided in this section 5.

.02 *Time and manner for withdrawing a section 163(j)(7) election.* A taxpayer that wishes to withdraw an election as described in section 5.01 of this revenue procedure for a 2018, 2019, or 2020 taxable year must timely file an amended Federal income tax return, amended Form 1065, or AAR, as applicable, for the taxable year in which the election was made, with an election withdrawal statement. Except as provided in Rev. Proc. 2020-23, regarding the time to file amended returns by BBA partnerships for 2018 and 2019 taxable years, the amended Federal income tax return or amended Form 1065 must be filed on or before October 15, 2021, but in no event later than the applicable period of limitations on assessment for the taxable year for which the amended return is being filed. In the case of a BBA partnership that chooses not to file an amended Form 1065 as permitted under Rev. Proc. 2020-23, the BBA partnership may withdraw a section 163(j)(7) election by filing an AAR on or before October 15, 2021, but in no event later than the applicable period of limitations on making adjustments under section 6235 for the reviewed year, as defined in § 301.6241-1(a)(8). The amended Federal income tax return, amended Form 1065, or AAR, as applicable, must include the adjustment to taxable income for the withdrawn section 163(j)(7) election and any collateral adjustments to taxable income or to tax liability, including any adjustments under section 481. A taxpayer also must file amended Federal income tax returns, amended Forms 1065, or AARs, as applicable, including such collateral adjustments, for any affected succeeding taxable years. An example of such collateral adjustments is the amount of depreciation allowed or allowable in the applicable taxable year for the property to which the withdrawn section 163(j)(7) election applies.

.03 *Section 163(j)(7) election withdrawal statement contents.* The election withdrawal statement should be titled, “Revenue Procedure 2020-22 Section 163(j)(7) Election Withdrawal.” The election withdrawal statement must contain the taxpayer’s name, address, and SSN or EIN, and must state that, pursuant to Revenue Procedure 2020-22, the taxpayer is withdrawing its election under section 163(j)(7)(B) or 163(j)(7)(C), as applicable.

.04 *Depreciation.* A taxpayer that is withdrawing a prior section 163(j)(7) election must determine its depreciation for the property that is affected by the withdrawn election in accordance with section 168 on the amended Federal income tax returns, amended Forms 1065, or AARs, as applicable.

## SECTION 6. ELECTIONS UNDER SECTION 2306 OF THE CARES ACT

.01 *Election out of the 50 percent ATI limitation.*

(1) *In general.* Except as otherwise provided in this section 6.01(1), a taxpayer may elect under section 163(j)(10)(A)(iii) not to apply the 50 percent ATI limitation for a 2019 or 2020 taxable year. A partnership can make this election only for a 2020 taxable year because partnerships cannot use the 50 percent ATI limitation for a 2019 taxable year.

(2) *Time and manner of making the election.* A taxpayer permitted to make the election, as described in section 6.01 of this revenue procedure, makes the election not to apply the 50 percent ATI limitation for a 2019 or 2020 taxable year by timely filing a Federal income tax return or Form 1065, including extensions, an amended Federal income tax return, amended Form 1065, or AAR, as applicable, using the 30 percent ATI limitation. No formal statement is required to make the election.

(3) *Consent granted to revoke the election.* If a taxpayer made the election, as described in section 6.01(2) of this revenue procedure, not to apply the 50 percent ATI limitation, for a 2019 or 2020 taxable year, and the taxpayer wishes to revoke that election for such taxable year, the Commissioner grants the taxpayer consent to revoke that election, provided the taxpayer timely files an amended Federal in-

come tax return, amended Form 1065, or AAR, as applicable, for the applicable tax year, using the 50 percent ATI limitation.

(4) *Annual election; who makes the election.* The election in section 6.01 of this revenue procedure must be made for each taxable year. For a consolidated group, the election is made by the agent for a consolidated group, within the meaning of § 1.1502-77, on behalf of members of the consolidated group. For partnerships, the election is made by the partnership, but only for a 2020 taxable year. For an applicable CFC, as defined in proposed § 1.163(j)-7(f)(2), the election is not effective unless made for the applicable CFC by each controlling domestic shareholder, as defined in § 1.964-1(c)(5).

.02 *Election to use 2019 ATI in 2020 taxable year*

(1) *In general.* Under section 163(j)(10)(B), a taxpayer may elect to use the taxpayer’s ATI for the last taxable year beginning in 2019 (that is, the taxpayer’s 2019 ATI) as the ATI for any taxable year beginning in 2020, subject to modifications for short taxable years.

(2) *Time and manner of making or revoking the election.* A taxpayer makes an election under this section 6.02 for a 2020 taxable year by timely filing a Federal income tax return or Form 1065, including extensions, an amended Federal income tax return, amended Form 1065, or AAR, as applicable, using the taxpayer’s 2019 ATI. A taxpayer revokes an election under this section 6.02 for a 2020 taxable year by timely filing an amended Federal income tax return, amended Form 1065, or AAR by a BBA partnership, as applicable, not using the taxpayer’s 2019 ATI. No formal statement is required to make or revoke the election.

(3) *Who makes the election.* For a consolidated group, the election under section 6.02 of this revenue procedure is made by the agent for a consolidated group, within the meaning of § 1.1502-77, on behalf of itself and members of the group. For partnerships, the election is made by the partnership. For an applicable CFC, the election is not effective unless made for the applicable CFC by each controlling domestic shareholder. In the case of a CFC group, as defined in proposed § 1.163(j)-7(f)(6), the election is not effective for any CFC group member, as defined in

proposed § 1.163(j)-7(f)(8), unless made for every taxable year of a CFC group member for which the election is available and for which the CFC group member is a CFC group member on the last day of the CFC group member's taxable year.

(4) *Short taxable year.* If an election is made under section 6.02 of this revenue procedure for a 2020 taxable year that is a short taxable year, the ATI for the taxpayer's applicable taxable year beginning in 2020 is equal to the amount that bears the same ratio to such ATI as the number of months in the short taxable years bears to 12.

*.03 Election out of the 50 percent EBIE rule.*

(1) *In general.* Under section 163(j)(10)(A)(ii)(II), a partner may elect out of the 50 percent EBIE rule.

(2) *Time and manner of making or revoking the election.* A partner makes the election under section 6.03 of this revenue procedure by timely filing a Federal income tax return or Form 1065, including extensions, an amended Federal income tax return, an amended Form 1065, or an AAR, as applicable, for the partner's first taxable year beginning in 2020, by not applying the 50 percent EBIE rule in determining the section 163(j) limitation. A partner revokes the election under this section 6.03 by timely filing an amended Federal income tax return, amended Form 1065, or AAR, as applicable, for the partner's first taxable year beginning in 2020, by applying the 50 percent EBIE rule in determining the section 163(j) limitation.

## SECTION 7. EFFECTIVE DATE

This revenue procedure is effective April 10, 2020.

## SECTION 8. DRAFTING INFORMATION

The principal authors of this revenue procedure are Jaime Park, Susie Bird, and Charles Gorham of the Office of Associate Chief Counsel (Income Tax & Accounting). For further information regarding this revenue procedure, contact Ms. Park at (202) 317-4877 (not a toll-free call), Ms. Bird at (202) 317-4860 (not a toll-free call), or Mr. Gorham at (202) 317-5091 (not a toll-free number).

26 CFR 601.601. Rules and regulations.  
(Also Part I, §§ 6031, 6222, 6227.)

# Rev. Proc. 2020-23

## SECTION 1. PURPOSE

This revenue procedure allows eligible partnerships to file amended partnership returns for taxable years beginning in 2018 and 2019 using a Form 1065, U.S. Return of Partnership Income (Form 1065), with the "Amended Return" box checked, and issue an amended Schedule K-1, Partner's Share of Income, Deductions, Credits, etc. (Schedule K-1), to each of its partners. The option to file amended returns only applies to partnerships satisfying the requirements of section 3 of this revenue procedure.

## SECTION 2. BACKGROUND

.01 Section 1101(a) of the Bipartisan Budget Act of 2015 (BBA), P.L. 114-74, Title XI (November 2, 2015), replaced subchapter C of chapter 63 of subtitle F of the Internal Revenue Code (Code) effective for partnership taxable years beginning after December 31, 2017. Prior to the enactment of the BBA, subchapter C of chapter 63 contained the unified partnership audit and litigation rules enacted by the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), P.L. 97-248 (September 3, 1982), that were commonly referred to as the TEFRA partnership procedures. Section 1101(c) of the BBA replaced the TEFRA partnership procedures with a centralized partnership audit regime that, in general, determines, assesses, and collects tax at the partnership level. The centralized partnership audit procedures enacted by the BBA are found at sections 6221 through 6241 of the Code. The centralized partnership audit procedures apply to all partnerships, unless the partnership makes a valid election under section 6221(b) not to have those procedures apply. Partnerships subject to the centralized partnership audit regime are referred to as BBA partnerships.

.02 Section 6031(a) of the Code requires every partnership to file a return for each taxable year stating the items of its gross income and the deductions allowable by subtitle A of the Code and such

other information as required by forms and regulations, including information about the partners in the partnership. For a partnership, the return required by section 6031(a) is Form 1065, which includes Schedules K-1. Schedule K-1 reports the partner's name, taxpayer identification number, and distributive share of partnership-related items and other information related to the partner's interest in the partnership. Section 6031(b) requires that a partnership required to file a return under section 6031(a) furnish a copy of the Schedule K-1 to each partner that includes such information as may be required to be shown by regulations. In general, section 6031(b) also prohibits BBA partnerships from amending the information required to be furnished to their partners after the due date of the return, unless specifically provided by the Secretary of the Treasury or his delegate. This revenue procedure exercises that authority to allow a BBA partnership to file an amended partnership return and issue amended Schedules K-1 under the circumstances described in this revenue procedure.

.03 Section 6222(a) of the Code requires partners in a BBA partnership to treat partnership-related items, as defined in section 6241 and the corresponding regulations, consistently on the partner's return with how the BBA partnership treated such items on its return. This consistency requirement generally applies to all partners. Consistent treatment with the partnership generally requires that partners in a BBA partnership file their returns consistent with the information reported to them on the Schedule K-1.

.04 The Coronavirus Aid, Relief, and Economic Security Act (CARES Act), P.L. 116-136, 134 Stat. 281 (March 27, 2020), provides retroactive tax relief that affects partnerships, including relief for the taxable years ending in 2018, 2019, and, in some cases, 2020. Without the option to file amended returns, as granted in section 3 of this revenue procedure, BBA partnerships that already filed their Forms 1065 for the affected years generally are unable to take advantage of the CARES Act relief for partnerships except by filing Administrative Adjustment Requests (AARs) pursuant to section 6227. Filing an AAR would result in the partners' only being able to receive any benefits from that



relief on the current taxable year's federal income tax return. Thus, if an AAR were filed, the partners generally would not be able to take advantage of CARES Act benefits from an AAR until they file their current year returns, which could be in 2021. This process would significantly delay the relief provided in the CARES Act intended to apply to the affected taxable years and provide an immediate benefit to taxpayers.

.05 This revenue procedure allows BBA partnerships the option to file an amended return instead of an AAR, though it does not prevent a partnership from filing an AAR to obtain the benefits of the CARES Act or any other tax benefits to which the partnership is entitled. A BBA partnership that files an amended return pursuant to this revenue procedure is still subject to the centralized partnership audit procedures enacted by the BBA.

### **SECTION 3. OPTION PROVIDED TO ELIGIBLE BBA PARTNERSHIPS FOR THE 2018 AND 2019 TAXABLE YEARS**

.01 *Scope.* The filing and furnishing option provided by section 3.02 of this revenue procedure applies to BBA partnerships described in section 3.03 of this revenue procedure for the taxable years described in section 3.04 of this revenue procedure.

.02 *Option to file amended return.* BBA partnerships that filed a Form 1065 and furnished all required Schedules K-1 for the taxable years beginning in 2018 or 2019 prior to the issuance of this revenue procedure may file amended partnership returns and furnish corresponding Schedules K-1 before September 30, 2020. The amended returns may take into account tax changes brought about by the CARES Act as well as any other tax attributes to which the partnership is entitled by law.

.03 *Eligible BBA partnerships.* The filing and furnishing option provided in section 3.02 of this revenue procedure is available only to BBA partnerships that filed Forms 1065 and furnished Schedules K-1 for the partnership taxable years beginning in 2018 or 2019 prior to the issuance of this revenue procedure. For purposes of section 6222, the amended return replaces any prior return (including any

AAR filed by the partnership) for the taxable year for purposes of determining the partnership's treatment of partnership-related items. See section 4.03 of this revenue procedure for a special rule regarding partnerships who have previously filed AARs for an affected taxable year.

.04 *Eligible taxable years.* The filing and furnishing option provided in this revenue procedure applies only to partnership taxable years that began in 2018 or 2019.

### **SECTION 4. PROCEDURE**

.01 *Filing requirements.* To take advantage of the option to file an amended return provided by section 3 of this revenue procedure, a BBA partnership must file a Form 1065 (with the "Amended Return" box checked) and furnish corresponding amended Schedules K-1. The BBA partnership must clearly indicate the application of this revenue procedure on the amended return and write "FILED PURSUANT TO REV PROC 2020-23" at the top of the amended return and attach a statement with each Schedule K-1 sent to its partners with the same notation. The BBA partnership may file electronically or by mail, but filing electronically may allow for faster processing of the amended return.

.02 *Special rule for BBA partnerships whose returns are under examination.* If a BBA partnership is currently under examination for a taxable year beginning in 2018 or 2019 and wishes to take advantage of the option to file an amended return provided by section 3 of this revenue procedure, the partnership may only do so if the partnership sends notice to the revenue agent coordinating the partnership's examination in writing that the partnership seeks to use the amended return option described in this revenue procedure prior to or contemporaneously with filing the amended return as described in section 4.01 of this revenue procedure. The partnership must also provide the revenue agent with a copy of the amended return upon filing.

.03 *Special rule for BBA partnerships who have previously filed an AAR.* If a BBA partnership has previously filed an AAR and wishes to file an amended return pursuant to this revenue procedure for the same taxable year, the partnership should

use the items as adjusted in the AAR, where applicable, in lieu of any reporting from the originally filed partnership return.

.04 *Coordination with Notice 2019-46.* If, under Notice 2019-46, 2019-37 I.R.B. 695, a partnership has applied the rules of the proposed GILTI regulations under proposed §1.951A-5 for its taxable years ending before June 22, 2019 (Form 1065, Form 8992, U.S. Shareholder Calculation of Global Intangible Low-Taxed Income (GILTI), and Schedules K-1), the partnership may continue to apply the rules of proposed §1.951A-5 for purposes of filing an amended Form 1065 for such taxable years under this revenue procedure if the partnership furnishes amended Schedules K-1 consistent with those proposed regulations and provides appropriate notifications to its partners under the principles of section 5.01 of Notice 2019-46 within the period described in section 3.02 of this revenue procedure. Nothing in this revenue procedure changes a partnership's obligation to provide information described in section 5.02 of Notice 2019-46. If a partnership applies the final GILTI regulations under §1.951A-1(e), any amended Schedules K-1 issued under this revenue procedure must be consistent with those final regulations.

### **SECTION 5. DRAFTING INFORMATION**

The principal author of this revenue procedure is Joy E. Gerdy Zogby of the Office of the Associate Chief Counsel (Procedure and Administration). For further information, please contact 202-317-4927 (not a toll-free number).

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*26 CFR 601.105: Examination of returns and claims for refund, credit, or abatement; determination of correct tax liability.  
(Also: Part I. §§172; 6411)*

## **Rev. Proc. 2020-24**

### **SECTION 1. PURPOSES**

.01 This revenue procedure provides guidance regarding elections described in section 1.02 of this revenue procedure related to new § 172(b)(1)(D) of the Internal

Revenue Code (Code) enacted by section 2303(b) of the Coronavirus Aid, Relief and Economic Security Act (CARES Act), Public Law 116-136, 134 Stat. 281 (March 27, 2020). Section 2303(b) of the CARES Act amended § 172(b)(1) to provide for a carryback of any net operating loss (NOL) arising in a taxable year beginning after December 31, 2017, and before January 1, 2021, to each of the five taxable years preceding the taxable year in which the loss arises (carryback period). Section 172(b)(1)(D). As a result of that amendment, taxpayers take into account such NOLs in the earliest taxable year in the carryback period, carrying forward unused amounts to each succeeding taxable year.

.02 This revenue procedure prescribes when and how to file the following elections.

(1) *Election to waive NOL carryback.* Section 4.01(1) of this revenue procedure provides guidance regarding an election under § 172(b)(3) to waive the carryback period for an NOL arising in a taxable year beginning after December 31, 2017, and before January 1, 2020.

(2) *Election to exclude section 965 years.* Section 4.01(2) of this revenue procedure provides guidance regarding an election under § 172(b)(1)(D)(v)(I) to exclude from the carryback period for an NOL arising in a taxable year beginning after December 31, 2017, and before January 1, 2021, any taxable year in which the taxpayer has a section 965(a) inclusion, as defined in § 1.965-1(f)(37) (a section 965 year).

(3) *Elections under the CARES Act special rule concerning taxable years beginning before January 1, 2018, and ending after December 31, 2017.* Section 4.04(1) of this revenue procedure provides guidance regarding elections under the special rule set forth in § 2303(d) of the CARES Act to waive any carryback period, to reduce any carryback period, or to revoke any election made under § 172(b) to waive any carryback period for a taxable year that began before January 1, 2018, and ended after December 31, 2017.

## SECTION 2. BACKGROUND

.01 For a taxable year beginning before January 1, 2021, § 172(a)(1), as amended by the CARES Act, allows a deduction for

the taxable year equal to the aggregate of the NOL carryovers and carrybacks to the taxable year. For any taxable year beginning after December 31, 2017, and before January 1, 2021, new § 172(b)(1)(D)(i) provides that an NOL must be carried back to each of the five taxable years preceding the taxable year of the NOL (that is, the taxable years in the carryback period for the NOL). Section 172(b)(3) permits a taxpayer entitled to a carryback period under § 172(b)(1) to make an irrevocable election to relinquish the carryback period for an NOL for any taxable year.

.02 Section 172(b)(1)(D)(iv) provides that if an NOL is carried back under § 172(b)(1)(D)(i) to any section 965 year, then the taxpayer is treated as having made the election under § 965(n) with respect to each such section 965 year.

.03 Section 172(b)(1)(D)(v) provides two special rules for elections under § 172(b)(3). The first rule allows a taxpayer with one or more section 965 years to elect, in lieu of the election under § 172(b)(3), to exclude all section 965 years from the carryback period for an NOL. See § 172(b)(1)(D)(v)(I). The second rule provides that a taxpayer must make an election under § 172(b)(1)(D)(v)(I) or § 172(b)(3) to exclude section 965 years from or waive, respectively, the carryback period for an NOL arising in a taxable year beginning in 2018 or 2019 by the due date, including extensions of time, for filing the taxpayer's Federal income tax return for the first taxable year ending after March 27, 2020 (that is, the date of enactment of § 172(b)(1)(D)). See § 172(b)(1)(D)(v)(II).

.04 Section 965 and the regulations thereunder generally require the subpart F income (as defined in § 952) of a deferred foreign income corporation to be increased for the last taxable year of such corporation that begins before January 1, 2018, by the greater of the accumulated post-1986 deferred foreign income of such corporation as of November 2, 2017, or December 31, 2017, and for certain taxpayers to include in gross income their pro rata share of the increase in subpart F income of the deferred foreign income corporation. Section 965(n) and § 1.965-7(e) allow a taxpayer to make an election for a taxable year to not take into account § 965(a) inclusions, reduced by § 965(c)

deductions, and associated § 78 gross-ups in determining the taxpayer's (1) NOL deduction under § 172 for the taxable year, or (2) taxable income for the taxable year (computed without regard to the deduction allowable under § 172) that may be reduced by NOL carryovers or carrybacks to the taxable year under § 172.

.05 Section 6411(a) provides that a taxpayer may file an application for a tentative carryback adjustment of the tax for the prior taxable year affected by an NOL carryback from any taxable year. Section 6411(a) also provides that the application must be filed on or after the date of filing for the return for the taxable year of the NOL from which the carryback results and within a period of 12 months after that taxable year or, for any portion of a business credit carryback attributable to an NOL from a subsequent taxable year, within a period of 12 months from the end of the subsequent taxable year. Section 6411(b) provides a 90-day period during which the Internal Revenue Service (IRS) will make a limited examination of the application to discover omissions and errors of computation and determine the amount of the decrease in tax attributable to the carryback. The IRS may disallow, without further action, any application that contains errors of computation that cannot be corrected within the 90-day period or that contains material omissions. The decrease in tax attributable to the carryback is applied against unpaid amounts of tax. Any remainder of the decrease is credited or refunded within the 90-day period.

.06 Section 2303(d) of the CARES Act provides a special rule for NOLs arising in taxable years which begin before January 1, 2018, and end after December 31, 2017. Under that special rule, applications under § 6411(a) with respect to such NOLs are treated as timely filed if filed no later than 120 days after March 27, 2020, the date of enactment of the CARES Act. Additionally, elections to forgo or reduce the carryback of such NOLs, or elections to revoke any such prior elections, shall be treated as timely made if made no later than 120 days after March 27, 2020.

## SECTION 3. SCOPE

This revenue procedure applies to taxpayers that want to (1) elect under

§ 172(b)(3) to waive the carryback period for an NOL arising in a taxable year beginning in 2018 or 2019, (2) elect under § 172(b)(1)(D)(v)(I) to exclude all section 965 years from the carryback period for an NOL arising in a taxable year that begins in 2018, 2019, or 2020, or (3) make an application under § 6411(a) for an NOL arising in a taxable year that began before January 1, 2018, and ended after December 31, 2017.

## SECTION 4. APPLICATION

.01 *Time and manner of filing election to waive carryback or exclude section 965 years from carryback.*

(1) *Elections to waive carryback under § 172(b)(3) for NOLs arising in taxable years beginning in 2018 or 2019.* A taxpayer within the scope of this revenue procedure may elect under § 172(b)(3) to waive the carryback period for an NOL arising in a taxable year beginning in 2018 or 2019. Such an election must be made no later than the due date, including extensions, for filing the taxpayer's Federal income tax return for the first taxable year ending after March 27, 2020. A taxpayer must make an election described in this section 4.01(1) by attaching to its Federal income tax return filed for the first taxable year ending after March 27, 2020, a separate statement for each of taxable years 2018 or 2019 for which the taxpayer intends to make the election. The election statement must state that the taxpayer is electing to apply § 172(b)(3) under Rev. Proc. 2020-24 and the taxable year for which the statement applies. Once made, the election is irrevocable.

(2) *Election to exclude section 965 years from carryback period.* A taxpayer within the scope of this revenue procedure may elect under § 172(b)(1)(D)(v)(I) to exclude all section 965 years from the carryback period for an NOL arising in a taxable year beginning in 2018, 2019, or 2020.

(a) *When to file.* An election under this section 4.01(2) for an NOL arising in a taxable year beginning in 2018 or 2019 must be made no later than the due date, including extensions, for filing the taxpayer's Federal income tax return for the first taxable year ending after March 27, 2020. For an NOL arising in a taxable year

beginning after December 31, 2019, and before January 1, 2021, an election under this section 4.01(2) must be made by no later than the due date, including extensions, for filing the taxpayer's Federal income tax return for the taxable year in which the NOL arises.

(b) *What to file.* A taxpayer must make the election described in this section 4.01(2) by attaching an election statement to the earliest filed, after this revenue procedure is effective, of:

(1) The Federal income tax return for the taxable year in which the NOL arises;

(2) The taxpayer's claim for tentative carryback adjustment (Form 1045, *Application for Tentative Refund*; or Form 1139, *Corporation Application for Tentative Refund*) applying the NOL to a taxable year in the carryback period; or

(3) The amended Federal income tax return applying the NOL to the earliest taxable year in the carryback period that is not a section 965 year.

(c) A taxpayer making the election who claims a refund or credit as a result of the carryback of the NOL by filing amended Federal income tax returns for taxable years in the carryback period must also attach an election statement to each amended return. The election statement must state that the taxpayer is electing to apply § 172(b)(1)(D)(v)(I) under Rev. Proc. 2020-24, the taxable year in which the NOL arose, and the taxpayer's section 965 years. Once made, the election is irrevocable.

(d) *Effect of election.* An election under § 172(b)(1)(D)(v)(I) to exclude all section 965 years from the carryback period for an NOL allows a taxpayer to disregard those taxable years when applying an NOL to the carryback period and determining whether the taxpayer has an overpayment and can receive a refund or credit for any of the remaining years in the carryback period to which the NOL is applied. A taxpayer who makes an election under § 172(b)(2)(D)(v)(I) for an NOL must include all section 965 years for purposes of counting the five taxable years in the carryback period for the NOL.

.02 *Carrybacks to section 965 years.* To the extent an NOL is carried back pursuant to § 172(b)(1)(D)(i) to a section 965 year, the deemed election under § 965(n) pursuant to § 172(b)(1)(D)(iv) may not

be waived for that section 965 year (including if a taxpayer previously revoked an election under § 965(n) for that section 965 year pursuant to § 1.965-7(e)(2)(ii)(B)). If the deemed election under § 965(n) applies to a section 965 year for which a taxpayer previously revoked or did not previously make an election under § 965(n), the deemed election shall only apply for purposes of the carryback of an NOL to such section 965 year.

.03 *Consolidated groups.*

(1) *Defined terms.* For purposes of this revenue procedure, with regard to an affiliated group of corporations (as defined in § 1504) filing (or required to file) a consolidated return for the taxable year (consolidated group)—

(a) *Taxpayer.* The term "taxpayer" includes a consolidated group.

(b) *NOL.* The term "NOL" includes, with regard to a consolidated taxable year, the excess of deductions over gross income, as determined under § 1.1502-11(a) (without regard to any consolidated net operating loss (CNOL) deduction).

(2) *Manner of making elections.* The agent for the consolidated group must make the election under § 172(b)(3) or 172(b)(1)(D)(v)(I). See §§ 1.1502-21(b) and 1.1502-77(a) and (c).

.04 *Applications under § 6411(a).* A taxpayer within the scope of this revenue procedure may make an application under § 6411(a) for an NOL arising in a taxable year that began before January 1, 2018, and ended after December 31, 2017, by filing the application no later than the deadline described in this section 4.04.

(1) *NOLs arising in a taxable year beginning before January 1, 2018, and ending after December 31, 2017.* Taxpayers with an NOL arising in a taxable year that began before January 1, 2018, and ended after December 31, 2017, who make an application under § 6411(a) on either Form 1045 or Form 1139 with respect to a carryback of such NOL will be treated as having timely filed if the application is filed no later than July 27, 2020. Similarly, elections for such taxable years with an NOL to waive any carryback period, to reduce any carryback period, or to revoke any election made under § 172(b) to waive any carryback period will be treated as timely filed if filed no later than July 27, 2020. A taxpayer may file such elections

where the taxpayer files its Federal income tax return by attaching the statement required to make the election, with “Filed pursuant to Rev. Proc. 2020-24” at the top, to an amended return, Form 1045, or Form 1139 containing only the taxpayer’s name, address, and taxpayer identification number. The statement required to make the election must indicate the section under which the election is being made and shall set forth information to identify the election, the period for which it applies, and the taxpayer’s basis and entitlement to make the election.

(2) *NOLs arising in taxable years beginning after December 31, 2017.* Taxpayers with NOLs arising in taxable years beginning after December 31, 2017, may consult Notice 2020-26 for procedures on how to file applications under § 6411(a) for taxable years that may otherwise be outside of the period for filing such applications.

## SECTION 5. EFFECTIVE DATE

This revenue procedure is effective **April 9, 2020.**

## SECTION 6. DRAFTING INFORMATION

The principal authors of this revenue procedure are James P. Beatty of the Office of the Associate Chief Counsel (Income Tax & Accounting) and Natalie Punchak of the Office of Associate Chief Counsel (International). For further information regarding this revenue procedure, contact James P. Beatty on (202) 317-7006 (not a toll free call) or Natalie Punchak on (202) 317-6934 (not a toll free number).

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*26 CFR 601.105: Examination of returns and claims for refund, credit or abatement; determination of correct tax liability.*

*(Also Part I, §§ 860D, 860F, 860G, 1001; 1.856-6, 1.860G-2, 1.1001-3, 301.7701-2, 301.7701-3, 301.7701-4.)*

# Rev. Proc. 2020-26

## SECTION 1. PURPOSE

This revenue procedure describes safe harbors under which modifications to certain mortgage loans in connection with a

forbearance program, described in section 2 of this revenue procedure, are not treated as replacing the unmodified obligation with a newly issued obligation, as giving rise to prohibited transactions, or as manifesting a power to vary for purposes of determining the Federal income tax status of certain securitization vehicles that hold the loans. This revenue procedure also describes a safe harbor under which certain securitization vehicles are not treated as having improper knowledge of an anticipated default on the grounds that they acquired a mortgage loan with respect to which the borrower had participated in a forbearance program.

## SECTION 2. BACKGROUND—FORBEARANCE PROGRAMS

.01 On March 27, 2020, the President signed into law the Coronavirus Aid, Relief, and Economic Security Act, Pub. L. No. 116-136, 134 Stat. 281 (2020) (CARES Act). Under Division A of Title IV of the CARES Act, the term “COVID-19 emergency” means the national emergency concerning the novel coronavirus disease (COVID-19) outbreak declared by the President on March 13, 2020, under the National Emergencies Act (50 U.S.C. 1601 et seq.). See sections 4022(a)(1) and 4023(f)(4) of the CARES Act. The CARES Act provides, among other things, that during the covered period, borrowers with Federally backed mortgage loans and multifamily borrowers with Federally backed multifamily mortgage loans experiencing a financial hardship due, directly or indirectly, to the COVID-19 emergency may request and obtain forbearance on their loans. See sections 4022 and 4023 of the CARES Act.

.02 For Federally backed multifamily mortgage loans, the CARES Act defines the term “covered period” to be the period beginning on the date of its enactment (March 27, 2020) and ending on the earlier of the termination date of the COVID-19 emergency or December 31, 2020. See section 4023(f)(5) of the CARES Act. For Federally backed mortgage loans, however, there is no corresponding statutory definition of “covered period” in section 4022 of the CARES Act.

.03 Section 4022(a)(2) of the CARES Act defines the term “Federally backed

mortgage loan” to include any loan that is secured by a first or subordinate lien on residential real property (including individual units of condominiums and cooperatives) designed principally for the occupancy of from 1- to 4- families and that is (A) insured by the Federal Housing Administration under title II of the National Housing Act (12 U.S.C. 1707 et seq.); (B) insured under section 255 of the National Housing Act (12 U.S.C. 1715z-20); (C) guaranteed under section 184 or 184A of the Housing and Community Development Act of 1992 (12 U.S.C. 1715z-13a, 1715z-13b); (D) guaranteed or insured by the Department of Veterans Affairs; (E) guaranteed or insured by the Department of Agriculture; (F) made by the Department of Agriculture; or (G) purchased or securitized by the Federal Home Loan Mortgage Corporation or the Federal National Mortgage Association.

.04 Upon a request by a borrower with a Federally backed mortgage loan experiencing a financial hardship due to the COVID-19 emergency for a forbearance on such loan, the borrower’s servicer shall provide the forbearance for up to 180 days, which may be extended for an additional period of up to 180 days at the request of the borrower, provided that, the borrower’s request for an extension is made during the covered period, and, at the borrower’s request, either the initial or extended period of forbearance may be shortened. See section 4022(b)(2) and (c)(1) of the CARES Act. During the period of forbearance, no fees, penalties, or interest beyond the amounts scheduled or calculated as if the borrower made all contractual payments on time and in full under the terms of the mortgage contract shall accrue on the borrower’s account. See section 4022(b)(3) and (c)(1) of the CARES Act.

.05 The term “multifamily borrower” means a borrower with a residential mortgage loan that is secured by a lien against a property comprising 5 or more dwelling units. See section 4023(f)(3) of the CARES Act. The term “Federally backed multifamily mortgage loan” includes any loan (other than temporary financing such as a construction loan) that (A) is secured by a first or subordinate lien on residential multifamily real property designed principally for the occupancy of 5 or more

families, including any such secured loan the proceeds of which are used to prepay or pay off an existing loan secured by the same property; and (B) is made in whole or in part, or insured, guaranteed, supplemented, or assisted in any way, by any officer or agency of the Federal Government or under or in connection with a housing or urban development program administered by the Secretary of Housing and Urban Development or a housing or related program administered by any other such officer or agency, or is purchased or securitized by the Federal Home Loan Mortgage Corporation or the Federal National Mortgage Association. *See* section 4023(f)(2) of the CARES Act.

.06 Upon receipt of an oral or written request for forbearance from a multifamily borrower with a Federally backed multifamily mortgage loan that was current on its payments as of February 1, 2020, and that is experiencing a financial hardship during the COVID-19 emergency, a servicer shall (A) document the financial hardship; (B) provide the forbearance for up to 30 days; and (C) subject to satisfying certain conditions, extend the forbearance for up to 2 additional 30 day periods. *See* section 4023(b) and (c)(1) of the CARES Act. A multifamily borrower shall have the option to discontinue the forbearance at any time. *See* section 4023(c)(2) of the CARES Act.

.07 Comments received by the Department of the Treasury (Treasury Department) and the Internal Revenue Service (IRS) have indicated that many holders and servicers of mortgage loans that are not Federally backed mortgage loans or Federally backed multifamily mortgage loans (non-Federally-backed mortgage loans) intend, either voluntarily or through a State-mandated loan forbearance program (in either case, a “program”), to provide forbearances for the next three to six months on non-Federally-backed mortgage loans to borrowers that are experiencing a financial hardship due, directly or indirectly, to the COVID-19 emergency. These programs often contemplate related modifications in addition to the forbearance itself. For example, loan payments deferred as result of the forbearance may be added to the principal amount of the loan to be paid by the borrower after what would otherwise be the final payment on

the loan. Other programs contemplate that, at the end of the forbearance period, an amortizing loan will be reamortized to preserve the original maturity date.

.08 Many Federally backed mortgage loans, Federally backed multifamily mortgage loans, and non-Federally-backed mortgage loans are held in securitization vehicles such as investment trusts and real estate mortgage investment conduits (REMICs). *See generally*, sections 860A through 860G of the Internal Revenue Code (Code).

.09 Comments received by the Treasury Department and the IRS have requested guidance on: (1) whether the forbearance of Federally backed mortgage loans, Federally backed multifamily mortgage loans, and non-Federally-backed mortgage loans held by investment trusts and REMICs will jeopardize the Federal tax qualifications of the securitization vehicles; and (2) whether Federally backed mortgage loans, Federally backed multifamily mortgage loans, and non-Federally-backed mortgage loans for which servicers have provided forbearances to borrowers that are experiencing financial hardship due to the COVID-19 emergency may be acquired by a REMIC without the acquiring REMIC being treated as having improper knowledge of an anticipated default for purposes of the rules governing REMIC foreclosure property.

### **SECTION 3. BACKGROUND— REMICs**

.01 REMICs are widely used securitization vehicles for mortgages. REMICs are governed by sections 860A through 860G of the Code.

.02 For an entity to qualify as a REMIC, all of the interests in the entity must consist of one or more classes of regular interests and a single class of residual interests, *see* section 860D(a), and those interests must be issued on the startup day, within the meaning of § 1.860G–2(k) of the Income Tax Regulations.

.03 A regular interest is one that is designated as a regular interest and whose terms are fixed on the startup day. *See* section 860G(a)(1). In addition, a regular interest must (1) unconditionally entitle the holder to receive a specified principal amount (or other similar amount), and (2)

provide that interest payments, if any, at or before maturity are based on a fixed rate (or, to the extent provided in regulations, at a variable rate).

.04 The principal amount of a regular interest generally may not be contingent. *See* § 1.860G-1(a)(5). Notwithstanding this general rule, § 1.860G–1(b)(3) lists certain contingencies affecting the payment of principal and interest, including defaults on qualified mortgages and permitted investments, unanticipated expenses incurred by the REMIC, or lower than expected returns on permitted investments, that do not prevent an interest in a REMIC from being a regular interest.

.05 An interest issued after the startup day does not qualify as a REMIC regular interest.

.06 Under section 860D(a)(4), an entity qualifies as a REMIC only if, among other things, as of the close of the third month beginning after the startup day and at all times thereafter, substantially all of its assets consist of qualified mortgages and permitted investments. This asset test is satisfied if the entity owns no more than a *de minimis* amount of other assets. *See* § 1.860D–1(b)(3)(i). As a safe harbor, the amount of assets other than qualified mortgages and permitted investments is *de minimis* if the aggregate of the adjusted bases of those assets is less than one percent of the aggregate of the adjusted bases of all of the entity’s assets. *See* § 1.860D–1(b)(3)(ii).

.07 With limited exceptions, a mortgage loan is not a qualified mortgage unless it is transferred to the REMIC on the startup day in exchange for regular or residual interests in the REMIC.

.08 In addition, status as a qualified mortgage depends in part on the collateral securing the obligation on its origination date. *See* § 1.860G-2(a)(1).

.09 The legislative history of the REMIC provisions indicates that Congress intended the provisions to apply only to an entity that holds a substantially fixed pool of real estate mortgages and related assets and that “has no powers to vary the composition of its mortgage assets.” S. Rep. No. 99–313, 99th Cong., 2d Sess. 791–92, 1986–3 (Vol. 3) C.B. 791–92.

.10 Section 1.1001–3(c)(1)(i) defines a “modification” of a debt instrument as any alteration, including any deletion or

addition, in whole or in part, of a legal right or obligation of the issuer or holder of a debt instrument, whether the alteration is evidenced by an express agreement (oral or written), conduct of the parties, or otherwise. Section 1.1001-3(e) governs which modifications of debt instruments are “significant.” Under § 1.1001-3(b), for most Federal income tax purposes, a significant modification produces a deemed exchange of the original debt instrument for a new debt instrument.

.11 Under § 1.860G-2(b), related rules apply to determine REMIC qualification. Except as specifically provided in § 1.860G-2(b)(3), if there is a significant modification of an obligation that is held by a REMIC, then the modified obligation is treated as one that was newly issued in exchange for the unmodified obligation that it replaced. *See* § 1.860G-2(b)(1). For this purpose, the rules in § 1.1001-3(e) determine whether a modification is “significant.” *See* § 1.860G-2(b)(2). Thus, even if an entity initially qualifies as a REMIC, one or more significant modifications of loans held by the entity may terminate the REMIC qualification if the modified loans are retained by the entity and their presence causes less than substantially all of the entity’s assets to be qualified mortgages.

.12 Certain loan modifications, however, are not treated as resulting in a newly issued obligation for purposes of § 1.860G-2(b)(1), even if the modifications are significant under the rules in § 1.1001-3. In particular, under § 1.860G-2(b)(3)(i), if a change in the terms of an obligation is “occasioned by default or a reasonably foreseeable default,” the change is not a significant modification for purposes of § 1.860G-2(b)(1), regardless of the modification’s status under § 1.1001-3.

.13 Under section 860G(a)(5), a REMIC’s permitted investments include any (a) cash flow investment, (b) qualified reserve asset, or (c) foreclosure property. “Foreclosure property” means property—(A) which would be foreclosure property under section 856(e) (without regard to paragraph (5) thereof) if acquired by a real estate investment trust, and (B) which is acquired in connection with the default or imminent default of a qualified

mortgage held by the REMIC. *See* section 860G(a)(8).

.14 A REMIC cannot treat property as foreclosure property if the loan with respect to which the default occurs (or is imminent) was acquired by the REMIC with an intent to evict or foreclose, or when the REMIC knew or had reason to know that default would occur (improper knowledge). *See* § 1.856-6(b)(3).

.15 Section 860F(a)(1) imposes a tax on REMICs equal to 100 percent of the net income derived from “prohibited transactions.” The disposition of a qualified mortgage is a prohibited transaction unless the “disposition [is] pursuant to— (i) the substitution of a qualified replacement mortgage for a qualified mortgage . . . , (ii) a disposition incident to the foreclosure, default, or imminent default of the mortgage, (iii) the bankruptcy or insolvency of the REMIC, or (iv) a qualified liquidation.” *See* section 860F(a)(2)(A). The receipt of any income attributable to any asset which is not a permitted investment is a prohibited transaction. *See* section 860F(a)(2)(B).

.16 Under section 860C(b)(1), “[t]he taxable income of a REMIC shall be determined under an accrual method of accounting . . . except that— . . . (C) there shall not be taken into account any item of income, gain, loss, or deduction allocable to a prohibited transaction, . . . .”

#### **SECTION 4. BACKGROUND— TRUSTS**

.01 Section 301.7701-2(a) of the Procedure and Administration Regulations defines a “business entity” as any entity recognized for Federal tax purposes (including an entity with a single owner that may be disregarded as an entity separate from its owner under § 301.7701-3) that is not properly classified as a trust under § 301.7701-4 or otherwise subject to special treatment under the Code.

.02 Section 301.7701-4(a) provides that an arrangement is treated as a trust if the purpose of the arrangement is to vest in trustees responsibility for the protection and conservation of property for beneficiaries who cannot share in the discharge of this responsibility and, therefore, are not associates in a joint enterprise for the conduct of business for profit.

.03 Section 301.7701-4(c) provides that an “investment” trust is not classified as a trust if there is a power under the trust agreement to vary the investment of the certificate holders.

#### **SECTION 5. SCOPE**

This revenue procedure applies to the following transactions:

.01 For mortgage loans held by REMICs or investment trusts—

(1) Forbearances of any Federally backed mortgage loans or Federally backed multifamily mortgage loans provided under sections 4022 or 4023 of the CARES Act, respectively, and all related modifications, and

(2) Forbearances (and all related modifications) that are not described in section 5.01(1) of this revenue procedure, that are provided by a holder or servicer, that are agreed to by the borrower of any Federally backed or non-Federally-backed mortgage loan, and that are made under forbearance programs for borrowers experiencing a financial hardship due, directly or indirectly, to the COVID-19 emergency. For this purpose, forbearance programs are programs that are identical or similar to those described in section 2.07 of this revenue procedure pursuant to which, between March 27, 2020, and December 31, 2020, inclusive, the borrower requests or agrees to the forbearance (and all related modifications).

.02 The direct or indirect acquisition by a REMIC on or after March 27, 2020, of—

(1) Any Federally backed mortgage loans, and any Federally backed multifamily mortgage loans, with respect to which the borrower received a forbearance under section 4022 or 4023 of the CARES Act, respectively; and

(2) Any mortgage loans not described in section 5.02(1) of this revenue procedure for which—

(a) Between March 27, 2020, and December 31, 2020, inclusive, the borrower requested or agreed to a forbearance; and

(b) The forbearance was granted under a forbearance program that is for borrowers experiencing a financial hardship due to the COVID-19 emergency and that is identical or similar to those described in section 2.07 of this revenue procedure.

Loans described in this section 5.02 are hereinafter referred to as “forbearance loans.”

## **SECTION 6. APPLICATION**

.01 For mortgage loans held by REMICs, forbearances (and all related modifications) described in section 5.01 of this revenue procedure—

(1) Are not treated as resulting in a newly issued mortgage loan for purposes of § 1.860G-2(b)(1);

(2) Are not prohibited transactions under section 860F(a)(2); and

(3) Do not result in a deemed reissuance of the REMIC regular interests.

.02 For mortgage loans held by investment trusts, forbearances (and all related modifications) do not manifest a power to vary the investment of the certificate holders if the forbearances (and all related modifications)—

(1) Are described in section 5.01(1) of this revenue procedure; or

(2) Are described in section 2.07 of this revenue procedure and that relief was requested or agreed to between March 27, 2020, and December 31, 2020, and grant-

ed as a result of a borrower experiencing a financial hardship due to the COVID-19 emergency.

.03 If a forbearance loan described in section 5.02 of this revenue procedure is acquired by a REMIC—

(1) That prior forbearance (and all related modifications) are not treated as evidence that the REMIC had improper knowledge of an anticipated default under § 1.856-6(b)(3); and

(2) That prior forbearance (and all related modifications) are not taken into account in the determination of the origination date of the mortgage loan for purposes of § 1.860G-2(a)(1).

.04 For mortgage loans held by REMICs, delays and shortfalls in payments associated with or caused by forbearances (and any related modifications) described in section 5.01 of this revenue procedure are contingencies under § 1.860G-1(b)(3)(ii) that can be disregarded. As a result, an interest in a REMIC does not fail to be a regular interest because of such contingencies. For this purpose, contingencies that can be disregarded include excess fees paid for specially serviced loans, an inability of a servicer to advance funds, or

payments that are subject to forbearance not accruing compound interest.

## **SECTION 7. NO INFERENCES ON LAW**

.01 No inference should be drawn about whether similar consequences would obtain if a transaction falls outside the limited scope of this revenue procedure.

.02 Furthermore, there should be no inference that, in the absence of this revenue procedure, transactions within its scope would have impaired the Federal tax status of securitization vehicles, would have given rise to prohibited transactions, or would have involved improper knowledge.

## **SECTION 8. DRAFTING INFORMATION**

The principal authors of this revenue procedure are Diana Imholtz and Michael Chin of the Office of Associate Chief Counsel (Financial Institutions and Products). For further information, contact Mr. Chin at (202) 317-6842 (not a toll-free number).

# Part IV

## Notice of Proposed Rulemaking

### Guidance Involving Hybrid Arrangements and the Allocation of Deductions Attributable to Certain Disqualified Payments under Section 951A (Global Intangible Low-Taxed Income)

#### REG-106013-19

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed regulations that adjust hybrid deduction accounts to take into account earnings and profits of a controlled foreign corporation that are included in income by a United States shareholder. This document also contains proposed regulations that address, for purposes of the conduit financing rules, arrangements involving equity interests that give rise to deductions (or similar benefits) under foreign law. Further, this document contains proposed regulations relating to the treatment of certain payments under the global intangible low-taxed income (GILTI) provisions. The proposed regulations affect United States shareholders of foreign corporations and persons that make payments in connection with certain hybrid arrangements.

DATES: Written or electronic comments and requests for a public hearing must be received by June 8, 2020.

ADDRESSES: Submit electronic submissions via the Federal eRulemaking Portal at [www.regulations.gov](http://www.regulations.gov) (indicate IRS and REG-106013-19) by following the online instructions for submitting comments. Once submitted to the Federal eRulemak-

ing Portal, comments cannot be edited or withdrawn. The Department of the Treasury (Treasury Department) and the IRS will publish for public availability any comment received to its public docket, whether submitted electronically or in hard copy. Send hard copy submissions to: CC:PA:LPD:PR (REG-106013-19), Room 5203, Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Washington, DC 20044.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations under section 951A, Jorge M. Oben at (202) 317-6934; concerning all other proposed regulations, Richard F. Owens at (202) 317-6501; concerning submissions of comments or requests for a public hearing, Regina L. Johnson at (202) 317-6901 (not toll free numbers).

SUPPLEMENTARY INFORMATION:

#### Background

##### I. Section 245A(e) – Hybrid Dividends

Section 245A(e) was added to the Internal Revenue Code (“Code”) by the Tax Cuts and Jobs Act, Pub. L. No. 115-97 (2017) (the “Act”), which was enacted on December 22, 2017. Section 245A(e) and the final regulations under section 245A(e), which are published in the Rules and Regulations section of this issue of the **Federal Register** (the “section 245A(e) final regulations”), neutralize the double non-taxation effects of a hybrid dividend or tiered hybrid dividend through either denying the section 245A(a) dividends received deduction with respect to the dividend or requiring an inclusion under section 951(a)(1)(A) with respect to the dividend, depending on whether the dividend is received by a domestic corporation or a controlled foreign corporation (“CFC”). The section 245A(e) final regulations require that certain shareholders of a CFC maintain a hybrid deduction account with respect to each share of stock of the CFC that the shareholder owns, and provide that a dividend received by the shareholder from the CFC is a hybrid div-

idend or tiered hybrid dividend to the extent of the sum of those accounts. A hybrid deduction account with respect to a share of stock of a CFC reflects the amount of hybrid deductions of the CFC that have been allocated to the share, reduced by the amount of hybrid deductions that gave rise to a hybrid dividend or tiered hybrid dividend.

##### II. Section 1.881-3 – Conduit Financing Arrangements

###### A. In general

Section 7701(l) of the Code authorizes the Secretary to prescribe regulations recharacterizing any multiple-party financing transaction as a transaction directly among any two or more of such parties where the Secretary determines that such recharacterization is appropriate to prevent the avoidance of any tax imposed by the Code. In prescribing such regulations, the legislative history to section 7701(l) states that “it would be within the proper scope of the provision for the Secretary to issue regulations dealing with multi-party financing transactions involving . . . equity investments.” H.R. Conf. Rep. No. 103-213, at 655 (1993).

On August 11, 1995, the Treasury Department and the IRS published in the **Federal Register** final regulations (TD 8611, 60 FR 40997) that allow the IRS to disregard the participation of one or more intermediate entities in a financing arrangement where such entities are acting as conduit entities, and to recharacterize the financing arrangement as a transaction directly between the remaining parties to the financing arrangement for purposes of imposing tax under sections 871, 881, 1441 and 1442.

###### B. Limited treatment of equity interests as financing transactions

Section 1.881-3(a)(2)(i)(A) defines a financing arrangement to mean a series of transactions by which one person (the “financing entity”) advances money or other property, or grants rights to use property, and another person (the “fi-



nanced entity”) receives money or other property, or rights to use property, if the advance and receipt are effected through one or more other persons (“intermediate entities”). Except in cases in which §1.881-3(a)(2)(i)(B) applies (special rule to treat two or more related persons as a single intermediate entity in the absence of a financing transaction between the related persons), the regulations apply only if “financing transactions,” as defined in §1.881-3(a)(2)(ii), link the financing entity, each of the intermediate entities, and the financed entity. Section 1.881-3(a)(2)(ii)(A) and (B) limit the definition of financing transaction in the case of equity investments to stock in a corporation (or a similar interest in a partnership, trust, or other person) that is subject to certain redemption, acquisition, or payment rights or requirements (“redeemable equity”).

If it is determined that an intermediate entity is participating as a conduit entity in a conduit financing arrangement, the financing arrangement may be recharacterized as a transaction directly between the remaining parties (in most cases, the financing entity and the financed entity). *See* §1.881-3(a)(3)(ii)(A). The portion of the financed entity’s payments subject to this recharacterization is determined under §1.881-3(d)(1)(i). Under §1.881-3(d)(1)(i), if the aggregate principal amount of the financing transactions to which the financed entity is a party exceeds the aggregate principal amount linking any of the parties to the financing arrangement, then the recharacterized portion is determined by multiplying the payment by a fraction the numerator of which is the lowest aggregate principal amount of the financing transactions linking any of the parties to the financing transaction and the denominator of which is the aggregate principal amounts linking the financed entity to the financing arrangement. Conversely, if the aggregate principal amount of the financing transactions to which the financed entity is a party is less than or equal to the aggregate principal amount of the financing transactions linking any of the parties to the financing arrangement, the entire amount of the payment is recharacterized.

### C. Hybrid instruments

On December 22, 2008, the Treasury Department and the IRS published in the **Federal Register** (73 FR 78252) a notice of proposed rulemaking (REG-113462-08) (“2008 proposed regulations”) that proposed adding §1.881-3(a)(2)(i)(C) to the conduit financing regulations to treat an entity disregarded as an entity separate from its owner for U.S. tax purposes as a person for purposes of determining whether a conduit financing arrangement exists. The preamble to the 2008 proposed regulations provides that the Treasury Department and the IRS are also studying transactions where a financing entity advances cash or other property to an intermediate entity in exchange for a hybrid instrument (that is, an instrument treated as debt under the tax laws of the foreign country in which the intermediary is resident and equity for U.S. tax purposes), and states that they may issue separate guidance to address the treatment under §1.881-3 of certain hybrid instruments.

The preamble to the 2008 proposed regulations presents two possible approaches to hybrid instruments and requests comments on those and other possible approaches and factors that should be considered. The first approach would treat all transactions involving hybrid instruments between a financing entity and an intermediate entity as *per se* financing transactions under §1.881-3(a)(2)(ii)(A). The second approach would treat only certain hybrid instruments as financing transactions based on specific factors or criteria. Only one comment was received. The comment suggested that the Treasury Department and the IRS take a more targeted approach in identifying specific transactions where there is evidence of limited taxation in the intermediary jurisdiction as a direct consequence of the hybrid instrument.

On December 9, 2011, the Treasury Department and the IRS published in the **Federal Register** final regulations (TD 9562, 76 FR 76895) that adopted the 2008 proposed regulations’ treatment of disregarded entities under §1.881-3 without substantive changes. The preamble to the final regulations states that the Treasury Department and the IRS would continue

to study the treatment of hybrid instruments in financing transactions.

### III. Section 951A – Global Intangible Low-Taxed Income

Section 951A, added to the Code by the Act, requires a United States shareholder of any CFC for any taxable year to include in gross income the shareholder’s global intangible low-taxed income (“GILTI inclusion amount”) for such taxable year. On October 10, 2018, the Treasury Department and the IRS published in the **Federal Register** proposed regulations (REG-104390-18, 83 FR 51072) implementing section 951A. On June 21, 2019, the Treasury Department and the IRS published in the **Federal Register** final regulations (“GILTI final regulations”) (TD 9866, 84 FR 29288) that adopted the proposed regulations, with revisions.

The GILTI final regulations include a rule that provides that a deduction or loss attributable to basis created by reason of a transfer of property from a CFC to a related CFC during the period after December 31, 2017, the final date for measuring earnings and profits (“E&P”) for purposes of section 965, and before the date on which section 951A first applies with respect to the transferor CFC’s income (for example, December 1, 2018, for a CFC with a taxable year ending November 30) (the “disqualified period,” and such basis, “disqualified basis”), is allocated and apportioned solely to residual CFC gross income. *See* §1.951A-2(c)(5)(i). Residual CFC gross income is gross income other than gross tested income, subpart F income, or income effectively connected with a trade or business in the United States. *See* §1.951A-2(c)(5)(iii)(B). The rule also provides that any depreciation, amortization, or cost recovery allowances attributable to disqualified basis are not properly allocable to property produced or acquired for resale under section 263, 263A, or 471. *See* §1.951A-2(c)(5)(i). The purpose of the rule is to ensure that taxpayers cannot take advantage of the disqualified period to engage in transactions that allowed taxpayers to enhance their tax attributes, including by reducing their tested income or increasing their tested loss over

time, without resulting in any current tax cost. *See* 84 FR 29299.

## Explanation of Provisions

### I. Rules Under Section 245A(e) to Reduce Hybrid Deduction Accounts

#### A. In general

As discussed in part II.C.2 of the Summary of Comments and Explanation of Revisions of the section 245A(e) final regulations, the Treasury Department and the IRS have determined that hybrid deduction accounts with respect to stock of a CFC should be reduced in certain cases. In particular, the accounts should generally be reduced to the extent that earnings and profits of the CFC that have not been subject to foreign tax as a result of certain hybrid arrangements are, by reason of certain provisions (not including section 245A(e)), “included in income” in the United States (that is, taken into account in income and not offset by, for example, a deduction or credit particular to the inclusion). By adjusting the accounts in this manner, section 245A(e) neutralizes the double non-taxation effects of certain hybrid arrangements in a manner consistent with the results that would arise were the sheltered earnings and profits (that is, the earnings and profits that were not subject to foreign tax as a result of the arrangement) distributed as a dividend for which the section 245A(a) deduction is not allowed. In such a case, the dividend consisting of the sheltered earnings and profits would generally be taken into account in a United States shareholder’s gross income, and the United States shareholder would generally be taxed at the U.S. corporate statutory rate and allowed neither a dividends received deduction for the dividend nor other relief particular to the dividend (such as foreign tax credits).

The proposed regulations thus provide a new rule that, as part of the end-of-the-year adjustments to a hybrid deduction account, reduces the account by three categories of amounts included in the gross income of a domestic corporation with respect to the share. *See* proposed §1.245A(e)-1(d)(4)(i)(B). The first category relates to an inclusion under section 951(a)(1)(A) (“subpart F inclusion”) with

respect to the share, and the second relates to a GILTI inclusion amount with respect to the share. *See* proposed §1.245A(e)-1(d)(4)(i)(B)(1) and (2). The third category is for inclusions under sections 951(a)(1)(B) and 956 with respect to the share, to the extent the inclusion occurs by reason of the application of section 245A(e) to the hypothetical distribution described in §1.956-1(a)(2). *See* proposed §1.245A(e)-1(d)(4)(i)(B)(3). An amount in the third category provides a dollar-for-dollar reduction of the account because, due to the lack of an availability of deductions or credits particular to the amount (including foreign tax credits) to offset or reduce such amount, the entirety of such amount is assumed to be included in income in the United States. *See, for example,* §1.960-2(b)(1) (no foreign income taxes are deemed paid under section 960(a) with respect to an inclusion under section 951(a)(1)(B)).

As discussed in part I.B of this Explanation of Provisions, the entirety of an amount in the first or second category may not be included in income in the United States and, as a result, such an amount does not provide a dollar-for-dollar reduction of the account. In addition, the reduction of the account for these amounts cannot exceed the hybrid deductions allocated to the share for the taxable year multiplied by the ratio of the subpart F income or tested income, as applicable, of the CFC for the taxable year to the CFC’s taxable income. *See* proposed §1.245A(e)-1(d)(4)(i)(B)(1)(ii) and (d)(4)(i)(B)(2)(ii); *see also* proposed §1.245A(e)-1(d)(4)(i)(B)(1)(iii) and (d)(4)(i)(B)(2)(iii) (in certain cases, excess amounts are allocated to other hybrid deduction accounts and reduce those accounts). This limitation is, for example, intended to prevent a subpart F inclusion for a taxable year from removing from the account hybrid deductions incurred in a prior taxable year, because such hybrid deductions generally represent an amount of prior year earnings that were not subject to foreign tax as a result of a hybrid arrangement, and the subpart F inclusion in the current year does not subject such earnings to U.S. tax (but rather, subjects certain current year earnings to U.S. tax). In addition, because hybrid deductions incurred in the current taxable year may ratably shelter from foreign tax each type

of earnings of a CFC (as opposed to, for example, only sheltering from foreign tax earnings of a type that the United States views as attributable to subpart F income), the limitation is generally intended to ensure that, for example, a subpart F inclusion does not remove from the account hybrid deductions that sheltered from foreign tax current year earnings of a type that the United States views as attributable to income other than subpart F income.

#### B. Adjusted subpart F and GILTI inclusions

The proposed regulations generally reduce a hybrid deduction account with respect to a share of stock of a CFC by an “adjusted subpart F inclusion” or an “adjusted GILTI inclusion” (or both) with respect to the share. *See* proposed §1.245A(e)-1(d)(4)(i)(B)(1) and (2). An adjusted subpart F inclusion or an adjusted GILTI inclusion is intended to measure, in an administrable manner, the extent to which a domestic corporation’s subpart F inclusion or GILTI inclusion amount is likely included in income in the United States, taking into account foreign tax credits associated with the inclusion and, in the case of a GILTI inclusion amount, the deduction under section 250(a)(1)(B).

The starting point in determining an adjusted subpart F inclusion with respect to a share of stock of a CFC is identifying a domestic corporation’s pro rata share of the CFC’s subpart F income, and then attributing such inclusion to particular shares of stock of the CFC. *See* proposed §1.245A(e)-1(d)(4)(ii)(A). For purposes of attributing the inclusion, the proposed regulations provide that the principles of section 951(a)(2) and §1.951-1(b) and (e) apply.

Once the amount of the subpart F inclusion attributable to the share is determined, the “associated foreign income taxes” with respect to the amount must be determined. *See* proposed §1.245A(e)-1(d)(4)(ii)(A) and (D). The term associated foreign income taxes means the amount of current year tax allocated and apportioned to the subpart F income groups of the CFC, to the extent allocated to the share. *See* proposed §1.245A(e)-1(d)(4)(ii)(D)(1) and (d)(4)(ii)(E). The computation of associated foreign income taxes

does not take into account any limitations on foreign tax credits, such as under section 904, because doing so would involve considerable complexity. These rules are intended to approximate, in an administrable manner, deemed paid credits resulting from the application of section 960(a) that are eligible to be claimed with respect to the subpart F inclusion attributable to the share.

The final step is to adjust, pursuant to a two-step process, the subpart F inclusion attributable to the share, to approximate the tax effect of the associated foreign income taxes. See proposed §1.245A(e)-1(d)(4)(ii)(A). First, the associated foreign income taxes are added to the subpart F inclusion, to reflect that when a domestic corporation claims section 960 credits it includes in gross income under section 78 an amount equal to such credits. See proposed §1.245A(e)-1(d)(4)(ii)(A)(1). Second, an amount equal to the amount of income offset by the associated foreign income taxes – calculated as the associated foreign tax credits divided by the corporate tax rate – is subtracted from the sum of the amounts described in the previous sentence. See proposed §1.245A(e)-1(d)(4)(ii)(A)(2). The difference of the amounts is the adjusted subpart F inclusion with respect to the share.<sup>1</sup>

Similar rules apply for purposes of determining an adjusted GILTI inclusion with respect to a share of stock of a CFC. However, special rules account for the fact that the computation of foreign tax credits under section 960(d) takes into account a domestic corporation's inclusion percentage (as described in §1.960-2(c)(2)) and the 80 percent limit in section 960(d)(1). See proposed §1.245A(e)-1(d)(4)(ii)(B)(3) and (d)(4)(ii)(D)(2). In addition, a special rule accounts for the effect of a section 250 deduction that a domestic corporation may claim related to GILTI. See proposed §1.245A(e)-1(d)(4)(ii)(B)(2).

### C. Applicability date

The proposed rules relating to hybrid deduction accounts are proposed to apply to taxable years ending on or after the

date that final regulations are published in the **Federal Register**. For taxable years before taxable years covered by such final regulations, a taxpayer may apply the rules set forth in the final regulations, provided that it consistently applies the rules to those taxable years. See section 7805(b)(7). In addition, a taxpayer may rely on the proposed rules with respect to any period before the date that the proposed regulations are published as final regulations in the **Federal Register**, provided that it consistently does so.

## II. Conduit Regulations under §1.881-3 to Address Equity Interests that Give Rise to Deductions or other Benefits under Foreign Law

### A. Overview

Under the current conduit financing regulations, an instrument that is treated as equity for U.S. tax purposes (and is not redeemable equity described in §1.881-3(a)(2)(ii)(B)) generally will not be characterized as a financing transaction, even though the instrument gives rise to a deduction or other benefit under the tax laws of the issuer's jurisdiction. For example, an instrument that is treated as stock (that is not redeemable equity) for U.S. tax purposes, but as indebtedness under the laws of the issuer's jurisdiction, would not be characterized as a financing transaction under the current regulations.

The Treasury Department and the IRS have determined that these types of instruments can be used to inappropriately avoid the application of the conduit financing regulations and, therefore, the proposed regulations expand the definition of equity interests treated as a financing transaction by taking into account the tax treatment of the instrument under the tax law of the relevant foreign country, which is generally the country where the equity issuer resides. The Treasury Department and the IRS have determined that, while these types of instruments are characterized as equity for U.S. tax purposes, they still raise conduit financing

concerns if they are either indebtedness under the issuer's tax law or provide benefits similar to indebtedness under the issuer's tax law. For example, a financing company may have an incentive to form a corporation in a country that allows a tax benefit, such as a notional interest deduction with respect to equity, that encourages the routing of income through the intermediary issuer in functionally the same manner as when an intermediate entity issues a debt instrument that is treated as a financing transaction under the current regulations. Similarly, a financing entity may form an intermediate corporation in a country to take advantage of the country's purported integration regime that provides a substantial refund of the issuer's corporate tax paid upon a distribution to a related shareholder, and the shareholder is not taxable on that distribution under the laws of the intermediate country. The Treasury Department and IRS have concluded that these structures raise concerns similar to those Congress intended to address when it enacted sections 267A and 245A(e) regarding arrangements that "exploit differences in the treatment of a transaction or entity under the laws of two or more tax jurisdictions..." See S. Comm. on the Budget, Reconciliation Recommendations Pursuant to H. Con. Res. 71, S. Print No. 115-20, at 389 (2017).

The Treasury Department and the IRS have determined that the conduit regulations should apply in these cases generally based on benefits that are associated with an equity interest, rather than targeting only particular transactions based on specific factors or criteria as recommended by a comment, because these arrangements are often deliberately structured and a more limited approach could be easily circumvented or difficult to administer. However, even if the equity interests of an intermediate entity are treated as a financing transaction under the proposed regulations, the intermediate entity will not be a conduit entity if, for example, its participation in the financing arrangement is not pursuant to a tax avoidance plan. See §1.881-3(b).

<sup>1</sup> Thus, for example, in a case in which the subpart F inclusion attributable to a share is \$94.75x and the associated foreign income taxes with respect to such is \$5.25x, the adjusted subpart F inclusion with respect to the share would be \$75x, calculated as \$100x (\$94.75x + \$5.25x) less \$25x (\$5.25x ÷ 21%).

*B. Treatment of equity interests that give rise to deductions or other benefits under foreign law*

The proposed regulations expand the types of equity interests treated as a financing transaction to include stock or a similar interest if under the tax laws of a foreign country where the issuer is a resident, the issuer is allowed a deduction or another tax benefit for an amount paid, accrued or distributed with respect to the stock or similar interest. Similarly, if the issuer maintains a taxable presence, referred to as a permanent establishment (“PE”) under the laws of many foreign countries without regard to a treaty, and such country allows a deduction (including a notional deduction) for an amount paid, accrued or distributed with respect to the deemed equity or capital of the PE, the amount of the deemed equity or capital will be treated as a financing transaction. See proposed §1.881-3(a)(2)(ii)(B)(I)(iv). The proposed regulations also treat stock or a similar interest as a financing transaction if a person related to the issuer, generally a shareholder or other interest holder in an entity, is entitled to a refund (including a credit) or similar tax benefit for taxes paid by the issuer to its country of residence, without regard to the person’s tax liability with respect to the payment, accrual or distribution under the laws of the issuer. See proposed §1.881-3(a)(2)(ii)(B)(I)(v).

An equity interest treated as a financing transaction under the proposed regulations would include, for example, stock that gives rise to a notional interest deduction under the tax laws of the foreign country in which the issuer is a tax resident or the tax laws of the country in which the issuer maintains a permanent establishment to which a financing payment is attributable. However, if an equity interest constitutes a financing transaction because the issuer is allowed a notional interest deduction and is one of the financing transactions that links a party to the financing arrangement, the proposed regulations limit the portion of the financed entity’s payment that is recharacterized under §1.881-3(d)(1)(i) to the financing transaction’s principal amount as determined under §1.881-3(d)(1)(ii), multiplied by the applicable rate used to compute the issuer’s notional in-

terest deduction in the year of the financed entity’s payment. See proposed § 1.881-3(d)(1)(iii). This limitation is intended to recharacterize only the portion of the payment that can be traced to the notional interest deduction on the principal amount of the equity on which the notational deduction is based. Notional interest deductions may also accrue with respect to equity composed of retained earnings, not related to the financing transaction, and therefore are not taken into account under this rule.

The proposed regulations also make conforming changes to reflect the application of these rules in the context of Chapter 4 withholding (sections 1471 and 1472).

*C. Interaction with section 267A*

While the proposed conduit regulations may apply to many of the same instruments identified in the final regulations under section 267A issued in the Rules and Regulations section of this issue of the **Federal Register** (the “section 267A final regulations”), in some respects the proposed conduit regulations have a broader scope than those rules in order to prevent the use of conduit entities from inappropriately obtaining the benefits of an applicable U.S. income tax treaty. For example, the imported mismatch rules in the section 267A final regulations, in determining whether a deduction for an interest or royalty payment is disallowed by reason of the income attributable to the payment being offset by an offshore deduction, only take into account offshore deductions that produce a deduction/no inclusion (“D/NI”) outcome as a result of hybridity. A D/NI outcome is not a result of hybridity if, for example, the no-inclusion occurs because the foreign tax law does not impose a corporate income tax.

The existing conduit regulations, in contrast, already apply whether or not there is a D/NI outcome with respect to an offshore financing transaction. The proposed regulations will now also cover, without regard to how the transaction is treated for U.S. tax purposes (as debt or equity), any financing transaction where the intermediate entity is allowed a deduction or other tax benefit similar to those described in the section 267A final regula-

tions and applicable in the imported mismatch context.

*D. Applicability date*

The proposed rules relating to conduit transactions are proposed to apply to payments made on or after the date that final regulations are published in the **Federal Register**.

*III. Rules under Section 951A to Address Certain Disqualified Payments Made During the Disqualified Period*

*A. In general*

As discussed in part III of the Background of this preamble, the GILTI final regulations provide that (i) a deduction or loss attributable to disqualified basis created by reason of a transfer from a CFC to a related CFC during the disqualified period is allocated and apportioned solely to residual CFC gross income, and (ii) any depreciation, amortization, or cost recovery allowances attributable to disqualified basis are not properly allocable to property produced or acquired for resale under section 263, 263A, or 471. See §1.951A-2(c)(5)(i).

The Treasury Department and the IRS understand that, in addition to the transactions circumscribed by the rules in §1.951A-2(c)(5), taxpayers also may have entered into transactions in which, for example, a CFC that licensed property to a related CFC received pre-payments of royalties due under the license from the related CFC, which did not constitute subpart F income. Although the recipient of the pre-payments (“related recipient CFC”) would generally have been required to include the royalties in income upon payment during the disqualified period, when they would not have affected amounts included under section 965 with respect to the related recipient CFC and also would not have given rise to gross tested income under section 951A, the related CFC that made the pre-payment would generally only be allowed to deduct the payment over time as economic performance occurred. See section 461. Accordingly, the related CFC that made the pre-payment would claim deductions that reduce tested income (or increase

tested loss) during taxable years to which section 951A applies, even though the corresponding income would not have been subject to tax under section 951 (including as a result of section 965) or section 951A.

The Treasury Department and the IRS have determined that the deductions attributable to pre-payments (including, but not limited to, deductions attributable to pre-paid rents and royalties) should be subject to similar treatment as the final GILTI regulations' treatment of deductions or loss attributable to disqualified basis. Accordingly, proposed §1.951A-2(c)(6) treats a deduction by a CFC related to a deductible payment to a related recipient CFC during the disqualified period as allocated and apportioned solely to residual CFC gross income, as defined in §1.951A-2(c)(5)(iii)(B), and provides that any deduction related to such a payment is not properly allocable to property produced or acquired for resale under section 263, 263A, or 471, consistent with §1.951A-2(c)(5)(i) and the authority therefor described in the preamble to the final GILTI regulations. See 84 FR 29298-29300. This rule applies only to the extent the payments would constitute income described in section 951A(c)(2)(A)(i) and §1.951A-2(c)(1), without regard to whether section 951A applies. See proposed §1.951A-2(c)(6)(ii)(A).

## B. Applicability date

The proposed rules relating to section 951A are proposed to apply to taxable years of foreign corporations ending on or after April 7, 2020, and to taxable years of United States shareholders in which or with which such taxable years end. See section 7805(b)(1)(B). Given the applicability date, these rules would effectively be limited to payments made during the disqualified period that give rise to deductions or loss in taxable years of foreign corporations ending on or after April 7, 2020 and would not, for example, affect

payments made during the disqualified period for which the associated deduction or loss is taken into account in the year paid.

## Special Analyses

### I. Regulatory Planning and Review

Executive Orders 13771, 13563, and 12866 direct agencies to assess costs and benefits of available regulatory alternatives and, if regulation is necessary, to select regulatory approaches that maximize net benefits, including potential economic, environmental, public health and safety effects, distributive impacts, and equity. Executive Order 13563 emphasizes the importance of quantifying both costs and benefits, reducing costs, harmonizing rules, and promoting flexibility. The preliminary Executive Order 13771 designation for this proposed rulemaking is regulatory.

The proposed regulations have been designated by the Office of Management and Budget's Office of Information and Regulatory Affairs as significant under Executive Order 12866 pursuant to section 1(b) the Memorandum of Agreement (April 11, 2018) between the Treasury Department and the Office of Management and Budget regarding review of tax regulations.

### A. Background

The Act introduced two new provisions, sections 245A(e) and 267A, that affect the treatment of hybrid arrangements and a new section, 951A, which imposes tax on United States shareholders with respect to certain earnings of their CFCs.<sup>2</sup> The Treasury Department and the IRS previously issued proposed regulations under sections 245A(e) and 267A and are issuing final regulations simultaneously with these current proposed regulations. The Treasury Department and IRS have

also previously issued final regulations (REG-104390-18, 83 FR 51072), which provided additional rules implementing section 951A. In addition to these rules, the Treasury Department and the IRS previously provided guidance regarding conduit financing arrangements under sections 881 and 7701(l). See TD 8611, 60 FR 40997 and TD 9562, 76 FR 76895.

Section 245A(e) disallows the dividends received deduction (DRD) for any dividend received by a U.S. shareholder from a CFC if the dividend is a hybrid dividend. In addition, section 245A(e) treats hybrid dividends between CFCs with a common U.S. shareholder as subpart F income. The statute defines a hybrid dividend as an amount received from a CFC for which a deduction would be allowed under section 245A(a) and for which the CFC received a deduction or other tax benefit in a foreign country. This disallowance of the DRD for hybrid dividends and the treatment of hybrid dividends as subpart F income neutralizes the double non-taxation that these dividends might otherwise be produced by these dividends.<sup>3</sup> The section 245A(e) final regulations require that taxpayers maintain "hybrid deduction accounts" to track a CFC's (or a person related to a CFC's) hybrid deductions allowed in foreign jurisdictions across sources and years. The section 245A(e) final regulations then provide that a dividend received by a U.S. shareholder from the CFC is a hybrid dividend to the extent of the sum of those accounts.

These proposed regulations also include rules regarding conduit financing arrangements.<sup>4</sup> Under the current conduit financing regulations, a "financing arrangement" means a series of transactions by which one entity (the financing entity) advances money or other property to another entity (the financed entity) through one or more intermediaries. If the IRS determines that a principal purpose of such an arrangement is to avoid U.S. tax, the

<sup>2</sup> Hybrid arrangements are tax-avoidance tools used by certain multinational corporations (MNCs) that have operations both in the U.S. and a foreign country. These hybrid arrangements use differences in tax treatment by the U.S. and a foreign country to reduce taxes in one or both jurisdictions. Hybrid arrangements can be "hybrid entities," in which a taxpayer is treated as a flow-through or disregarded entity in one country but as a corporation in another, or "hybrid instruments," which are financial transactions that are treated as debt in one country and as equity in another.

<sup>3</sup> The tax treatment under which certain payments are deductible in one jurisdiction and not included in income in a second jurisdiction is referred to as a deduction/no-inclusion outcome ("D/NI outcome").

<sup>4</sup> On December 22, 2008, the Treasury Department and the IRS published a notice of proposed rulemaking (REG-113462-08) ("2008 proposed regulations") that proposed adding §1.881-3(a)(2)(i)(C) to the conduit financing regulations. The preamble to the 2008 proposed regulations provides that the Treasury Department and the IRS are also studying transactions where a financing entity advances cash or other property to an intermediate entity in exchange for a hybrid instrument (that is, an instrument treated as debt under the tax laws of the foreign country in which the intermediary is resident and equity for U.S. tax purposes), and states that they may issue separate guidance to address the treatment under §1.881-3 of certain hybrid instruments.

IRS may disregard the participation of intermediate entities. As a result, U.S.-source payments from the financed entity are, for U.S. withholding tax purposes, treated as being made directly to the financing entity.

For example, consider a foreign entity that is seeking to finance its U.S. subsidiary but is not entitled to U.S. tax treaty benefits; thus, U.S.-source payments made to this entity are not entitled to reduced withholding tax rates. Instead of lending money directly to the U.S. subsidiary, the foreign entity might loan money to an affiliate residing in a treaty jurisdiction and have the affiliate lend on to the U.S. subsidiary in order to access U.S. tax treaty benefits.

Under the current conduit financing regulations, if the IRS determines that a principal purpose of such an arrangement is to avoid U.S. tax, the IRS may disregard the participation of the affiliate. As a result, U.S.-source interest payments from the U.S. subsidiary are, for U.S. withholding tax purposes, treated as being made directly to the foreign entity.

In general, the current conduit financing regulations apply only if “financing transactions,” as defined under the regulations, link the financing entity, the intermediate entities, and the financed entity. Under the current conduit financing regulations, an instrument that is equity for U.S. tax purposes generally will not be treated as a “financing transaction” unless it provides the holder significant redemption rights. This is the case even if the instrument gives rise to a deduction under the laws of the foreign jurisdiction (e.g., perpetual debt). As a result, the current conduit financing regulations would not apply, and the U.S.-source payment might be entitled to a lower rate of U.S. withholding tax.

The proposed regulations also implement items in section 951A of the Act. Section 951A provides for the taxation of global intangible low-taxed income (GILTI), effective beginning with the first taxable year of a CFC that begins after December 31, 2017. The GILTI final regulations address the treatment of a deduction or loss attributable to basis created by certain transfers of property from one CFC to a related CFC after December 31, 2017, but before the date on which section 951A

first applies to the transferring CFC’s income. Those regulations state that such a deduction or loss is allocated to residual CFC gross income; that is, income that is not attributable to tested income, subpart F income, or income effectively connected with a trade or business in the United States.

### *B. Overview of proposed regulations*

These proposed regulations address three main issues: (i) adjustments to hybrid deduction accounts under section 245A(e) and the final regulations; (ii) conduit financing arrangements that use certain equity interests that allow the issuer a deduction or other tax benefit under foreign tax law; and (iii) certain payments between related CFCs during a disqualified period under section 951A and the GILTI final regulations.

First, the proposed regulations address adjustments to hybrid deduction accounts under section 245A(e) and the final regulations. The section 245A(e) final regulations stipulate that hybrid deduction accounts should generally be reduced to the extent that earnings and profits of the CFC that have not been subject to foreign tax as a result of certain hybrid arrangements are included in income in the United States by some provision other than section 245A(e). The proposed regulations provide new rules for reducing hybrid deduction accounts by reason of income inclusions attributable to subpart F, GILTI, and sections 951(a)(1)(B) and 956. An inclusion due to subpart F or GILTI reduces a hybrid deduction account only to the extent that the inclusion is not offset by a deduction or credit, such as a foreign tax credit, that likely will be afforded to the inclusion. Because deductions and credits are typically not available to offset income inclusions under section 951(a)(1)(B) and 956, these inclusions reduce a hybrid deduction account dollar-for-dollar.

Second, the proposed regulations address conduit financing arrangements under §1.881-3 by expanding the types of transactions classified as financing transactions. The proposed rules state that if the issuer of a financial instrument is allowed a deduction or tax benefit for an amount paid, accrued, or distributed with respect to a stock or similar interest under the tax

law of the foreign jurisdiction where the issuer is a resident, then it may now be characterized as a financing transaction even though the instrument is equity for U.S. tax purposes. Accordingly, the conduit financing regulations would apply to multiple-party financing arrangements using these types of instruments, which include certain types of hybrid instruments. This change essentially aligns the conduit regulations with the policy of section 267A by discouraging the exploitation of differences in treatment of financial instruments across jurisdictions. While section 267A and the final regulations apply only if the D/NI outcome is a result of the use of a hybrid entity or instrument, the conduit financing regulations apply regardless of causation and instead look to whether there is a tax avoidance plan. Thus, this new rule will address economically similar transactions that section 267A and the section 267A final regulations do not cover.

Finally, the proposed regulations address certain payments made after December 31, 2017, but before the date of the start of the first fiscal year for the transferor CFC for which 951A applies (the “disqualified period”) in which payments, such as pre-payments of royalties, create income during the disqualified period and a corresponding deduction or loss claimed in taxable years after the disqualified period. Absent the proposed regulations, those deductions or losses could have been used to reduce tested income or increase tested losses, among other benefits. However, under the proposed regulations, these deductions will no longer provide such a tax benefit, and will instead be allocated to residual CFC income, similar to deductions or losses from certain property transfers in the disqualified period under the GILTI final regulations.

### *C. Need for the proposed regulations*

A failure to reduce hybrid deduction accounts by certain earnings of a CFC that are indirectly included in the income of a U.S. shareholder may result in double taxation for some taxpayers—for example, those which have subpart F or GILTI income inclusions.

Failure to address certain equity interests under the conduit financing regu-

lations may allow some MNCs to avoid U.S. tax by shifting additional income towards conduit financing arrangements that use financial instruments treated as equity for U.S. tax purposes but as debt in a foreign jurisdiction. These arrangements are economically similar to the hybrid arrangements that are addressed by the Act and by the section 267A final regulations and to other arrangements covered by the conduit financing regulations, but they have not yet been addressed themselves.

The Treasury Department and IRS are aware that certain transactions that accelerate income, but do not give rise to a disposition of property (e.g., prepayments of royalties from a related CFC) fall outside the purview of the GILTI final regulations. In order for the Code to treat similar transactions similarly, these types of transactions need to be addressed by regulation.

#### *D. Economic analysis*

##### 1. Baseline

The Treasury Department and the IRS have assessed the benefits and costs of the proposed regulations relative to a no-action baseline reflecting anticipated federal income tax-related behavior in the absence of these regulations.

##### 2. Economic Analysis of Specific Provisions and Alternatives Considered

###### i. Section 245A(e) – Adjustment of hybrid deduction account

Under the final regulations, taxpayers must maintain hybrid deduction accounts to track income of a CFC that was sheltered from foreign tax due to hybrid arrangements, so that it may be included in U.S. income under section 245A(e) when paid as a dividend. The proposed regulations address how hybrid deduction accounts should be adjusted to account for earnings and profits of a CFC included in U.S. income due to certain provisions other than section 245A(e). The proposed regulations provide rules reducing a hybrid deduction account for three categories

of inclusions: subpart F inclusions, GILTI inclusions, and inclusions under sections 951(a)(1)(B) and 956.

One option for addressing the treatment of earnings and profits included in U.S. income due to provisions other than section 245A(e) would be to not issue additional guidance beyond current tax rules and thus not to adjust hybrid deduction accounts to account for such inclusions. This would be the simplest approach among those considered, but under this approach, some income could be subject to double taxation in the United States. For example, if no adjustment is made, to the extent that a CFC's earnings and profits were sheltered from foreign tax as a result of certain hybrid arrangements, the section 245A DRD would be disallowed for an amount of dividends equal to the amount of the sheltered earnings and profits, even if some of the sheltered earnings and profits were included in the income of a U.S. shareholder under the subpart F rules. The U.S. shareholder would be subject to tax on both the dividends and on the subpart F inclusion. Owing to this double taxation, this approach is not proposed by the Treasury Department and the IRS.

A second option would be to reduce hybrid deduction accounts by amounts included in gross income under the three categories; that is, without regard to deductions or credits that may offset the inclusion. While this option is also relatively simple, it could lead to double non-taxation and thus would give rise to results not intended by the statute. Subpart F and GILTI inclusions may be offset by – and thus may not be fully taxed in the United States as a result of – foreign tax credits and, in the case of GILTI, the section 250 deduction.<sup>5</sup> Therefore, this option for reducing hybrid deduction accounts may result in some income that was sheltered from foreign tax due to hybrid arrangements also escaping full U.S. taxation. This double non-taxation is economically inefficient because otherwise similar activities are taxed differently, incentivizing wasteful avoidance activities.

A third option, which is the option proposed by the Treasury Department and

the IRS, is to reduce hybrid deduction accounts by the amount of the inclusions from the three categories, but only to the extent that the inclusions are likely not offset by foreign tax credits or, in the case of GILTI, the section 250 deduction. For subpart F and GILTI inclusions, the proposed regulations stipulate adjustments to be made to account for the foreign tax credits and the section 250 deduction available to GILTI income. These adjustments are intended to provide a precise, administrable manner for measuring the extent to which a subpart F or GILTI inclusion is included in U.S. income and not shielded by foreign tax credits or deductions. This option results in an outcome aligned with statutory intent, as it generally ensures that the section 245A DRD is disallowed (and thus a dividend is included in U.S. income without any regard for foreign tax credits) only for amounts that were sheltered from foreign tax by reason of a hybrid arrangement but that have not yet been subject to U.S. tax.

Relative to a no-action baseline, the proposed regulations provide taxpayers with new instruction regarding how to adjust hybrid deduction accounts to account for earnings and profits that are included in U.S. income by reason of certain provisions other than section 245A(e). This new instruction avoids possible double taxation. Double taxation is inconsistent with the intent and purpose of the statute and is economically inefficient because it may result in otherwise similar income streams facing different tax treatment, incentivizing taxpayers to finance operations with specific income streams and activities that may not be the most economically productive.

The Treasury Department and IRS estimate that this provision will impact an upper bound of approximately 2,000 taxpayers. This estimate is based on the top 10 percent of taxpayers (by gross receipts) that filed a domestic corporate income tax return for tax year 2017 with a Form 5471 attached, because only domestic corporations that are U.S. shareholders of CFCs are potentially affected by section 245A(e).<sup>6</sup>

<sup>5</sup>Typically, deductions or credits are not available to offset income inclusions under sections 951(a)(1)(B) and 956, the third category addressed by the proposed regulations.

<sup>6</sup>Because of the complexities involved, primarily only large taxpayers engage in hybrid arrangements. The estimate that the top 10 percent of otherwise-relevant taxpayers (by gross receipts) are likely to engage in hybrid arrangements is based on the judgment of the Treasury Department and IRS.

This estimate is an upper bound on the number of large corporations affected because it is based on all transactions, even though only a portion of such transactions involve hybrid arrangements. The tax data do not report whether these reported dividends were part of a hybrid arrangement because such information was not relevant for calculating tax prior to the Act. In addition, this estimate is an upper bound because the Treasury Department and the IRS anticipate that fewer taxpayers would engage in hybrid arrangements going forward as the statute and §1.245A(e)-1 would make such arrangements less beneficial to taxpayers.

ii. Conduit financing regulations to address equity interests that give rise to deductions or other benefits under foreign law

The conduit financing regulations allow the IRS to disregard intermediate entities in a multiple-party financing arrangement for the purposes of determining withholding tax rates if the instruments used in the arrangement are considered “financing transactions.” Financing transactions generally exclude instruments that are treated as equity for U.S. tax purposes unless they have significant redemption features. Thus, in the absence of further guidance, the conduit financing regulations would not apply to certain arrangements using certain hybrid instruments or other instruments that are eligible for deductions in the jurisdiction of the issuer but treated as equity under U.S. law. This would allow payments made under these arrangements to continue to be eligible for reduced withholding tax rates through a conduit structure.

One option for addressing the current disparate treatment would be to not change the conduit financing regulations, which currently treat equity as a financing transaction only if it has specific redemption features; this is the no-action baseline. This option is not proposed by the Treasury Department and the IRS, since it is inconsistent with the Treasury Department’s and the IRS’s ongoing efforts to address financing transactions that use hy-

brid instruments, as discussed in the 2008 proposed regulations.

A second option considered would be to treat as a financing transaction an instrument that is equity for U.S. tax purposes but debt for purposes of the issuer’s jurisdiction of residence. This approach would prevent taxpayers from using this type of hybrid instrument to engage in treaty shopping through a conduit jurisdiction. However, this approach would not cover certain cases, such as if a jurisdiction offers a tax benefit to non-debt instruments (e.g., a notional interest deduction with respect to equity).

A third option, which is adopted in these proposed regulations, is to treat as a financing transaction any instrument that is equity for U.S. tax purposes and which entitles its issuer or its shareholder a deduction or similar tax benefit in the issuer’s resident jurisdiction or in the jurisdiction where the resident has a permanent establishment. This rule is broader than the second option. It covers all instruments that give rise to deductions or similar tax benefits, such as credits, rather than only those instruments that are treated as debt. This rule also covers instruments where a financing payment is attributable to a permanent establishment of the issuer, and the tax laws of the permanent establishment’s jurisdiction allow a deduction or similar treatment for the instrument. This will prevent issuers from routing transactions through their permanent establishments to avoid the anti-conduit rules. The Treasury Department and the IRS adopted this third option since it will most efficiently, and in a manner that is clear and administrable, prevent inappropriate avoidance of the conduit financing regulations. The Treasury Department and the IRS project that this third option will ensure that similar financing arrangements are treated similarly by the tax system.

Relative to a no-action baseline, the proposed regulations are likely to incentivize some taxpayers to shift away from conduit financing arrangements and hybrid arrangements. The Treasury Department and the IRS project little to no overall economic loss, or even an eco-

nomical gain, from this shift because conduit arrangements are generally not economically productive arrangements and are typically pursued only for tax-related reasons. The Treasury Department and the IRS recognize, however, that as a result of these provisions, some taxpayers may face a higher effective tax rate, which may lower their economic activity.

The Treasury Department and the IRS have not undertaken more precise quantitative estimates of either of these economic effects because we do not have readily available data or models to estimate with reasonable precision: (i) the types or volume of conduit arrangements that taxpayers would likely use under the proposed regulations or under the no-action baseline; or (ii) the effects of those arrangements on businesses’ overall economic performance, including possible differences in compliance costs. In the absence of such quantitative estimates, the Treasury Department and the IRS project that the proposed regulations will best enhance U.S. economic performance relative to the no-action baseline and relative to other alternative regulatory approaches and because they most comprehensively ensure that similar financing arrangements are treated similarly by the tax system.

The Treasury Department and the IRS estimate that the number of taxpayers potentially affected by the proposed conduit financing regulations will be an upper bound of approximately 7,000 taxpayers. This estimate is based on the top 10 percent of taxpayers (by gross receipts) that filed a domestic corporate income tax return with a Form 5472, “Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business,” attached because primarily foreign entities that advance money or other property to a related U.S. entity through one or more foreign intermediaries are potentially affected by the conduit financing regulations.<sup>7</sup>

This estimate is an upper bound on the number of large corporations affected because it is based on all domestic corporate arrangements involving foreign related parties, even though only a portion of

<sup>7</sup> Because of the complexities involved, primarily only large taxpayers engage in conduit financing arrangements. The estimate that the top 10 percent of otherwise-relevant taxpayers (by gross receipts) are likely to engage in conduit financing arrangements is based on the judgment of the Treasury Department and IRS.



such arrangements are conduit financing arrangements that use hybrid instruments. The tax data do not report whether these arrangements were part of a conduit financing arrangement because such information is not provided on tax forms. In addition, this estimate is an upper bound because the Treasury Department and the IRS anticipate that fewer taxpayers would engage in conduit financing arrangements that use hybrid instruments going forward as the proposed conduit financing regulations would make such arrangements less beneficial to taxpayers.

iii. Rules under section 951A to address certain disqualified payments made during the disqualified period

The final 951A regulations include a rule that addresses certain transactions involving asset transfers between related CFCs during the disqualified period that may have the effect of reducing GILTI inclusions due to timing differences between when a transaction occurs and when resulting deductions are claimed. The disqualified period of a CFC is the period between December 31, 2017, which is the last earnings and profits measurement date under section 965, and the beginning of the CFC's first taxable year that begins after December 31, 2017, which is the first taxable year with respect to which section 951A is effective.

The proposed regulations refine this rule to extend its applicability to other transactions for which similar timing differences can arise. For example, suppose that a CFC licensed property to a related CFC for ten years and received pre-payments of royalties during the disqualified period from the related CFC. Since these prepayments were received by the licensor CFC during the disqualified period, they would not have affected amounts included under section 965 nor given rise to GILTI tested income. However, the licensee CFC that made the payments would not have claimed the total of the corresponding deductions during the disqualified period, since the timing of deductions are generally tied to economic performance over the period of use. The licensee CFC would claim deductions over the ten years of the contract, and since these deductions would be claimed during taxable years when sec-

tion 951A is in effect, these deductions would reduce GILTI tested income or increase GILTI tested loss. Thus, this type of transaction could lower overall income inclusions for the U.S. shareholder of these CFCs in a manner that does not accurately reflect the earnings of the CFCs over time.

The Treasury Department and the IRS propose that all deductions attributable to payments to a related CFC during the disqualified period should be allocated and apportioned to residual CFC gross income. These deductions will not thereby reduce tested, subpart F or effectively connected income. This rule provides similar treatment to transactions involving prepayments as the rule in the GILTI final regulations provides to asset transfers between related CFCs during the disqualified period.

Relative to a no-action baseline, the proposed regulations harmonize the treatment of similar transactions. Since this rule applies to deductions resulting from transactions that occurred during the disqualified period and not to any new transactions, the Treasury Department and the IRS do not expect changes in taxpayer behavior under the proposed regulations, relative to the no-action baseline.

The Treasury Department and the IRS estimate that the number of taxpayers potentially affected by these proposed regulations will be an upper bound of approximately 25,000 to 35,000 taxpayers. This estimate is based on filers of income tax returns with a Form 5471 attached because only filers that are U.S. shareholders of CFCs or that have at least a 10 percent ownership in a foreign corporation would be subject to section 951A. This estimate is an upper bound because it is based on all filers subject to section 951A, even though only a portion of such taxpayers may have engaged in the pre-payment transactions during the disqualified period described in the proposed regulations. Therefore, the Treasury Department and the IRS estimate that the number of taxpayers potentially affected by these proposed regulations will be substantially less than 25,000 to 35,000 taxpayers.

## II. *Paperwork Reduction Act*

Pursuant to §1.6038-2(f)(14), certain U.S. shareholders of a CFC must provide

information relating to the CFC and the rules of section 245A(e) on Form 5471, "Information Return of U.S. Persons With Respect to Certain Foreign Corporations," (OMB control number 1545-0123), as the form or other guidance may prescribe. The proposed regulations do not impose any additional information collection requirements relating to section 245A(e). However, the proposed regulations provide guidance regarding certain computations required under section 245A(e), and such could affect the information required to be reported on Form 5471. For purposes of the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)) ("PRA"), the reporting burden associated with §1.6038-2(f)(14) is reflected in the PRA submission for Form 5471. See the chart at the end of this part II of this Special Analyses section for the status of the PRA submission for Form 5471. As described in the Special Analyses section the preamble to the section 245A(e) final regulations, and as set forth in the chart below, the IRS estimates the number of affected filers to be 2,000.

Pursuant to §1.6038-5, certain U.S. shareholders of a CFC must provide information relating to the CFC and the U.S. shareholder's GILTI inclusion under section 951A on new Form 8992, "U.S. Shareholder Calculation of Global Intangible Low-Taxed Income (GILTI)," (OMB control number 1545-0123), as the form or other guidance may prescribe. The proposed regulations do not impose any additional information collection requirements relating to section 951A. However, the proposed regulations provide guidance regarding computations required under section 951A for taxpayers who engaged in certain transactions during the disqualified period, and such guidance could affect the information required to be reported by these taxpayers on Form 8992. For purposes of the PRA, the reporting burden associated with the collection of information under §1.6038-5 is reflected in the PRA submission for Form 8992. See the chart at the end of this part II of this Special Analyses section for the status of the PRA submission for Form 8992. As discussed in the Special Analyses section of the preamble to the proposed regulations under section 951A (REG-104390-18, 83 FR 51072), and as set forth in the chart below, the IRS estimates the number of

filers subject to §1.6038-5 to be 25,000 to 35,000. Since the proposed regulations only apply to taxpayers who engaged in certain transactions during the disqualified period, the IRS estimates that the number of filers affected by the proposed regulations and subject to the collection of infor-

mation in §1.6038-5 will be significantly less than 25,000 to 35,000.

There is no existing collection of information relating to conduit financing arrangements, and the proposed regulations do not impose any new information collection requirements relating to conduit

financing arrangements. Therefore, a PRA analysis is not required with respect to the proposed regulations relating to conduit financing arrangements.

As a result, the IRS estimates the number of filers affected by these proposed regulations to be the following.

Tax Forms Impacted	Number of respondents (estimated, rounded to nearest 1,000)	Forms in which information may be collected
<b>Collection of information</b>		
§1.6038-2(f)(14)	2,000	Form 5471 (Schedule I)
§1.6038-5	25,000 – 35,000	Form 8992

Source: IRS data (MeF, DCS, and Compliance Data Warehouse)

The current status of the PRA submissions related to the tax forms associated with the information collections in §§1.6038-2(f)(14) and 1.6038-5 is provided in the accompanying table. The reporting burdens associated with the information collections in §§1.6038-2(f)(14) and 1.6038-5 are included in the aggregated burden estimates for OMB control number 1545-0123, which represents a total estimated burden time for all forms and schedules for corporations of 3.157 billion hours and total estimated monetized costs of \$58.148 billion (\$2017). The overall burden estimates provided in 1545-0123 are aggregate amounts that relate to the entire package of forms associated with the OMB control num-

ber, and are therefore not accurate for future calculations needed to assess the burden specific to certain regulations, such as the information collections under §1.6038-2(f)(14) or §1.6038-5. No burden estimates specific to the proposed regulations are currently available. The Treasury Department and the IRS have not identified any burden estimates, including those for new information collections, related to the requirements under the proposed regulations. The Treasury Department and the IRS estimate PRA burdens on a taxpayer-type basis rather than a provision-specific basis. Changes in those estimates will capture both changes made by the Act and those that

arise out of discretionary authority exercised in the proposed regulations.

The Treasury Department and the IRS request comments on all aspects of information collection burdens related to the proposed regulations, including estimates for how much time it would take to comply with the paperwork burdens related to the forms described and ways for the IRS to minimize the paperwork burden. Proposed revisions (if any) to these forms that reflect the information collections related to the proposed regulations will be made available for public comment at <https://apps.irs.gov/app/picklist/list/draftTaxForms.html> and will not be finalized until after these forms have been approved by OMB under the PRA.

Form	Type of Filer	OMB Number(s)	Status
Form 5471	Business (NEW Model)	1545-0123	Published in the Federal Register on 9/30/19 (84 FR 51718). Public Comment period closed on 11/29/19. Approved by OMB through 1/31/2021. Link: <a href="https://www.federalregister.gov/documents/2019/09/30/2019-21068/proposed-collection-comment-request-for-forms-1065-1066-1120-1120-c-1120-f-1120-h-1120-nd-1120-s">https://www.federalregister.gov/documents/2019/09/30/2019-21068/proposed-collection-comment-request-for-forms-1065-1066-1120-1120-c-1120-f-1120-h-1120-nd-1120-s</a>
	Individual (NEW Model)	1545-0074	Published in the Federal Register on 9/30/19 (84 FR 51712). Public Comment period closed on 11/29/19. Approved by OMB through 1/31/2021. Link: <a href="https://www.federalregister.gov/documents/2019/09/30/2019-21066/proposed-collection-comment-request-for-form-1040-form-1040nr-form-1040nr-ez-form-1040x-1040-sr-and-u">https://www.federalregister.gov/documents/2019/09/30/2019-21066/proposed-collection-comment-request-for-form-1040-form-1040nr-form-1040nr-ez-form-1040x-1040-sr-and-u</a>
Form 8992	Business (NEW Model)	1545-0123	Published in the Federal Register on 9/30/19 (84 FR 51718). Public Comment period closed on 11/29/19. Approved by OMB through 1/31/2021. Link: <a href="https://www.federalregister.gov/documents/2019/09/30/2019-21068/proposed-collection-comment-request-for-forms-1065-1066-1120-1120-c-1120-f-1120-h-1120-nd-1120-s">https://www.federalregister.gov/documents/2019/09/30/2019-21068/proposed-collection-comment-request-for-forms-1065-1066-1120-1120-c-1120-f-1120-h-1120-nd-1120-s</a>

### III. Regulatory Flexibility Act

It is hereby certified that this notice of proposed rulemaking will not have a sig-

nificant economic impact on a substantial number of small entities within the meaning of section 601(6) of the Regulatory Flexibility Act (5 U.S.C. chapter 6).

These proposed regulations, if finalized, would amend certain computations required under section 245A(e) or section 951A. As discussed in the Special

Analyses accompanying the preambles to the section 245A(e) final regulations and the proposed regulations under section 951A (REG-104390-18, 83 FR 51072), as well as in this part III of the Special Analyses, the Treasury Department and the IRS project that a substantial number of domestic small business entities will not be subject to sections 245A(e) and 951A, and therefore, the existing requirements in §§1.6038-2(f)(14) and 1.6038-5 will not have a significant economic impact on a substantial number of small entities.

The small entities that are subject to section 245A(e) and §1.6038-2(f)(14) are controlling U.S. shareholders of a CFC that engage in a hybrid arrangement, and the small entities that are subject to section 951A and §1.6038-5 are U.S. shareholders of a CFC. A CFC is a foreign corporation in which more than 50 percent of its stock is owned by U.S. shareholders, measured either by value or voting power. A U.S. shareholder is any U.S. person that owns 10 percent or more of a foreign corporation's stock, measured either by value or voting power, and a controlling U.S. shareholder of a CFC is a U.S. person that owns more than 50 percent of the CFC's stock.

The Treasury Department and the IRS estimate that there are only a small number of taxpayers having gross receipts below either \$25 million (or \$41.5 million for financial entities) who would potentially be affected by these regulations.<sup>8</sup> Our estimate of those entities who could potentially be affected is based on our review of those taxpayers who filed a domestic corporate income tax return in 2016 with gross receipts below either \$25 million (or \$41.5 million for financial institutions) who also reported dividends on a Form 5471. The Treasury Department and the IRS estimate that the number of small entities potentially affected by these regulations will be between 1 and 6 percent of all affected entities regardless of size.

The Treasury Department and the IRS cannot readily identify from these data amounts that are received pursuant to hybrid arrangements because those amounts are not separately reported on tax forms.

Thus, dividends received as reported on Form 5471 are an upper bound on the amount of hybrid arrangements by these taxpayers.

The Treasury Department and the IRS estimated the upper bound of the relative cost of the statutory and regulatory hybrids provisions, as a percentage of revenue, for these taxpayers as (i) the statutory tax rate of 21 percent multiplied by dividends received as reported on Form 5471, divided by (ii) the taxpayer's gross receipts. Based on this calculation, the Treasury Department and the IRS estimate that the upper bound of the relative cost of these statutory and regulatory provisions is above 3 percent for more than half of the small entities described in the preceding paragraph. Because this estimate is an upper bound, a smaller subset of these taxpayers (including potentially zero taxpayers) is likely to have a cost above three percent of gross receipts.

Notwithstanding this certification, the Treasury Department and IRS invite comments about the impact this proposal may have on small entities.

Pursuant to section 7805(f) of the Code, this notice of proposed rulemaking has been submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

### Comments and Requests for Public Hearing

Before the proposed regulations are adopted as final regulations, consideration will be given to any comments that are submitted timely to the IRS as prescribed in this preamble under the "ADDRESS-ES" heading. The Treasury Department and the IRS request comments on all aspects of the proposed rules.

All comments will be available at [www.regulations.gov](http://www.regulations.gov) or upon request. A public hearing will be scheduled if requested in writing by any person that timely submits written comments. If a public hearing is scheduled, then notice of the date, time, and place for the public hearing will be published in the **Federal Register**.

### Drafting Information

The principal authors of these regulations are Shane M. McCarrick and Richard F. Owens of the Office of Associate Chief Counsel (International). However, other personnel from the Treasury Department and the IRS participated in their development.

### List of Subjects in 26 CFR Part 1

Income taxes, Reporting and record-keeping requirements.

### Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

#### PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 \* \* \*

Par. 2. Section 1.245A(e)-1 is amended by:

1. Adding paragraphs (d)(4)(i)(B) and (d)(4)(ii).
2. Adding a sentence at the end of the introductory text of paragraph (g).
3. Adding paragraphs (g)(1)(v) and (h)(2).

The additions read as follows:

*§1.245A(e)-1 Special rules for hybrid dividends.*

\* \* \* \* \*

(d) \* \* \*

(4) \* \* \*

(i) \* \* \*

(B) Second, the account is decreased (but not below zero) pursuant to the rules of paragraphs (d)(4)(i)(B)(I) through (3) of this section, in the order set forth in this paragraph (d)(4)(i)(B).

(I) *Adjusted subpart F inclusions*—(i) *In general*. Subject to the limitation in paragraph (d)(4)(i)(B)(I)(ii) of this section, the account is reduced by an adjusted subpart F inclusion with respect to the share for the taxable year, as determined pursuant to the rules of paragraph (d)(4)(ii) of this section.

<sup>8</sup>This estimate is limited to those taxpayers who report gross receipts above \$0.

(ii) *Limitation.* The reduction pursuant to paragraph (d)(4)(i)(B)(1)(i) of this section cannot exceed the hybrid deductions of the CFC allocated to the share for the taxable year multiplied by a fraction, the numerator of which is the subpart F income of the CFC for the taxable year and the denominator of which is the taxable income (as determined under §1.952-2(b)) of the CFC for the taxable year. However, if the denominator of the fraction would be zero or less, then the fraction is considered to be zero.

(iii) *Special rule allocating reductions across accounts in certain cases.* This paragraph (d)(4)(i)(B)(1)(iii) applies after each of the specified owner's hybrid deduction accounts with respect to its shares of stock of the CFC are adjusted pursuant to paragraph (d)(4)(i)(B)(1)(i) of this section but before the accounts are adjusted pursuant to paragraph (d)(4)(i)(B)(2) of this section, to the extent that one or more of the hybrid deduction accounts would have been reduced by an amount pursuant to paragraph (d)(4)(i)(B)(1)(i) of this section but for the limitation in paragraph (d)(4)(i)(B)(1)(ii) of this section (the aggregate of the amounts that would have been reduced but for the limitation, the *excess amount*, and the accounts that would have been reduced by the excess amount, the *excess amount accounts*). When this paragraph (d)(4)(i)(B)(1)(iii) applies, the specified owner's hybrid deduction accounts other than the excess amount accounts (if any) are ratably reduced by the lesser of the excess amount and the difference of the following two amounts: the hybrid deductions of the CFC allocated to the specified owner's shares of stock of the CFC for the taxable year multiplied by the fraction described in paragraph (d)(4)(i)(B)(1)(ii) of this section; and the reductions pursuant to paragraph (d)(4)(i)(B)(1)(i) of this section with respect to the specified owner's shares of stock of the CFC.

(2) *Adjusted GILTI inclusions—(i) In general.* Subject to the limitation in paragraph (d)(4)(i)(B)(2)(ii) of this section, the account is reduced by an adjusted GILTI inclusion with respect to the share for the taxable year, as determined pursuant to the rules of paragraph (d)(4)(ii) of this section.

(ii) *Limitation.* The reduction pursuant to paragraph (d)(4)(i)(B)(2)(i) of this sec-

tion cannot exceed the hybrid deductions of the CFC allocated to the share for the taxable year multiplied by a fraction, the numerator of which is the tested income of the CFC for the taxable year and the denominator of which is the taxable income (as determined under §1.952-2(b)) of the CFC for the taxable year. However, if the denominator of the fraction would be zero or less, then the fraction is considered to be zero.

(iii) *Special rule allocating reductions across accounts in certain cases.* This paragraph (d)(4)(i)(B)(2)(iii) applies after each of the specified owner's hybrid deduction accounts with respect to its shares of stock of the CFC are adjusted pursuant to paragraph (d)(4)(i)(B)(2)(i) of this section but before the accounts are adjusted pursuant to paragraph (d)(4)(i)(B)(3) of this section, to the extent that one or more of the hybrid deduction accounts would have been reduced by an amount pursuant to paragraph (d)(4)(i)(B)(2)(i) of this section but for the limitation in paragraph (d)(4)(i)(B)(2)(ii) of this section (the aggregate of the amounts that would have been reduced but for the limitation, the *excess amount*, and the accounts that would have been reduced by the excess amount, the *excess amount accounts*). When this paragraph (d)(4)(i)(B)(2)(iii) applies, the specified owner's hybrid deduction accounts other than the excess amount accounts (if any) are ratably reduced by the lesser of the excess amount and the difference of the following two amounts: the hybrid deductions of the CFC allocated to the specified owner's shares of stock of the CFC for the taxable year multiplied by the fraction described in paragraph (d)(4)(i)(B)(2)(ii) of this section; and the reductions pursuant to paragraph (d)(4)(i)(B)(2)(i) of this section with respect to the specified owner's shares of stock of the CFC.

(3) *Certain section 956 inclusions.* The account is reduced by an amount included in the gross income of a domestic corporation under sections 951(a)(1)(B) and 956 with respect to the share for the taxable year of the domestic corporation in which or with which the CFC's taxable year ends, to the extent so included by reason of the application of section 245A(e) and this section to the hypothetical distribution described in §1.956-1(a)(2).

\* \* \* \* \*

(ii) *Rules regarding adjusted subpart F and GILTI inclusions.* (A) The term *adjusted subpart F inclusion* means, with respect to a share of stock of a CFC for a taxable year of the CFC, a domestic corporation's pro rata share of the CFC's subpart F income included in gross income under section 951(a)(1)(A) for the taxable year of the domestic corporation in which or with which the CFC's taxable year ends, to the extent attributable to the share (as determined under the principles of section 951(a)(2) and §1.951-1(b) and (e)), adjusted by—

(1) Adding to the amount the associated foreign income taxes with respect to the amount; and

(2) Subtracting from such sum the quotient of the associated foreign income taxes divided by the percentage described in section 11(b).

(B) The term *adjusted GILTI inclusion* means, with respect to a share of stock of a CFC for a taxable year of the CFC, a domestic corporation's GILTI inclusion amount (within the meaning of §1.951A-1(c)(1)) for the U.S. shareholder inclusion year (within the meaning of §1.951A-1(f)(7)), to the extent attributable to the share (as determined under paragraph (d)(4)(ii)(C) of this section), adjusted by—

(1) Adding to the amount the associated foreign income taxes with respect to the amount;

(2) Multiplying such sum by the difference of 100 percent and the percentage described in section 250(a)(1)(B); and

(3) Subtracting from such product the quotient of 80 percent of the associated foreign income taxes divided by the percentage described in section 11(b).

(C) A domestic corporation's GILTI inclusion amount for a U.S. shareholder inclusion year is attributable to a share of stock of the CFC based on a fraction—

(1) The numerator of which is the domestic corporation's pro rata share of the tested income of the CFC for the U.S. shareholder inclusion year, to the extent attributable to the share (as determined under the principles of §1.951A-1(d)(2)); and

(2) The denominator of which is the aggregate of the domestic corporation's pro rata share of the tested income of

each tested income CFC (as defined in §1.951A-2(b)(1)) for the U.S. shareholder inclusion year.

(D) The term *associated foreign income taxes* means—

(1) With respect to a domestic corporation's pro rata share of the subpart F income of the CFC included in gross income under section 951(a)(1)(A) and attributable to a share of stock of a CFC for a taxable year of the CFC, current year tax (as described in §1.960-1(b)(4)) allocated and apportioned under §1.960-1(d)(3)(ii) to the subpart F income groups (as described in §1.960-1(b)(30)) of the CFC for the taxable year, to the extent allocated to the share under paragraph (d)(4)(ii)(E) of this section; and

(2) With respect to a domestic corporation's GILTI inclusion amount under section 951A attributable to a share of stock of a CFC for a taxable year of the CFC, current year tax (as described in §1.960-1(b)(4)) allocated and apportioned under §1.960-1(d)(3)(ii) to the tested income groups (as described in §1.960-1(b)(33)) of the CFC for the taxable year, to the extent allocated to the share under paragraph (d)(4)(ii)(F) of this section, multiplied by the domestic corporation's inclusion percentage (as described in §1.960-2(c)(2)).

(E) Current year tax allocated and apportioned to a subpart F income group of a CFC for a taxable year is allocated to a share of stock of the CFC by multiplying the foreign income tax by a fraction—

(1) The numerator of which is the domestic corporation's pro rata share of the subpart F income of the CFC for the taxable year, to the extent attributable to the share (as determined under the principles of section 951(a)(2) and §1.951-1(b) and (e)); and

(2) The denominator of which is the subpart F income of the CFC for the taxable year.

(F) Current year tax allocated and apportioned to a tested income group of a CFC for a taxable year is allocated to a share of stock of the CFC by multiplying the foreign income tax by a fraction—

(1) The numerator of which is the domestic corporation's pro rata share of tested income of the CFC for the taxable year, to the extent attributable to the

share (as determined under the principles §1.951A-1(d)(2)); and

(2) The denominator of which is the tested income of the CFC for the taxable year.

\* \* \* \* \*

(g) \* \* \* No amounts are included in the gross income of US1 under sections 951(a)(1)(A), 951(a), or 951(a)(1)(B) and 956.

(1) \* \* \*

(v) *Alternative facts – account reduced by adjusted GILTI inclusion.* The facts are the same as in paragraph (g)(1)(i) of this section, except that for taxable year 1 FX has \$130x of gross tested income and \$10.5x of current year tax (as described in §1.960-1(b)(4)) that is allocated and apportioned under §1.960-1(d)(3)(ii) to the tested income groups of FX. In addition, FX has \$119.5x of tested income (\$130x of gross tested income, less the \$10.5x of current year tax deductions properly allocable to the gross tested income). Further, of US1's pro rata share of the tested income (\$119.5x), \$80x is attributable to Share A and \$39.5x is attributable to Share B (as determined under the principles of §1.951A-1(d)(2)). Moreover, US1's net deemed tangible income return (as defined in §1.951A-1(c)(3)) for taxable year 1 is \$71.7x, and US1 does not own any stock of a CFC other than its stock of FX. Thus, US1's GILTI inclusion amount (within the meaning of §1.951A-1(c)(1)) for taxable year 1, the U.S. shareholder inclusion year, is \$47.8x (net CFC tested income of \$119.5x, less net deemed tangible income return of \$71.7x) and US1's inclusion percentage (as described in §1.960-2(c)(2)) is 40% (\$47.8x/\$119.5x). At the end of year 1, US1's hybrid deduction account with respect to Share A is: first, increased by \$80x (the amount of hybrid deductions allocated to Share A); and second, decreased by \$10x (the sum of the adjusted GILTI inclusion with respect to Share A, and the adjusted GILTI inclusion with respect to Share B that is allocated to the hybrid deduction account with respect to Share A) to \$70x. See paragraphs (d)(4)(i)(A) and (B) of this section. In year 2, the entire \$30x of each dividend received by US1 from FX during year 2 is a hybrid dividend, because the sum of US1's hy-

brid deduction accounts with respect to each of its shares of FX stock at the end of year 2 (\$70x) is at least equal to the amount of the dividends (\$60x). See paragraph (b)(2) of this section. At the end of year 1, US1's hybrid deduction account with respect to Share A is decreased by \$60x (the amount of the hybrid deductions in the account that give rise to a hybrid dividend or tiered hybrid dividend during year 1) to \$10x. See paragraph (d)(4)(i)(C) of this section. Paragraphs (g)(1)(v)(A) through (C) of this section describe the computations pursuant to paragraph (d)(4)(i)(B)(2) of this section.

(A) To determine the adjusted GILTI inclusion with respect to Share A for taxable year 1, it must be determined to what extent US1's \$47.8x GILTI inclusion amount is attributable to Share A. See paragraph (d)(4)(ii)(B) of this section. Here, \$32x of the inclusion is attributable to Share A, calculated as \$47.8x multiplied by a fraction, the numerator of which is \$80x (US1's pro rata share of the tested income of FX attributable to Share A) and denominator of which is \$119.5x (US1's pro rata share of the tested income of FX, its only CFC). See paragraph (d)(4)(ii)(C) of this section. Next, the associated foreign income taxes with respect to the \$32x GILTI inclusion amount attributable to Share A must be determined. See paragraphs (d)(4)(ii)(B) and (D) of this section. Such associated foreign income taxes are \$2.8x, calculated as \$10.5x (the current year tax allocated and apportioned to the tested income groups of FX) multiplied by a fraction, the numerator of which is \$80x (US1's pro rata share of the tested income of FX attributable to Share A) and the denominator of which is \$119.5x (the tested income of FX), multiplied by 40% (US1's inclusion percentage). See paragraphs (d)(4)(ii)(D) and (F) of this section. Thus, pursuant to paragraph (d)(4)(ii)(B) of this section, the adjusted GILTI inclusion with respect to Share A is \$6.7x, computed by—

(1) Adding \$2.8x (the associated foreign income taxes with respect to the \$32x GILTI inclusion attributable to Share A) to \$32x, which is \$34.8x;

(2) Multiplying \$34.8x (the sum of the amounts in paragraph (g)(1)(v)(A)(1) of this section) by 50% (the difference of

100 percent and the percentage described in section 250(a)(1)(B)), which is \$17.4x; and

(3) Subtracting \$10.7x (calculated as \$2.24x (80% of the \$2.8x of associated foreign income taxes) divided by .21 (the percentage described in section 11(b)) from \$17.4x (the product of the amounts in paragraph (g)(1)(v)(A)(2) of this section), which is \$6.7x.

(B) Pursuant to computations similar to those discussed in paragraph (g)(1)(v)(A) of this section, the adjusted GILTI inclusion with respect to Share B is \$3.3x. However, the hybrid deduction account with respect to Share B is not reduced by such \$3.3x, because of the limitation in paragraph (d)(4)(i)(B)(2)(ii) of this section, which, with respect to Share B, limits the reduction pursuant to paragraph (d)(4)(i)(B)(2)(i) of this section to \$0 (calculated as \$0, the hybrid deductions allocated to the share for the taxable year, multiplied by 1, the fraction described in paragraph (d)(4)(i)(B)(2)(ii) of this section (computed as the \$119.5x of tested income divided by the \$119.5x of taxable income)). See paragraphs (d)(4)(i)(B)(2)(i) and (ii) of this section.

(C) US1's hybrid deduction account with respect to Share A is reduced by the entire \$6.7x adjusted GILTI inclusion with respect to the share, as such \$6.7x does not exceed the limit in paragraph (d)(4)(i)(B)(2)(ii) of this section (\$80x, calculated as \$80x, the hybrid deductions allocated to the share for the taxable year, multiplied by 1, the fraction described in paragraph (d)(4)(i)(B)(2)(ii) of this section). See paragraphs (d)(4)(i)(B)(2)(i) and (ii) of this section. In addition, the hybrid deduction account is reduced by another \$3.3x, the amount of the adjusted GILTI inclusion with respect to Share B that is allocated to the hybrid deduction account with respect to Share A. See paragraph (d)(4)(i)(B)(2)(iii) of this section. As a result, pursuant to paragraph (d)(4)(i)(B)(2) of this section, US1's hybrid deduction account with respect to Share A is reduced by \$10x (\$6.7x plus \$3.3x).

\*\*\*\*\*

(h) \*\*\*

(2) *Special rules.* Paragraphs (d)(4)(i)(B) and (d)(4)(ii) of this section (decrease

of hybrid deduction accounts; rules regarding adjusted subpart F and GILTI inclusions) apply to taxable years ending on or after [date of publication of the final regulations in the **Federal Register**]. However, a taxpayer may apply those paragraphs to taxable years ending before that date, so long as the taxpayer consistently applies paragraphs (d)(4)(i)(B) and (d)(4)(ii) to those taxable years.

Par. 3. Section 1.881-3 is amended by:

1. Adding a sentence at the end of paragraph (a)(1).

2. Revising paragraph (a)(2)(i)(C).

3. In paragraph (a)(2)(ii)(B)(I) introductory text, removing "one of the following" and adding "one or more of the following" in its place.

4. In paragraph (a)(2)(ii)(B)(I)(ii), removing the word "or" at the end of the paragraph.

5. In paragraph (a)(2)(ii)(B)(I)(iii), removing the period at the end and adding a semicolon in its place.

6. Adding paragraphs (a)(2)(ii)(B)(I)(iv) and (v) and (d)(1)(iii).

7. Adding a sentence at the end of paragraph (e) introductory text.

8. In paragraph (e), designating Examples 1 through 26 as paragraphs (e)(1) through (26), respectively.

9. In newly designated paragraph (e)(3), removing "Example 2" and "\$301.7701-3" and adding "paragraph (e)(2) of this section (the facts in Example 2)" and "\$301.7701-3 of this chapter" in their places, respectively.

10. Redesignating newly designated paragraphs (e)(4) through (26) as paragraphs (e)(6) through (28), respectively.

11. Adding new paragraphs (e)(4) and (5);

12. In newly redesignated paragraph (e)(9)(ii), removing "(a)(4)(i)" and adding "(a)(4)(i) of this section" in its place.

13. In newly redesignated paragraph (e)(23)(i), removing "Example 20" and adding "paragraph (e)(22) of this section (the facts in Example 22)" in its place.

14. In newly redesignated paragraph (e)(23)(ii), removing "Example 19" and "paragraph (i) of this Example 21" and adding "paragraph (e)(21) of this section (Example 21)" and "paragraph (e)(23)(i) of this section (this Example 23)" in their places, respectively.

15. In newly redesignated paragraph (e)(25)(i), removing "Example 22" and adding "paragraph (e)(24) of this section (the facts in Example 24)" in its place.

16. In newly redesignated paragraph (e)(26)(i), removing "Example 22" and adding in its place "paragraph (e)(24) of this section (the facts in Example 24)".

17. Adding paragraph (e)(29).

18. In paragraph (f):

i. Revising the paragraph heading.

ii. Removing "Paragraph (a)(2)(i)(C) and Example 3 of paragraph (e) of this section" and adding "Paragraphs (a)(2)(i)(C) and (e)(3) of this section" in its place.

iii. Adding a sentence at the end of the paragraph.

The additions and revision read as follows:

*§1.881-3 Conduit financing arrangements.*

(a) \*\*\*

(1) \*\*\* See §1.1471-3(f)(5) for the application of a conduit transaction for purposes of sections 1471 and 1472. See also §§1.267A-1 and 1.267A-4 (disallowing a deduction for certain interest or royalty payments to the extent the income attributable to the payment is offset by a deduction with respect to equity).

(2) \*\*\*

(i) \*\*\*

(C) *Treatment of disregarded entities.*

For purposes of this section, the term person includes a business entity that is disregarded as an entity separate from its single member owner under §§301.7701-1 through 301.7701-3 of this chapter and therefore such entity may be treated as a party to a financing transaction with its owner.

(ii) \*\*\*

(B) \*\*\*

(I) \*\*\*

(iv) The issuer is allowed a deduction or another tax benefit (such as an exemption, exclusion, credit, or a notional deduction determined with respect to the stock or similar interest) for amounts paid, accrued, or distributed (deemed or otherwise) with respect to the stock or similar interest, either under the laws of the issuer's country of residence or a country in which the issuer has a taxable presence, such as a permanent establishment, to

which a payment on a financing transaction is attributable; or

(v) A person related to the issuer is, under the tax laws of the issuer's country of residence, allowed a refund (including through a credit), or similar tax benefit for taxes paid by the issuer to its country of residence on amounts paid, accrued, or distributed (deemed or otherwise) with respect to the stock or similar interest, without regard to any related person's tax liability under the laws of the issuer's country of residence.

\*\*\*\*\*

(d) \*\*\*

(1) \*\*\*

(iii) *Limitation for certain types of stock.* If a financing transaction linking one of the parties to the financing arrangement is stock (or a similar interest in a partnership, trust, or other person) described in paragraph (a)(2)(ii)(B)(I)(iv) of this section, and the issuer is allowed a notional interest deduction with respect to its stock or similar interest (under the laws of its country of residence or another country in which it has a place of business or permanent establishment), the portion of the payment made by the financed entity that is recharacterized under paragraph (d)(1)(i) of this section attributable to such financing transaction will not exceed the financing transaction's principal amount as determined under paragraph (d)(1)(ii) of this section multiplied by the rate used to compute the issuer's notional interest deduction for the taxable year in which the payment is made.

\*\*\*\*\*

(e) *Examples.* \*\*\* For purposes of these examples, unless otherwise indicated, it is assumed that no stock is of the types described in paragraph (a)(2)(ii)(B)(I)(iv) or (v) of this section.

\*\*\*\*\*

(4) *Example 4. Hybrid instrument as financing arrangement.* The facts are the same as in paragraph (e)(2) of this section (the facts in *Example 2*), except that FP assigns the DS note to FS in exchange for stock issued by FS. The stock issued by FS is in form convertible debt with a 49-year term that is treated as debt under the tax laws of Country T. The FS stock is not subject to any of the redemption, acquisition, or payment rights or requirements specified in paragraphs (a)(2)(ii)(B)(I)(i) through (iii) of this section. Because the FS stock gives rise to a deduction under the tax laws of Country T, the FS stock is a financing transaction under paragraph (a)(2)(ii)(B)(I)(iv) of this section. Therefore, the DS note held by

FS and the FS stock held by FP are financing transactions within the meaning of paragraphs (a)(2)(ii)(A)(I) and (2) of this section, respectively, and together constitute a financing arrangement within the meaning of paragraph (a)(2)(i) of this section. See also §1.267A-4 for rules applicable to disqualified imported mismatch amounts.

(5) *Example 5. Refundable tax credit treated as financing transaction.* FS lends \$1,000,000 to DS in exchange for a note issued by DS. Additionally, Country T has a regime whereby FP, as the sole shareholder of FS, is allowed a refund with respect to distributions of earnings by FS that is equal to 90% of the Country T taxes paid by FS associated with any such distributed earnings. FP is not itself subject to Country T tax on distributions from FS. The loan from FS to DS is a financing transaction within the meaning of paragraph (a)(2)(ii)(A)(I) of this section. FP's stock in FS constitutes a financing transaction within the meaning of paragraph (a)(2)(ii)(B)(I)(v) of this section because FP, a person related to FS, is allowed a refund of FS's Country T taxes even though FP is not subject to Country T tax on such payments. Together, the FS stock held by FP and the DS note held by FS constitute a financing arrangement within the meaning of paragraph (a)(2)(i) of this section.

\*\*\*\*\*

(29) *Example 29. Amount of payment subject to recharacterization.* (i) FP lends \$10,000,000 to FS in exchange for a ten-year note with a stated interest rate of 6%. FP also contributes \$5,000,000 to FS in exchange for FS stock. Pursuant to Country T tax law, FS is entitled to a notional interest deduction with respect to the stock equal to the prevailing Country T government bond rate multiplied by the taxpayer's net equity for the previous taxable year. FS, pursuant to a tax avoidance plan, lends \$20,000,000 to DS in exchange for a note that pays 8% interest annually. DS makes its first \$1,600,000 payment on this note in year X, when the prevailing Country T bond rate is 1%.

(ii) Both the note and the stock issued by FS to FP are financing transactions. The note is an advance of money under paragraph (a)(2)(i)(A) of this section. The stock is described in paragraph (a)(2)(ii)(A)(2) of this section, by reason of paragraph (a)(2)(ii)(B)(I)(iv) of this section, because Country T law entitles FS to a notional interest deduction with respect to its stock. The note issued by DS is also financing transaction by reason of paragraph (a)(2)(ii)(A)(I) of this section. Accordingly, FP is advancing money and DS receives money, effected through FS an intermediary entity, and the receipt and advance are effected through financing transactions (that is, the FS note, FS stock, and the DS note linking all three entities). As such, the arrangement may be treated as a financing arrangement. See paragraph (a)(2)(i)(A) of this section. FP is the financing entity, FS is the intermediate entity, and DS is the financed entity. The aggregate principal amount of financing transactions linking DS to the financing arrangement (\$20,000,000) is greater than the aggregate principal amount of the financing transactions linking FP to the financing arrangement (\$15,000,000). Therefore, under paragraph (d)(1)(i) of this section, the amount of DS's payment recharacterized as a payment directly between DS and FP would be \$1,200,000

(\$1,600,000 x \$15,000,000 / \$20,000,000) prior to the application of paragraph (d)(1)(iii) of this section. However, of the \$1,200,000 subject to re-characterization, \$400,000 (\$1,200,000 x \$5,000,000 / \$15,000,000) is attributable to NID stock and thus subject to the limitation in paragraph (d)(1)(iii) of this section. Thus, only \$50,000 (\$5,000,000 x 1%) of the \$400,000 may be recharacterized as a transaction between DS and FP. The remaining \$800,000 is not subject to the limitation in paragraph (d)(1)(iii) of this section because it is not attributable to stock that entitles the issuer to a notional interest deduction. Accordingly, only \$850,000 of DS's payment is recharacterized as going directly from DS to FP. See also §1.267A-4 for rules applicable to disqualified imported mismatch amounts.

(f) *Applicability date.* \*\*\* Paragraphs (a)(2)(ii)(B)(I)(iv) and (v) and (d)(1)(iii) of this section apply to payments made on or after [date of publication of the final regulations in the **Federal Register**].

Par. 4. Section 1.951A-0, as proposed to be amended at 84 FR 29114 (June 21, 2019), is further amended by adding entries for §1.951A-2(c)(6), (c)(6)(i) and (ii), (c)(6)(ii)(A) through (C), (c)(6)(iii), (c)(6)(iv), (c)(6)(iv)(A), (c)(6)(iv)(A)(I) and (2), (c)(6)(iv)(B), (c)(6)(iv)(B)(I) and (2), (c)(7), (c)(7)(i) and (ii), (c)(7)(ii)(A), (c)(7)(ii)(A)(I) and (2), (c)(7)(ii)(B), (c)(7)(iii) through (v), (c)(7)(v)(A) through (D), (c)(7)(v)(D)(I) and (2), (c)(7)(v)(D)(2)(i) and (ii), (c)(7)(v)(E), (c)(7)(v)(E)(I) and (2), (c)(7)(vi), (c)(7)(vi)(A), (c)(7)(vi)(A)(I) and (2), and (c)(7)(vi)(B) and §1.951A-7(d) to read as follows:

§1.951A-0 *Outline of section 951A regulations.*

\*\*\*\*\*

§1.951A-2 *Tested income and tested loss.*

\*\*\*\*\*

(c) \*\*\*

(6) Allocation of deductions attributable to certain disqualified payments.

(i) In general.

(ii) Definitions related to disqualified payment.

(A) Disqualified payment.

(B) Disqualified period.

(C) Related recipient CFC.

(iii) Treatment of partnerships.

(iv) Examples.

(A) Example 1: Deduction related directly to disqualified payment to related recipient CFC.

(I) Facts.

(2) Analysis.

(B) Example 2: Deduction related indirectly to disqualified payment to partner-

ship in which related recipient CFC is a partner.

(1) Facts.

(2) Analysis.

(7) Election for application of high tax exception of section 954(b)(4).

(i) In general.

(ii) Definitions.

(A) Tentative gross tested income item.

(1) In general.

(2) Income attributable to a QBU.

(B) Tentative net tested income item.

(iii) Effective rate at which taxes are imposed.

(iv) Taxes paid or accrued with respect to a tentative net tested income item.

(v) Rules regarding the election.

(A) Manner of making election.

(B) Scope of election.

(C) Duration of election.

(D) Revocation of election.

(1) In general.

(2) Limitations by reason of revocation.

(i) In general.

(ii) Exception for change of control.

(E) Rules applicable to controlling domestic shareholder groups.

(1) In general.

(2) Definition of controlling domestic shareholder group.

(vi) Example.

(A) Example: Effect of disregarded payments between QBUs.

(1) Facts.

(2) Analysis.

(B) [Reserved]

\*\*\*\*\*

*§1.951A-7 Applicability dates.*

\*\*\*\*\*

(d) Deduction for certain disqualified payments.

Par. 5. Section 1.951A-2, as proposed to be amended at 84 FR 29114 (June 21, 2019), is further amended by redesignating paragraph (c)(6) as paragraph (c)(7) and adding a new paragraph (c)(6) and a reserved paragraph (c)(7)(vi)(B) to read as follows:

*§1.951A-2 Tested income and tested loss.*

\*\*\*\*\*

(c)\*\*\*

(6) *Allocation of deductions attributable to certain disqualified payments—(i) In general.* A deduction related directly or indirectly to a disqualified payment is

allocated or apportioned solely to residual CFC gross income, and any deduction related to a disqualified payment is not properly allocable to property produced or acquired for resale under section 263, section 263A, or section 471.

(ii) *Definitions related to disqualified payment.* The following definitions apply for purposes of this paragraph (c)(6).

(A) *Disqualified payment.* The term *disqualified payment* means a payment made by a person to a related recipient CFC during the disqualified period with respect to the related recipient CFC, to the extent the payment would constitute income described in section 951A(c)(2)(A)(i) and paragraph (c)(1) of this section without regard to whether section 951A applies.

(B) *Disqualified period.* The term *disqualified period* has the meaning provided in §1.951A-3(h)(2)(ii)(C)(1), substituting “related recipient CFC” for “transferor CFC.”

(C) *Related recipient CFC.* The term *related recipient CFC* means, with respect to a payment by a person, a recipient of the payment that is a controlled foreign corporation that bears a relationship to the payor described in section 267(b) or 707(b) immediately before or after the payment.

(iii) *Treatment of partnerships.* For purposes of determining whether a payment is made by a person to a related recipient CFC for purposes of paragraph (c)(6)(ii)(A) of this section, a payment by or to a partnership is treated as made proportionately by or to its partners, as applicable.

(iv) *Examples.* The following examples illustrate the application of this paragraph (c)(6).

(A) *Example 1: Deduction related directly to disqualified payment to related recipient CFC—(1) Facts.* USP, a domestic corporation, owns all of the stock in CFC1 and CFC2, each a controlled foreign corporation. Both USP and CFC2 use the calendar year as their taxable year. CFC1 uses a taxable year ending November 30. On October 15, 2018, before the start of its first CFC inclusion year, CFC1 receives and accrues a payment from CFC2 of \$100x of prepaid royalties with respect to a license. The \$100x payment is excluded from subpart F income pursuant to section 954(c)(6) and would constitute income described in section 951A(c)(2)(A)(i) and paragraph (c)(1) of this section without regard to whether section 951A applies.

(2) *Analysis.* CFC1 is a related recipient CFC (within the meaning of paragraph (c)(6)(ii)(C) of this section) with respect to the royalty prepayment

by CFC2 because it is related to CFC2 within the meaning of section 267(b). The royalty prepayment is received by CFC1 during its disqualified period (within the meaning of paragraph (c)(6)(ii)(B) of this section) because it is received during the period beginning January 1, 2018, and ending November 30, 2018. Because it would constitute income described in section 951A(c)(2)(A)(i) and paragraph (c)(1) of this section without regard to whether section 951A applies, the payment is a disqualified payment. Accordingly, CFC2’s deductions related to such payment accrued during taxable years ending on or after April 7, 2020 are allocated or apportioned solely to residual CFC gross income under paragraph (c)(6)(i) of this section.

(B) *Example 2: Deduction related indirectly to disqualified payment to partnership in which related recipient CFC is a partner—(1) Facts.* The facts are the same as in paragraph (c)(6)(iv)(A)(1) of this section (the facts in *Example 1*), except that CFC1 and USP own 99% and 1%, respectively of FPS, a foreign partnership, which has a taxable year ending November 30. USP receives a prepayment of \$100x from CFC2 for the performance of future services. USP subcontracts the performance of these future services to FPS for which FPS receives and accrues a \$100x prepayment from USP. The services will be performed in the same country under the laws of which CFC1 and FPS are created or organized, and the \$100x prepayment is not foreign base company services income under section 954(e) and §1.954-4(a). The \$100x prepayment would constitute income described in section 951A(c)(2)(A)(i) and paragraph (c)(1) of this section without regard to whether section 951A applies.

(2) *Analysis.* CFC1 is a related recipient CFC (within the meaning of paragraph (c)(6)(ii)(C) of this section) with respect to the services prepayment by USP because, under paragraph (c)(6)(iii) of this section, it is treated as receiving \$99x (99% of \$100x) of the services prepayment from USP, and it is related to USP within the meaning of section 267(b). The services prepayment is received by CFC1 during its disqualified period (within the meaning of paragraph (c)(6)(ii)(B) of this section) because it is received during the period beginning January 1, 2018, and ending November 30, 2018. Because it would constitute income described in section 951A(c)(2)(A)(i) and paragraph (c)(1) of this section without regard to whether section 951A applies, the prepayment is a disqualified payment. CFC2’s deductions related to its prepayment to USP are indirectly related to the disqualified payment by USP. Accordingly, CFC2’s deductions related to such payment accrued during taxable years ending on or after April 7, 2020 are allocated or apportioned solely to residual CFC gross income under paragraph (c)(6)(i) of this section.

\*\*\*\*\*

Par. 6. Section 1.951A-7, as proposed to be amended at 84 FR 29114 (June 21, 2019), is further amended by adding paragraph (d) to read as follows:

*§1.951A-7 Applicability dates.*

\*\*\*\*\*

(d) *Deduction for certain disqualified payments.* Section §1.951A-2(c)(6) ap-



plies to taxable years of foreign corporations ending on or after April 7, 2020, and to taxable years of United States shareholders in which or with which such taxable years end.

Sunita Lough,  
*Deputy Commissioner for Services  
and Enforcement.*

(Filed by the Office of the Federal Register on April 7, 2020, 8:45 a.m., and published in the issue of the Federal Register for April 8, 2020, 85 F.R. 19858)

# Definition of Terms

*Revenue rulings and revenue procedures (hereinafter referred to as “rulings”) that have an effect on previous rulings use the following defined terms to describe the effect:*

*Amplified* describes a situation where no change is being made in a prior published position, but the prior position is being extended to apply to a variation of the fact situation set forth therein. Thus, if an earlier ruling held that a principle applied to A, and the new ruling holds that the same principle also applies to B, the earlier ruling is amplified. (Compare with *modified*, below).

*Clarified* is used in those instances where the language in a prior ruling is being made clear because the language has caused, or may cause, some confusion. It is not used where a position in a prior ruling is being changed.

*Distinguished* describes a situation where a ruling mentions a previously published ruling and points out an essential difference between them.

*Modified* is used where the substance of a previously published position is being changed. Thus, if a prior ruling held that a principle applied to A but not to B, and the

new ruling holds that it applies to both A and B, the prior ruling is modified because it corrects a published position. (Compare with *amplified* and *clarified*, above).

*Obsoleted* describes a previously published ruling that is not considered determinative with respect to future transactions. This term is most commonly used in a ruling that lists previously published rulings that are obsoleted because of changes in laws or regulations. A ruling may also be obsoleted because the substance has been included in regulations subsequently adopted.

*Revoked* describes situations where the position in the previously published ruling is not correct and the correct position is being stated in a new ruling.

*Superseded* describes a situation where the new ruling does nothing more than restate the substance and situation of a previously published ruling (or rulings). Thus, the term is used to republish under the 1986 Code and regulations the same position published under the 1939 Code and regulations. The term is also used when it is desired to republish in a single ruling a series of situations, names, etc., that were previously published over a period of time in separate rulings. If the

new ruling does more than restate the substance of a prior ruling, a combination of terms is used. For example, *modified* and *superseded* describes a situation where the substance of a previously published ruling is being changed in part and is continued without change in part and it is desired to restate the valid portion of the previously published ruling in a new ruling that is self contained. In this case, the previously published ruling is first modified and then, as modified, is superseded.

*Supplemented* is used in situations in which a list, such as a list of the names of countries, is published in a ruling and that list is expanded by adding further names in subsequent rulings. After the original ruling has been supplemented several times, a new ruling may be published that includes the list in the original ruling and the additions, and supersedes all prior rulings in the series.

*Suspended* is used in rare situations to show that the previous published rulings will not be applied pending some future action such as the issuance of new or amended regulations, the outcome of cases in litigation, or the outcome of a Service study.

# Abbreviations

*The following abbreviations in current use and formerly used will appear in material published in the Bulletin.*

A—Individual.  
Acq.—Acquiescence.  
B—Individual.  
BE—Beneficiary.  
BK—Bank.  
B.T.A.—Board of Tax Appeals.  
C—Individual.  
C.B.—Cumulative Bulletin.  
CFR—Code of Federal Regulations.  
CI—City.  
COOP—Cooperative.  
Ct.D.—Court Decision.  
CY—County.  
D—Decedent.  
DC—Dummy Corporation.  
DE—Donee.  
Del. Order—Delegation Order.  
DISC—Domestic International Sales Corporation.  
DR—Donor.  
E—Estate.  
EE—Employee.  
E.O.—Executive Order.  
ER—Employer.

ERISA—Employee Retirement Income Security Act.  
EX—Executor.  
F—Fiduciary.  
FC—Foreign Country.  
FICA—Federal Insurance Contributions Act.  
FISC—Foreign International Sales Company.  
FPH—Foreign Personal Holding Company.  
FR.—Federal Register.  
FUTA—Federal Unemployment Tax Act.  
FX—Foreign corporation.  
G.C.M.—Chief Counsel’s Memorandum.  
GE—Grantee.  
GP—General Partner.  
GR—Grantor.  
IC—Insurance Company.  
I.R.B.—Internal Revenue Bulletin.  
LE—Lessee.  
LP—Limited Partner.  
LR—Lessor.  
M—Minor.  
Nonacq.—Nonacquiescence.  
O—Organization.  
P—Parent Corporation.  
PHC—Personal Holding Company.  
PO—Possession of the U.S.  
PR—Partner.  
PRS—Partnership.

PTE—Prohibited Transaction Exemption.  
Pub. L.—Public Law.  
REIT—Real Estate Investment Trust.  
Rev. Proc.—Revenue Procedure.  
Rev. Rul.—Revenue Ruling.  
S—Subsidiary.  
S.P.R.—Statement of Procedural Rules.  
Stat.—Statutes at Large.  
T—Target Corporation.  
T.C.—Tax Court.  
T.D.—Treasury Decision.  
TFE—Transferee.  
TFR—Transferor.  
T.I.R.—Technical Information Release.  
TP—Taxpayer.  
TR—Trust.  
TT—Trustee.  
U.S.C.—United States Code.  
X—Corporation.  
Y—Corporation.  
Z—Corporation.

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<sup>1</sup> A cumulative list of all revenue rulings, revenue procedures, Treasury decisions, etc., published in Internal Revenue Bulletins 2018–27 through 2018–52 is in Internal Revenue Bulletin 2018–52, dated December 27, 2018.

## **Finding List of Current Actions on Previously Published Items<sup>1</sup>**

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<sup>1</sup> A cumulative list of all revenue rulings, revenue procedures, Treasury decisions, etc., published in Internal Revenue Bulletins 2018–27 through 2018–52 is in Internal Revenue Bulletin 2018–52, dated December 27, 2018.

# **Internal Revenue Service**

## **Washington, DC 20224**

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## **INTERNAL REVENUE BULLETIN**

The Introduction at the beginning of this issue describes the purpose and content of this publication. The weekly Internal Revenue Bulletins are available at [www.irs.gov/irb/](http://www.irs.gov/irb/).

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## **We Welcome Comments About the Internal Revenue Bulletin**

If you have comments concerning the format or production of the Internal Revenue Bulletin or suggestions for improving it, we would be pleased to hear from you. You can email us your suggestions or comments through the IRS Internet Home Page ([www.irs.gov](http://www.irs.gov)) or write to the Internal Revenue Service, Publishing Division, IRB Publishing Program Desk, 1111 Constitution Ave. NW, IR-6230 Washington, DC 20224.