The Final Code Sec. 267A Regulations and Payments by CFCs

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Code Sec. 267A generally disallows deductions for hybrid interest and royalty payments that are not included in the income of the recipient, which generally increases U.S. taxable income by the amount of the disallowed deduction. The final regulations issued under Code Sec. 267A set forth the exclusive circumstances in which a deduction will be disallowed under Code Sec. 267A.[1] Although Code Sec. 267A does not apply to deductible amounts that are included in Subpart F income or global intangible low-taxed income ("GILTI"), which significantly limits the potential application of Code Sec. 267A to U.S.-based multinationals, the provision can apply to certain foreign-to-foreign payments within a U.S.-parented structure.

The final regulations are complex, meticulously mechanical, and generally require an understanding of both U.S. and foreign income tax laws. While Code Sec. 267A does not expressly identify payments made by controlled foreign corporations ("CFCs"), the final regulations clarify that deductions for hybrid interest and royalty payments made by certain CFCs are potentially subject to disallowance under Code Sec. 267A, which could result in a corresponding increase in the Subpart F income earned, or the GILTI tested income derived by, the CFC making the otherwise deductible payment.

A CFC's deductions for hybrid payments of interest, other amounts treated as interest, and royalties will be disallowed under the final Code Sec. 267A regulations if they fall into one of three categories. The first category is for disqualified hybrid amounts that relate to hybrid and branch arrangements as described in Reg. §1.267A-2.[2] The second category is for disqualified imported mismatch amounts that relate to payments offset by a hybrid deduction as described in Reg. §1.267A-4. The final category is for payments that satisfy the conditions of a general anti-avoidance rule in Reg. §1.267A-5(b)(6).

In addition to requiring an element of hybridity, the disallowance rules in the final regulations are limited to circumstances where the hybrid payment results in a "deduction-no inclusion" (or "D/NI") outcome.[3] This aspect of the final regulations is built into the rules and principles of Reg. §1.267A-3(a). These rules determine whether there is a "no-inclusion" outcome by the recipient of the payment (or another related foreign person in the case of the

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disqualified imported mismatch payment rules in Reg. §1.267A-4). If there is *not* a "no-inclusion" outcome, then an otherwise deductible hybrid payment by a CFC is not disallowed under the final Code Sec. 267A regulations. However, the presence of a "no-inclusion" outcome may result in disallowance of the CFC's hybrid deduction unless another exception applies that would prevent disallowance.

The final regulations also incorporate exceptions in Reg. §1.267A-3(b) that turn off the disallowance rules for certain hybrid payments made by CFCs. These exceptions reflect congressional intent that amounts that are included or includible in income in the United States, for example because another CFC includes the hybrid payment in Subpart F income, should not be disallowed because doing so would subject the hybrid payment to double U.S. taxation (*e.g.*, because both CFCs' Subpart F income would be increased).[4] These exceptions are particularly helpful when applying the final Code Sec. 267A regulations to hybrid financing and licensing arrangements between commonly controlled CFCs, but they are not blanket protections from preventing the disallowance of a hybrid deduction.

This article focuses on how the final Code Sec. 267A regulations apply to hybrid interest or royalty payments made by CFCs, with an emphasis on how the rules and principles in Reg. §1.267A-3 apply. After providing a brief overview of the Subpart F income and GILTI rules that are relevant to the final Code Sec. 267A regulations and discussing some other aspects of the final regulations that are relevant to CFCs, the article discusses how the rules and principles of Reg. §1.267A-3 apply to otherwise deductible hybrid payments made by CFCs based on the recipient of the payment.

I. Overview of Subpart F Income and GILTI Rules

A CFC is a foreign corporation in which United States shareholders (within the meaning of Code Sec. 951(b)) ("Section 951(b) U.S. Shareholders") own more than 50% of the vote or value.[5] For this purpose, direct, indirect, and constructive ownership of the foreign corporation is taken into account.[6] Constructive ownership may be attributed from either foreign or domestic persons.[7]

Section 951(b) U.S. Shareholders must include in their gross income their *pro rata* share of any Subpart F income and GILTI derived by the CFC during the taxable year under Code Secs. 951 and 951A, respectively. The Section 951(b) U.S. Shareholder's *pro rata* share of the Subpart F income and GILTI of a CFC is determined based on the Section 951(b) U.S. Shareholder's direct and indirect ownership interest as determined under Code Sec. 958(a).[8] Corporate Section 951(b) U.S. Shareholders are generally entitled to a deduction equal to half of the amount of the GILTI included in their gross income.[9]

Most commonly, Subpart F income consists of foreign base company income ("FBCI").[10] FBCI includes foreign personal holding company income ("FPHCI"), which consists of, among other things, income from interest, income equivalent to interest, and royalties.[11] For purposes of the Subpart F income rules, the term "interest" includes all amounts that are treated as interest income (including interest on a tax-exempt obligation) by reason of the Internal Revenue Code (the "Code") or Treasury Regulations or any other provision of law.[12] Examples of interest treated as FPHCI include stated interest, acquisition discount, original issue discount, and unstated interest—among others.[13] The term "royalty" is not, however, defined by the Code or the Treasury Regulations for purposes of the Subpart F income rules. Thus, the general definition of a royalty is used, which generally includes remuneration for the privilege of using intangible property.[14]

Not all interest and royalty income of a CFC is treated as FPHCI. There are several exceptions to the definition of FPHCI in the Code and Treasury Regulations that apply to payments of interest, income equivalent to interest, and royalties received by a CFC. The temporary exception in Code Sec. 954(c)(6) is particularly relevant for intercompany financing and licensing arrangements between related CFCs.[15] If interest or royalty income of a CFC is not FPHCI, it will generally be treated as gross tested income and taken into account for purposes of the GILTI rules, which are further described below.

The amount of Subpart F, FBCI that is taxable to a Section 951(b) U.S. Shareholder for a taxable year is a net amount. The Code and Treasury Regulations are clear that the amount of Subpart F, FBCI that is taxable to a Section 951(b) U.S. Shareholder is "reduced … so as to take into account deductions (including taxes) [of the CFC] properly allocable to such income."[16] In order for these deductions (*e.g.*, hybrid interest or royalty expenses paid to related persons) to reduce the amount of Subpart F FBCI that is taxable to a Section 951(b) U.S. Shareholder, the deductions must otherwise be allowed under the Code and Treasury Regulations.[17] As a result, if the final Code Sec. 267A regulations were to apply to disallow a deduction for a hybrid interest or

royalty payment made by a CFC, the amount of Subpart F, FBCI taxable to the Section 951(b) U.S. Shareholder may be higher.[18]

The GILTI of a Section 951(b) U.S. Shareholder for a taxable year is the amount by which such shareholder's "net CFC tested income" for the year exceeds its "net deemed tangible income return" for the year.[19] The "net CFC tested income" for a taxable year is the amount by which the aggregate of its *pro rata* share of each of its CFC's "tested income" for the year exceeds the aggregate of its *pro rata* share of each of its CFC's "tested loss" for the year.[20] Such "tested income" is determined without regard to gross income taken into account in determining Subpart F income of the CFC and gross income excluded from FBCI by reason of the high-tax election under Code Sec. 954(b)(4), among other types of gross income.[21] Thus, if an interest or royalty payment received by a CFC qualifies for the exception to FPHCI under Code Sec. 954(c)(6), such amount will generally be treated as tested income for GILTI purposes.

A CFC has "tested income" for a taxable year if its gross income exceeds the deductions (including taxes) properly allocable to such income.[22] A CFC's "tested loss" means, with respect to any CFC, the excess of any properly allocable deductions over its gross income.[23] Similar to the Subpart F income rules, only a CFC's "allowable deductions" are taken into account in determining the "tested income" or "tested loss" of a CFC for a taxable year.[24] Accordingly, if the final Code Sec. 267A regulations were to apply to disallow a deduction for interest or royalty expense of a CFC, there would be a corresponding increase in tested income (or a reduction in tested loss, or both), which may increase the amount of GILTI taxable to the Section 951(b) U.S. Shareholder.

II. Overview of Selected Final Code Sec. 267A Regulation Provisions Relevant to CFCs

As indicated above, the final Code Sec. 267A regulations are limited in scope. The rules in the regulations apply only to persons that meet the definition of a "specified party" and apply to only certain types of "specified payments" made by such persons. Moreover, as described above, the rules target only situations involving a D/NI outcome that is a result of hybridity and generally apply only to payments made to related persons. The regulations also provide exceptions for specified payments that have a corresponding and proportionate increase in income that is included or includible in the United States, which reflects the Congressional intent to avoid double U.S. taxation by virtue of disallowing a deduction.[25] With these requirements in mind, this section of the article describes some of the fundamental rules in the final Code Sec. 267A regulations related to payments made by CFCs.

The final Code Sec. 267A regulations apply only to a person that is a "specified party."[26] The definition of a "specified party" includes many, but not all, CFCs.[27] In order for a CFC to be considered a specified party, the CFC must have at least one owner that is (i) a tax resident of the United States (ii) that, for purposes of Code Secs. 951 and 951A, owns, directly or indirectly, within the meaning of Code Sec. 958(a), at least 10% (by vote or value) of the stock of the CFC (referred to herein as a "Specified Party CFC").[28] For purposes of this test, a domestic partnership is treated as a foreign person.[29]

Thus, CFCs with substantial, direct or indirect, ownership by Section 951(b) U.S. Shareholders should be considered Specified Party CFCs, in which case the final Code Sec. 267A regulations may be relevant to hybrid financing and licensing arrangements. However, foreign-controlled CFCs *(i.e.*, foreign corporations that are considered CFCs as a result of downward ownership attribution from a foreign person following the repeal of former Code Sec. 958(b)(4)) that have marginal (*i.e.*, less than 10%) or no direct or indirect ownership by a Section 951(b) U.S. Shareholder should not be considered a specified party, which should generally render the final Code Sec. 267A regulations irrelevant.[30]

In addition, the final regulations apply only to "specified payments." Such payments are limited to amounts paid or accrued for interest, royalties, and structured payments.[31] The regulations include very detailed rules describing what types of payments fall within each of these categories. The definitions are based on U.S. federal income tax authorities and principles rather than the foreign tax laws of the Specified Party CFC that is making the payment. Thus, if the tax laws of the Specified Party CFC's country of organization treat a payment by the CFC as deductible interest, but U.S. federal income tax laws do not, Code Sec. 267A should not apply to the payment made by the CFC. The opposite would be true if the U.S. and foreign tax characterizations were flipped.

The final regulations adopt a definition of interest that is based on, and similar in scope to, the definition

of interest in the regulations issued under Code Sec. 163(j).[32] As such, interest is defined broadly to cover interest associated with conventional debt instruments, other amounts treated as interest under U.S. federal income tax authorities, and transactions that are indebtedness in substance but not in form.[33] While this definition is not worded identically with the definition of interest for purposes of the Subpart F, FPHCI rules described above, both definitions are very broad and capture amounts treated as interest in other provisions of the Code and Treasury Regulations, so there should be substantial, if not complete, alignment between the two sets of rules.

The definition used for royalties is based in large part on the definition incorporated into Article 12 of the 2006 U.S. Model Income Tax Treaty.[34] Thus, for purposes of the final Code Sec. 267A regulations, royalties generally include amounts paid or accrued as consideration for the use of, or the right to use, certain intangible property and other information in connection with industrial, commercial, and scientific experience.[35] The broad definition of royalties for purposes of the final Code Sec. 267A regulations is consistent with the approach in the Subpart F income rules described above, so there should be substantial, if not complete, alignment between these two sets of rules, as well.

The final regulations also apply to "structured payments," which are amounts that the regulations treat as identical to interest.[36] Structured payments include certain substitute interest payments described in Reg. §1.861-2(a)(7) as well as items of expense or loss (*e.g.*, commitment fees, debt issuance costs, or guaranteed payments) that are economically equivalent to interest if a principal purpose of structuring the transaction was to reduce an amount incurred by the specified party that otherwise would be treated as interest or a structured payment for purposes of the final regulations.[37]

In summary, only CFCs that meet the definition of a specified party are subject to the final Code Sec. 267A regulations, which does not necessarily include all CFCs. Moreover, the final Code Sec. 267A regulations apply only to specified payments, which are limited to interest payments, royalty payments, and structured payments. Thus, deductible payments falling outside of these categories, *e.g.*, payments for rents or services or other expenses or other deductible losses (whether or not incurred as party of a hybrid or branch arrangement) should not be disallowed under the final Code Sec. 267A regulations.

III. Application of Final Code Sec. 267A Regulations to Specified Payments Made by CFCs

As noted above, the final Code Sec. 267A regulations are complex and include meticulous detail that could potentially apply to countless arrangements involving specified payments made by Specified Party CFCs. The following section attempts to synthesize the rules in the regulations in a somewhat comprehensible manner by focusing the discussion on the recipient of the specified payment, because the recipient and its relatedness status, its country's tax laws, and whether or not its earnings are included or includible in income in the United States significantly influence whether or not a deduction for the specified payment is disallowed under the final Code Sec. 267A regulations for purposes of computing the Specified Party CFC's Subpart F income or tested income or tested loss (or both) for GILTI purposes.

Accordingly, following is a discussion of the potential applicability of the final Code Sec. 267A regulations to specified payments of interest or royalties by a Specified Party CFC to unrelated U.S. or foreign persons, related U.S. corporations, and related CFCs.

A. Specified Payments Made by CFCs to Unrelated Persons

Except for certain limited circumstances, the final Code Sec. 267A regulations do not apply to specified payments of interest or royalties to unrelated U.S. or foreign persons.[38] In order for a Specified Party CFC's interest or royalty payment to give rise to a disqualified hybrid amount under one of the tests in Reg. §1.267A-2, the specified recipient of the payment must be related to the Specified Party CFC.[39] Moreover, in order for a Specified Party CFC's interest or royalty payment to give rise to a disqualified imported mismatch amount under Reg. §1.267A-4, each of (i) the person incurring the hybrid deduction, (ii) the imported mismatch payee (if different from the person identified in (i)), and (iii) if applicable, each intermediary tax resident or taxable branch in the chain of funded taxable payments must be related to the Specified Party CFC.[40] For this purpose, relatedness status is determined based on the rules in Code Sec. 954(d)(3)[41] except that the downward attribution rules do not apply to attribute stock or other interests.[42] Thus, in general, if a Specified Party CFC makes a specified payment to an unrelated U.S. or foreign person, the final

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Code Sec. 267A regulations should not apply to such payment.

However, as noted above, there are limited circumstances in which a specified payment interest or royalty payment made by a Specified Party CFC to an *unrelated* person could be disallowed under the final Code Sec. 267A regulations. The tests in Reg. §§1.267A-2 and 1.267A-4 for disqualified hybrid amounts and disqualified imported mismatch amounts, respectively, each include a special exception for interest or royalty payments made pursuant to a "structured arrangement."[43] Under the structured arrangement exception, the tests in Reg. §§1.267A-2 and 1.267A-4 generally apply in the same manner except there is no relatedness requirement with respect to persons described in the immediately preceding paragraph, but the additional requirements for a "structured arrangement" must be satisfied.[44]

In addition, the general anti-avoidance rule in Reg. §1.267A-5(b)(6) is written to apply to specified payments made by CFCs to both related and *unrelated* persons. In order for the general anti-avoidance rule to apply to disallow a deduction of a Specified Party CFC for an otherwise deductible hybrid interest or royalty payment, such payment must not be included in the income of a related or unrelated tax resident or taxable branch (as a result of hybridity), and a principal purpose of the terms or structure of the arrangement pursuant to which the payment is made must be to avoid the application of the final Code Sec. 267A regulations.[45]

Thus, while the final Code Sec. 267A regulations generally apply only to payments made by Specified Party CFCs to related persons, if the structured arrangement exception or the general anti-avoidance rule applies, an otherwise deductible interest or royalty payment made by a Specified Party CFC to an unrelated person may be disallowed under the final Code Sec. 267A regulations for purposes of computing the Subpart F income or tested income (or tested loss, or both) of the Specified Party CFC. However, given the requirements of these provisions, the circumstances in which they would apply appear fairly narrow.

The remainder of this article focuses on payments made by Specified Party CFCs to related persons and assumes that the general anti-avoidance rule would not apply.

B. Specified Payments Made by CFCs to Related U.S. Corporations

A specified payment of interest or royalties by a Specified Party CFC to a related U.S. corporation (or U.S. eligible entity classified as a corporation) generally should not be disallowed under the final Code Sec. 267A regulations.

First, to the extent that a specified payment made by a Specified Party CFC to a related U.S. corporation would otherwise satisfy one of the disqualified hybrid amount tests in Reg. §1.267A-2, the final Code Sec. 267A regulations include a special exception for amounts included or includible in income in the United States. Specifically, the amount that otherwise satisfies one of the tests in Reg. §1.267A-2, which the regulations refer to as a "tentative disqualified hybrid amount," is reduced to the extent that the related U.S. corporation recipient "takes the disqualified hybrid amount into account in determining its gross income."[46] Accordingly, if the U.S. corporation includes the entire specified payment in its gross income, the tentative disqualified hybrid amount is reduced to zero; and therefore, the Specified Party CFC's deduction for the specified payment does not give rise to a disqualified hybrid amount within the meaning of Reg. §1.267A-2.[47]

Second, the disqualified imported mismatch rules in Reg. §1.267A-4, by their terms, are limited to payments made to "foreign" tax residents and taxable branches, which excludes U.S. tax residents and taxable branches.[48] For this purpose, U.S. tax residents include U.S. corporations.[49] Thus, payments made by a Specified Party CFC to a related U.S. corporation generally should be entirely outside of the scope of the disqualified imported mismatch rules.

Therefore, to the extent a Specified Party CFC enters into a hybrid financing or licensing arrangement with a related U.S. corporation, the Specified Party CFC's hybrid interest or royalty deductions generally should not be disallowed under the final Code Sec. 267A regulations.[50]

C. Specified Payments Made by CFCs to Related CFCs

The following section focuses on specified payments made by a Specified Party CFC to a related CFC. In general, this section of the article addresses how the rules in Reg. §1.267A-3 apply to a specified payment that would otherwise meet the definition of a disqualified hybrid amount in one of the tests in Reg. §1.267A-2 under three different common scenarios (the disqualified imported mismatch rules are discussed below in Section III.D of the article). The first scenario involves a Specified Party CFC making a specified payment to a related CFC that does not result in a D/NI outcome. The following two scenarios involve a Specified Party CFC making a

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specified payment to a related CFC, which results in a D/NI outcome, but the related CFC has varying levels of Code Sec. 958(a) ownership by Section 951(b) U.S. Shareholders. The discussion of each scenario draws general conclusions from the relevant provisions in Reg. §1.267A-3 while flagging potential traps under slightly modified facts.

1. Specified Payments to Related CFCs with No D/NI Outcome

As described above, the final Code Sec. 267A regulations are limited to circumstances in which a specified payment of interest or royalties results in a D/NI outcome. Thus, even if a specified payment of interest or royalties made by a Specified Party CFC would otherwise meet the definition of a disqualified hybrid amount, the Specified Party CFC's deduction for such amount should not be disallowed for purposes of computing its Subpart F income or tested income (or tested loss, or both) to the extent the related CFC recipient does not have "no-inclusion" with respect to such payment.

The "no-inclusion" aspect of the D/NI outcome with respect to a payment made to a related CFC is a determination of how much of the payment is included in the income of such CFC under its foreign tax laws as interpreted through the lens of the rules in Reg. §1.267A-3(a). In general, a related CFC includes in income a specified payment to the extent that (i) it takes the payment into account 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);[51] and (ii) the payment is not reduced or offset by an exemption, exclusion, deduction, credit (other than for withholding tax on the payment), or other similar relief particular to such type of payment.[52]

The final regulations include a list of the types of reductions or offsets that could give rise to a complete or partial "no-inclusion" outcome. These include a participation exemption, a dividends received deduction, a deduction or exclusion with respect to a particular category of income (*e.g.*, 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.[53]

A related CFC will not be treated as having a "no-inclusion" outcome with respect to a payment of interest or royalties to the extent such payment is reduced or offset by a "generally applicable deduction or other tax attribute, such as a deduction for depreciation or a net operating loss."[54] For this purpose, a deduction of the related CFC may be treated as being "generally applicable" even if it arises from a transaction related to the specified payment, *e.g.*, if the deduction and payment are in connection with a back-to-back financing arrangement.[55]

Furthermore, "no-inclusion" outcomes that are not a result of hybridity are not taken into account for purposes of the final Code Sec. 267A regulations. While there are many nuances to the concept of hybridity in the final Code Sec. 267A regulations, hybridity is generally considered present when an arrangement or entity is treated differently for U.S. and foreign income tax purposes and such differences result in a D/NI outcome.[56] Thus, a related CFC generally should not have a "no-inclusion" outcome with respect to a payment of interest or royalties received by a Specified Party CFC if the related CFC's no-inclusion is the result of the related CFC's tax law containing a pure territorial system (and thus exempting from taxation all foreign source income) or not having a corporate income tax.[57]

However, third-country inclusions do not cure D/NI outcomes that are a result of hybridity. The final regulations are clear that there may be more than one specified recipient with respect to a specified payment of interest or royalties by a Specified Party CFC.[58] A no-inclusion outcome with respect to at least one of the specified recipients is sufficient for the Specified Party CFC's deduction to be potentially disallowed under the Code Sec. 267A regulations.

For instance, assume that a U.S. corporation owns 55% of FX, a Country X corporation, and FX is the sole owner of FZ, a Country Z entity which is fiscally transparent for Country X tax purposes, and FZ is the sole owner of a Specified Party CFC. If the Specified Party CFC makes a payment to FZ that is treated as interest for both U.S. and Country Z tax purposes, but as an exempt dividend for Country X tax purposes, each of FX and FZ will be treated as specified recipients of the payment made by the Specified Party CFC.[59] Subject to the relief provided by Reg. §1.267A-3(b) discussed below, FX's no-inclusion with respect to the payment will potentially cause the final Code Sec. 267A regulations to disallow the Specified Party CFC's deduction for the interest payment, even though FZ takes it into account in determining its gross income.[60]

Therefore, in general, if a Specified Party CFC makes a specified payment to a related CFC, and the related CFC does not have a "no-inclusion" outcome with respect to such payment under the rules in Reg. §1.267A-3(a), then the payment should not be treated as disqualified hybrid amount and the Specified Party CFC's deduction

should not be disallowed for purposes of computing its Subpart F income or tested income (or tested loss, or both) for GILTI purposes.[61]

2. Complete Code Sec. 958(a) Ownership of the Related CFC

Consistent with the language of Code Sec. 267A(b)(1), the final Code Sec. 267A regulations contain broad relief for Specified Party CFCs to the extent they make specified payments of interest or royalties to a related CFC and such amounts are includible in income at the Section 951(b) U.S. Shareholder level under Code Sec. 951(a) or 951A(a). Thus, except as described below, if a Section 951(b) U.S. Shareholder directly or indirectly owns all of the stock (within the meaning of Code Sec. 958(a)) of the related CFC to which the specified payment is made, the exceptions in Reg. §1.267A-3(b)(3) and (4) generally should prevent the Specified Party CFC's deduction from being disallowed under the final Code Sec. 267A regulations.

Specifically, under Reg. §1.267A-3(b)(3), a "tentative disqualified hybrid amount" is reduced to the extent that it is received by a CFC and includible in the gross income of a Section 951(b) U.S. Shareholder of the CFC under Code Sec. 951(a)(1)(A). Whether an amount is includible under Code Sec. 951(a)(1)(A) is determined without regard to properly allocable deductions of the CFC, qualified deficits under Code Sec. 952(c)(1)(B), or the earnings and profits limitation under Reg. §1.952-1(c).[62]

For example, assume that a Section 951(b) U.S. Shareholder owns all of the stock of FX, a Country X corporation, which in turn owns all of the stock of FZ, a Country Z corporation. Also assume that FZ makes a $100× payment to FX that is treated as interest for U.S. and Country Z tax purposes, but as a dividend for Country X tax purposes in which FX is granted a 80% participation exemption. Further assume that the $100× payment would be allocable and apportioned to FZ's Subpart F income (such that FX is not eligible for the Subpart F, FPHCI exception in Code Sec. 954(c)(6)).

In this example, each of FX and FZ is a CFC, and FZ is a Specified Party CFC because US1 owns 100% of the stock of FZ within the meaning of Code Sec. 958(a). A payment that is treated as interest for U.S. tax purposes, but as a dividend for foreign tax purposes generally is treated as a payment made as part of a hybrid transaction within the meaning of Reg. §1.267A-2(a). Thus, a portion or all of the $100× interest payment (based on the U.S. tax characterization) is potentially subject to disallowance under Code Sec. 267A as a disqualified hybrid amount.

Of the $100× payment, $20× is included in the income of FX. This amount is not treated as a payment made pursuant to a hybrid transaction under Reg. §1.267A-2(a) and thus is not disallowed under the final Code Sec. 267A regulations.[63] The remaining $80× of the payment meets the definition of a payment made pursuant to a hybrid transaction and will be disallowed as a disqualified hybrid amount unless an exception in Reg. §1.267A-3(b) applies.

Here, the entire $80× is a tentative disqualified hybrid amount and is reduced to zero because the $80× will be includible in the gross income of the Section 951(b) U.S. Shareholder under Code Sec. 951(a)(1)(A). As a result, none of FZ's otherwise allowable $100× deduction should be disallowed under the final Code Sec. 267A regulations for purposes of computing its Subpart F income.

There is a similar exception for amounts that are taken into account for GILTI purposes. Specifically, under Reg. §1.267A-3(b)(4), a tentative disqualified hybrid amount is reduced to the extent it increases a Section 951(b) U.S. Shareholder's *pro rata* share of tested income (as determined under Reg. §§1.951A-1(d)(2) and 1.951A-2(b)(1)) with respect to a CFC, reduces the Section 951(b) U.S. Shareholder's *pro rata* share of tested loss (as determined under Reg. §§1.951A-1(d)(4) and 1.951A-2(b)(2)) of the CFC, or both.

Thus, using the example above, if FZ's $100× payment would be allocable and apportioned to FZ's gross tested income under Reg. §1.951A-2(c)(1) such that the payment qualified for the Subpart F, FPHCI exception in Code Sec. 954(c)(6) exception to Subpart F, FPHCI, then the result would be the same except that the exception in Reg. §1.267A-3(b)(4) would apply because the Section 951(b) U.S. Shareholder would increase its *pro rata* share of FX's tested income by $80×.

However, given the concern of potential effective tax rate arbitrage opportunities presented by the partial deductibility of GILTI, the relief provided in Reg. §1.267A-3(b)(4) is reduced in certain circumstances to offset the benefit of the deduction under Code Sec. 250(a)(1)(B) where the deduction of the Specified Party CFC would reduce income taxed at the full marginal U.S. tax rate.[64]

To the extent that a Specified Party CFC has a tentative disqualified hybrid amount that would be allocated and apportioned to gross income of the CFC that is gross income taken into account in determining Subpart F income or gross income that is effectively connected with

the conduct of a U.S. trade or business (as described in Reg. §1.882-4(a)(1)), the reduction for tentative disqualified hybrid amounts provided in Reg. §1.267A-3(b)(4) is decreased to equal the reduction that would otherwise be provided multiplied by the difference of 100% and the percentage described in Code Sec. 250(a)(1)(B), which is currently 50%.[65]

For example, assume that a corporate Section 951(b) U.S. Shareholder owns all of the stock of two CFCs—FX, a Country X corporation, and FZ, a Country Z corporation. Also assume that FZ makes a $100× payment to FX that gives rise to a $80× tentative disqualified hybrid amount that increases FX's tested income for GILTI purposes, but that would be allocated and apportioned to the gross income of FZ in determining its Subpart F income.

The $80× tentative disqualified hybrid amount would increase the corporate Section 951(b) U.S. Shareholder's *pro rata* share of the tested income of FX, and such amount would be taxed at an effective U.S. tax rate of 10.5% (after taking into account the current 50% deduction provided by Code Sec. 250(a)(1)(B)). However, FZ's deduction would reduce its Subpart F income, on which the corporate Section 951(b) U.S. Shareholder would be taxed at the full U.S. corporate tax rate, which is currently 21%.

Accordingly, the relief provided by Reg. §1.267A-3(b)(4) would be reduced to $40× ($80× multiplied by 100% minus 50%). As a result, $40× of the $100× payment made by FZ to FX would be disallowed by the final Code Sec. 267A regulations in computing FZ's Subpart F income to account for the lower effective rate imposed on the GILTI derived by FX.[66]

Furthermore, the relief provided by either Reg. §1.267A-3(b)(3) or (4) may be eliminated in the event the Section 951(b) U.S. Shareholder makes a high-tax election under Code Sec. 954(b)(4) (and Reg. §1.954-1(d)) or Reg. §1.951A-2(c)(7), respectively, with respect to the related CFC that receives the specified payment. In general, under those exceptions, if the income of a CFC is taxed at a foreign tax rate greater than 90% of the U.S. corporate tax rate, a Section 951(b) U.S. Shareholder may elect to exclude the high-taxed amounts from the Subpart F income or tested income of the CFC that is taxable to the Section 951(b) U.S. Shareholder. In that event, the Section 951(b) U.S. Shareholder would not have an amount included or includible in income under Code Sec. 951(a) or Code Sec. 951A(a), as the case may be, with respect to the related CFC that received the specified payment. Based on the language of Reg. §1.267A-3(b)(3) and (4), this would make those exceptions unavailable. As a result, the Specified Party CFC's deduction for the specified payment would be disallowed under the final Code Sec. 267A regulations to the extent it otherwise met the definition of a disqualified hybrid amount.

Thus, in summary, if a Specified Party CFC makes a specified payment to a related CFC that is wholly directly or indirectly owned by a Section 951(b) U.S. Shareholder, absent the special circumstances described above, the exceptions in Reg. §1.267A-3(b)(3) and (4) generally should apply to prevent the Specified Party CFC's deduction from being disallowed under the final Code Sec. 267A regulations.

3. Partial-to-No Code Sec. 958(a) Ownership of the Related CFC

The benefit of the exceptions for amounts included or includible in income under Code Sec. 951 and 951A phases out as the Code Sec. 958(a) ownership of the related CFC stock by Section 951(b) U.S. Shareholders decreases. This requires more careful planning to ensure that the hybrid financing or licensing arrangement involving the Specified Party CFC does not trigger one of the disqualified hybrid amount tests in Reg. §1.267A-2.

For example, assume that a domestic corporation, US1, and FW, an unrelated Country W corporation, own 55% and 45% of the stock of FX, a Country X corporation, respectively. FX in turn owns all of the stock of FZ, a Country Z corporation. Also assume that FZ makes a $100× payment to FX that is treated as interest for both U.S. and Country Z tax purposes, but as a dividend for Country X tax purposes. FX is eligible for an 85% participation exemption and included $15× in income for Country X tax purposes (and within the meaning of Reg. §1.267A-3(a)). Finally, assume that (i) the $100× payment qualifies for the Subpart F, FPHCI exception in Code Sec. 954(c)(6) and increases the tested income of FX by such amount, and (ii) if FZ were permitted a deduction for the $100×, it would be allocated and apportioned to gross tested income under Reg. §1.951A-2(c)(1).

In this example, each of FX and FZ is a CFC, and FZ is a Specified Party CFC because US1 owns 55% of the stock of FZ within the meaning of Code Sec. 958(a). Because the $100× payment is treated as interest for U.S. tax purposes, but as a dividend for foreign tax purposes, it is considered a payment made as part of a hybrid transaction within the meaning of

Reg. §1.267A-2(a). Thus, a portion or all of the $100× interest payment is subject to disallowance as a disqualified hybrid amount.

Of the $100× payment, $15× is included in the income of FX. This amount is not treated as a payment made pursuant to a hybrid transaction under Reg. §1.267A-2(a) and thus is not disallowed as a disqualified hybrid amount.[67] The remaining $85× of the payment meets the definition of a payment made pursuant to a hybrid transaction and will be disallowed under Code Sec. 267A as a disqualified hybrid amount unless an exception in Reg. §1.267A-3(b) applies.

The rules in Reg. §1.267A-3(b) treat the $85× as a "tentative disqualified hybrid amount."[68] As described above, a tentative disqualified hybrid amount is reduced to the extent that one of the exceptions in Reg. §1.267A-3(b)(2)-(5) applies with the resulting positive amount, if any, being treated as the disqualified hybrid amount that is disallowed under Code Sec. 267A. Based on the facts of the example above, the relevant exception is for amounts includible in income under Code Sec. 951A under Reg. §1.267A-3(b)(4). That exception applies to the extent that US1's *pro rata* share of FX's tested income is increased, its tested loss is decreased, or both, under Code Sec. 951A. Because US1's *pro rata* share of FX's tested income is based on US1's Code Sec. 958(a) ownership interest in FX, US1's *pro rata* share of FX's tested income is increased by $46.75× (calculated as $85 multiplied by 55%). The $85× tentative disqualified hybrid amount is reduced by the $46.75× to arrive at the disqualified hybrid amount of $38.25×.[69]

For purposes of calculating FZ's net tested income for the tax year, $61.75× of the interest payment (equal to the $15× that was not treated as a payment made pursuant to a hybrid transaction plus the $46.75× that was eligible for the exception in Reg. §1.267A-3(b)(4)) is not disallowed as a disqualified hybrid amount, but the remaining $38.25× would be disallowed. As noted above, this would be the case even if Country W had CFC rules similar to the United States that required FW to include the $38.25× in income.[70]

Accordingly, while the exceptions in Reg. §1.267A-3(b)(3) and (4) provide helpful relief for Specified Party CFCs, the relief is not complete when specified payments are made to related CFCs with partial-to-no Code Sec. 958(a) ownership by Section 951(b) U.S. Shareholders. In that case, ensuring that a hybrid arrangement does not meet the definitions of one of the disqualified hybrid amount tests in Reg. §1.267A-2 becomes significantly more important.[71]

D. Specified Payments Made by a CFC to a Related CFC That Are Potentially Subject to the Disqualified Imported Mismatch Rules in Reg. §1.267A-4

Non-hybrid interest and royalty payments made by Specified Party CFCs to related CFCs are also subject to disallowance under the disqualified imported mismatch rules in Reg. §1.267A-4. The disqualified imported mismatch rules are intended to prevent the effects of an offshore hybrid arrangement (*i.e.*, an arrangement outside of the U.S. tax net) from being imported into the U.S. tax net through the use of a non-hybrid arrangement.[72] While the disqualified imported mismatch rules use different terminology, they are generally based on the same concepts of hybridity used in the disqualified hybrid amount rules in Reg. §1.267A-2.[73]

The key distinguishing feature between the disqualified imported mismatch rules and the disqualified hybrid amount rules in Reg. §1.267A-2 is that the disqualified hybrid amount rules generally require an analysis of a single interest or royalty payment by a Specified Party CFC, whereas the disqualified imported mismatch amount rules in Reg. §1.267A-4 require an analysis of a chain of two or more payments that start with a *non-hybrid* interest or royalty payment made by a Specified Party CFC (*i.e.*, the payment is treated as interest or a royalty for both U.S. and foreign tax purposes, and the foreign recipient includes the full amount of the payment in income). Thus, the disqualified imported mismatch payment rules may require an analysis of payments made by two or more CFCs.

In general, interest or royalty payments made by Specified Party CFCs will be a disqualified imported mismatch amount, and disallowed under the final Code Sec. 267A regulations, to the extent that the payment is (i) an imported mismatch payment, and (ii) the income attributable to the payment is directly or indirectly offset by a hybrid deduction of a related foreign tax resident or taxable branch.[74] The disqualified imported mismatch rules contain exclusions and exceptions for these two requirements for payments made by Specified Party CFCs, which are based, in large part, on the mechanics in the exceptions to disqualified hybrid amounts in Reg. §1.267A-3(b).

First, the regulations narrowly define an "imported mismatch payment" to mean a specified payment to the extent it is neither a disqualified hybrid amount nor included or includible in income in the United States.

The regulations further provide that for this purpose, "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)."[75]

In essence, this definition of an imported mismatch amount has the ability to turn off, or blunt the impact of, the disqualified imported mismatch rules with respect to imported hybrid financing or licensing arrangements involving related CFCs. That is, if a Specified Party CFC makes a payment of interest or royalties to a related CFC (which is not otherwise a disqualified hybrid amount) and the income attributable to the payment either (i) is included or includible in the gross income of the Section 951(b) U.S. Shareholder of the CFC under Code Sec. 951(a)(1)(A), or (ii) increases a Section 951(b) U.S. Shareholder's *pro rata* share of the tested income of the CFC, reduces the Section 951(b) U.S. Shareholder's *pro rata* share of tested loss with respect to the CFC, or both, then the Specified Party CFC's payment will not be an imported mismatch payment even if the income attributable to such payment is directly or indirectly offset by a hybrid deduction.[76] As indicated above, reduced Code Sec. 958(a) ownership of the related CFC or a Subpart F income or GILTI high-tax election with respect to the related CFC would, however, negate the benefit of the carve-out for amounts included or included in income in the United States.

Second, as described above, the disqualified imported mismatch amount rules apply only to the extent the income attributable to a payment made by a Specified Party CFC is directly or indirectly offset by a hybrid deduction incurred by a related foreign tax resident or taxable branch. For this purpose, a hybrid deduction is defined to generally mean a deduction allowed to a foreign tax resident under its tax law for an amount paid or accrued that is interest or a royalty under such foreign tax law, to the extent that a deduction for the amount would be disallowed if such foreign tax law contained rules substantially similar to those under Reg. §§1.267A-1 through 1.267A-3 and 1.267A-5.[77]

The general definition of a hybrid deduction is intended to cover hybrid deductions paid or accrued by CFCs.[78] However, the regulations include a special rule that excludes certain deductions of a CFC from the definition of a hybrid deduction.[79] The purpose of this exclusion is to avoid double U.S. taxation of specified payments involving CFCs.

Under the exception, a deduction of a CFC that would otherwise meet the definition of a hybrid deduction will not be considered a hybrid deduction to the extent that the amount paid or accrued by the CFC is (i) a disqualified hybrid amount, or (ii) included or includible in income in the United States.[80] For purposes of this exception, 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, it would be reduced under the rules in Reg. §1.267A-3(b)(2) through (5).[81]

Absent the exception for disqualified hybrid amounts of a CFC, the final Code Sec. 267A regulations would potentially disallow the deductions of both the Specified Party CFC that makes a non-hybrid specified payment and the related CFC that incurs the hybrid deduction, thus subjecting the same amount to double U.S. taxation.

The exception for disqualified hybrid amounts is, however, subject to downward adjustment under the rules in Reg. §1.267A-4(g). Those rules can cause some or all of the disqualified hybrid amount to revert back to being treated as a hybrid deduction to the extent doing so would not result in double U.S. taxation of the non-hybrid specified payment made by the Specified Party CFC at the beginning of the chain of payments. This would be the case, for example, where the related CFC that incurred the disqualified hybrid amount was only partially owned by one or more Section 951(b) U.S. Shareholders.

Specifically, under Reg. §1.267A-4(g), a disqualified hybrid amount will not be treated as a hybrid deduction only to the extent of the excess, if any, of the disqualified hybrid amount over the sum of the amounts that, if such disqualified hybrid amount is allowed as a deduction, would be allocated and apportioned:

- To residual CFC gross income of the CFC;[82]
- To gross income that is taken into account in determining the CFC's Subpart F income (under the rules of Code Sec. 954(b)(5)) multiplied by the difference between 100% and the percentage of stock (by value) of the CFC that, for purposes of Code Secs. 951 and 951A, is owned (within the meaning of Code Sec. 958(a), and determined by treating a domestic partnership as foreign) by one or more Section 951(b) U.S. Shareholders; and
- To gross tested income of the CFC (under the rules of Reg. §1.951A-2(c)(3)) multiplied by the same percentage as described in the preceding bullet.[83]

Similar to the exceptions in Reg. §1.267A-3(b)(3) and (4), the benefit of excluding a disqualified hybrid amount from the definition of a hybrid deduction is phased out as Code Sec. 958(a) ownership of the related CFC recipient decreases. Moreover, it appears the benefit would be

completely negated in the case of a Subpart F income or GILTI high-tax election with respect to the related CFC recipient.

The rules described above are illustrated in the following example. Assume that FX, a Country X corporation, owns all of the stock of US1, a U.S. corporation, and all of the interests in FY, a reverse hybrid entity (*i.e.*, it is fiscally transparent for Country Y purposes, but not for Country X tax purposes). FX and US1 own 70% and 30%, respectively, of FZ, a Country Z corporation. US1 also owns all of FW, a Country W corporation. Each of FW and FZ is a Specified Party CFC. Further assume that in Year 1, FW makes a $100× interest payment to FZ that is treated as interest for both U.S. and Country Z tax purposes and the full $100× is included in FZ's income for Country Z purposes. Also in Year 1, FZ makes a $100× interest payment to FY, for which FZ is allowed a $100× deduction under Country Z's tax law and none of the $100× is included in FX's income. Finally, assume that the interest payment by FW to FZ qualifies for the Subpart F FPHCI exception in Code Sec. 954(c)(6) and thus increases the tested income of FZ by such amount, and, if FW and FZ were permitted deductions for the $100× payments they make, such deductions would be allocated and apportioned to gross tested income under Reg. §1.951A-2(c)(1).

Based on the facts of this example, the interest payments made by FW and FZ are both potentially subject to disallowance under the final Code Sec. 267A regulations because both are Specified Party CFCs. Because the disqualified imported mismatch rules take into account whether FZ's deduction for the interest payment to FY is a disqualified hybrid amount, its deduction is analyzed first.

The entire amount of FZ's $100× interest payment to FY is a disqualified hybrid amount under Reg. §1.267A-2(d) as a payment made to a reverse hybrid entity without a corresponding inclusion in income by FX, FY's sole investor.[84] Furthermore, none of the exceptions in Reg. §1.267A-3(b) apply because FY is solely owned by FX, a Country X corporation, and there is no indirect U.S. ownership of FY within the meaning of Code Sec. 958(a)(2) that would result in the payment being included or includible in income in the United States under Code Sec. 951(a) or taken into account for GILTI purposes under Code Sec. 951A. As a result, all of FZ's $100× deduction is disallowed as a disqualified hybrid amount under Reg. §1.267A-1(b) for purposes of computing FZ's tested income, tested loss, or both for Year 1.

However, only a portion of FW's $100× interest payment to FZ is a disqualified imported mismatch amount. First, the amount of FW's imported mismatch payment must be determined, which is calculated by reducing the entire payment of $100× by the portion of the payment that is (i) a disqualified hybrid amount ($0), and (ii) included or includible in income in the United States to the extent it would be reduced by the exceptions in Reg. §1.267A-3(b)(2) through (5) if the payment were a tentative disqualified hybrid amount ($30×).[85] Thus, amount of the $100× treated as an imported mismatch payment is limited to $70×. As a result, at a minimum, $30× of the payment is not subject to disallowance under the final Code Sec. 267A regulations—which is determined without having to analyze any of the other aspects of the disqualified imported mismatch rules.[86]

Second, a multi-step process must be undertaken to determine the amount of the income attributable to the $70× payment that is directly or indirectly offset by a hybrid deduction of FZ, a related foreign tax resident. The first step of this process is to determine whether FZ has incurred a hybrid deduction that would offset the income attributable to the $70×. Based on the general definition of a hybrid deduction, the entire amount of FZ's $100× interest payment to FY would be a hybrid deduction because it would be disallowed if the tax law of Country Z had anti-hybrid rules similar to those under Reg. §§1.267A-1 through 1.267A-3 and 1.267A-5.

However, because FZ is a CFC (following the repeal of former Code Sec. 958(b)(4)), the special rules under Reg. §1.267A-4(b)(2)(iv) that will cause hybrid deductions of CFCs to not be treated as hybrid deductions potentially apply. Under these rules, an amount that is paid or accrued by a CFC that gives rise to a disqualified hybrid amount or is included or includible in income in the United States is not treated as a hybrid deduction. Based on the facts of the example, all of FZ's $100× interest payment to FY gave rise to a disqualified hybrid amount.

The $100× amount, however, is subject to the downward adjustment rules in Reg. §1.267A-4(g), meaning that not all of the $100× may be treated as a disqualified hybrid amount for purposes of determining the amount of FZ's hybrid deduction. Based on these rules, the amount of FZ's $100× interest payment that is treated as a disqualified hybrid amount is reduced by $70×, resulting in a disqualified hybrid amount of $30×. The $70× reduction represents the portion of the disqualified hybrid amount that, if allowed as a deduction, would be allocated and apportioned to the gross tested income of FZ ($100×) multiplied by the difference between 100% and the percentage of stock (by value) of FZ that is owned by US1 within the meaning of Code Sec. 958(a) (30%) (*i.e.*, $100× multiplied by 70%).

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Thus, after taking into account the special rules that apply to CFCs for determining the amount of a hybrid deduction, FZ is treated as having a hybrid deduction of $70×, which is equal to its $100× hybrid deduction under the general hybrid deduction definition reduced by $30× (the portion of FZ's hybrid deduction that is treated as a disqualified hybrid amount).

The final step in the process is to determine the amount by which the income of FZ that is attributable to the $70× payment it received from FW is directly or indirectly offset by a hybrid deduction of FZ (*i.e.*, $70×). The $70× hybrid deduction of FZ offsets the income attributable to FW's $70× imported mismatch payment—an imported mismatch payment that directly funds the hybrid deduction.[87] That is, the entire $70× of FW's imported mismatch payment directly funds the hybrid deduction because FZ incurs at least that amount of the hybrid deduction.[88] Therefore, the entire $70× of FW's imported mismatch payment is a disqualified imported mismatch amount under Reg. §1.267A-4(a)(1). As a result, FW's deduction for $70× is disallowed for purposes of computing its net tested income or tested loss for Year 1.

As the above example illustrates, the disqualified imported mismatch amount rules, as applied to payments between related CFCs, are highly mechanical and can be difficult to navigate. However, the rules in Reg. §1.267A-4 incorporate the principles of the exceptions in Reg. §1.267A-3(b) as it relates to not subjecting the initial non-hybrid payment to double U.S. taxation. Thus, to the extent that an intercompany financing or licensing arrangement imports a hybrid deduction into the United States, the Specified Party CFC's non-hybrid specified payment should not be disallowed to the extent it is paid or accrued to another CFC and ultimately included or includible in the income of a Section 951(b) U.S. Shareholder.

IV. Conclusion

In conclusion, while U.S.-based multinationals generally have been spared much of the pain of contending with the final Code Sec. 267A regulations, they nevertheless should be aware that the regulations may apply to some hybrid arrangements involving CFCs. The regulations include meticulously crafted rules that are designed to protect against hybrid arrangements that result in D/NI outcomes. However, the regulations also reflect congressional intent that a specified payment by a CFC should not be disallowed to the extent it is included or includible in income in the United States (including through Code Secs. 951 and 951A). The exceptions in Reg. §1.267A-3(b) afford significant protection against having a deduction disallowed under the final regulations, but there are gaps to these exceptions that arise in scenarios that are not completely uncommon. Thus, careful consideration should still be given when planning hybrid financing or licensing arrangements with CFCs.

ENDNOTES

1 Reg. §1.267A-1(b).

2 Reg. §1.267A-2 includes five separate tests for determining whether a deductible payment is a disqualified hybrid amount. These include payments pursuant to a hybrid transaction, disregarded payments, deemed branch payments, payments to reverse hybrids, and branch mismatch payments. Reg. §1.267A-2(a)-(e).

3 *See* T.D. 9896, 85 FR 19809; REG-104352-18, 83 FR 67615.

4 *See* Code Sec. 267A(b) (flush language) (The term "disqualified related party amount" "shall not include any payment to the extent such payment is included in the gross income of a United States shareholder under section 951(a).")

5 Code Sec. 957(a).

6 Code Secs. 951(b), 957(a), 958. *See also* Reg. §§1.958-1; 1.958-2.

7 *See, e.g.*, Reg. §1.958-2(g)(4), *Ex.* 4.

8 Code Secs. 951(a); 951A(e).

9 Code Sec. 250(a)(1)(B). Corporate Section 951(b) U.S. Shareholders may also, subject to certain limits and reductions, offset their tax liabilities from any Subpart F income or GILTI inclusions with tax credits for foreign taxes that are attributable to the Subpart F income or GILTI (as the case may be), which are deemed paid by the corporate Section 951(b) U.S. Shareholder. Code Secs. 901(a), 904, and 960(a) and (d).

10 Code Sec. 952(a)(2).

11 Code Sec. 954(a) and (c) (defining FPHCI); Reg. §1.954-1(c)(1)(iii)(A)(1)(i). FBCI also includes foreign base company sales income and foreign base company services income. *See* Code Sec. 954(d) and (e).

12 Reg. §1.954-2(a)(4)(i).

13 *See id. See* Reg. §1.954-2(h) (defining income equivalent to interest for purposes of the FPHCI rules).

14 *See, e.g.*, Reg. §1.543-1(b)(3).

15 Under this exception, FPHCI will not include interest income, income equivalent to interest, or royalty income derived by a CFC if (i) such income is received or accrued from a CFC; (ii) the CFC payor is a related person; and (iii) the expenses for the interest, income equivalent to interest, or royalty neither reduces the related CFC's Subpart F income or income effectively connected with a U.S. trade or business, nor creates or increases a deficit that may reduce Subpart F income. *See* Code Sec. 954(c)(6)(A) and (B).

16 Code Sec. 954(b)(5); Reg. §1.954-1(c)(1)(i). Under ordering rules provided in the regulations, definitely related expenses are allocated and apportioned to the various categories of FBCI under the principles of Code Secs. 861, 864, and 904(d). Reg. §1.954-1(c)(1)(i)(B). Second, a special rule provides that passive FPHCI must be reduced by related person interest expense, with any excess being allocated to the CFC's other categories of income. Reg. §1.954-1(c)(1)(i)(C). *See* Reg. §1.954-1(c)(1)(iii)(B) (defining passive FPHCI). Lastly, the other items of FBCI and FPHCI are reduced by other expenses allocable and apportionable to such income. Reg. §1.954-1(c)(1)(i)(D).

[17] Reg. §1.952-2(b)(1) ("[T]he taxable income of a foreign corporation for any taxable year shall … be determined by treating such foreign corporation as a domestic corporation taxable under section 11 and by applying the principles of section 63."); Code Sec. 63. ("[T]he term 'taxable income' means gross income minus the deductions allowed by this chapter.")

[18] Under Code Sec. 952(c), the amount of Subpart F income taxable to a Section 951(b) U.S. Shareholder is limited to the current year earnings and profits of the CFC. *See also* Reg. §1.952-2(c)(1). The computation of a CFC's current year earnings and profits is determined under "rules substantially similar to those applicable to domestic corporations," with certain modifications. *See* Code Secs. 964(a) and 952(c)(3). The earnings and profits of a domestic corporation, and by extension, a CFC, generally do not take into account whether the CFC's expenses are deductible for U.S. federal income tax purposes. *See*, *e.g.*, Reg. §1.312-7(b)(1) ("A loss … may be recognized though not allowed as a deduction … but the mere fact that it is not allowed does not prevent a decrease in earnings and profits by the amount of such disallowed loss."). The final Code Sec. 267A regulations include a special rule that for purposes of the earnings and profits limitation in Code Sec. 952(c) and Reg. §1.952-1(c), a CFC's current year earnings and profits will not be reduced for an interest or royalty payment that is disallowed under Code Sec. 267A if a principal purpose of the transaction to which the payment is made is to reduce or limit the CFC's Subpart F income. *See* Reg. §1.267A-5(b)(4).

[19] Code Sec. 951A(b)(1).

[20] Code Sec. 951A(c)(1).

[21] Code Sec. 951A(c)(2)(A)(i).

[22] Code Sec. 951A(c)(2)(A).

[23] Code Sec. 951A(c)(2)(B)(i).

[24] *See* Reg. §1.951A-2(b)(1) and (2). The gross income and allowable deduction of a CFC generally are determined under the rules of Reg. §1.952-2 for determining the Subpart F income of the CFC. Reg. §1.951A-2(c)(2)(i).

[25] The regulations also include a *de minimis* exception. Under this exception, Code Sec. 267A will not disallow a Specified Party CFC's otherwise allowable deductions for interest or royalties to the extent that the sum of the Specified Party CFC's (and all other related specified parties) disqualified hybrid amounts, disqualified imported mismatch amounts, and amounts subject to the anti-avoidance rule in Reg. §1.267A-5(b)(6) for the taxable year are less than $50,000. *See* Reg. §1.267A-1(c).

[26] *See* Reg. §1.267A-1(b).

[27] Code Sec. 1.267A-5(a)(17). The final Code Sec. 267A regulations define the term "controlled foreign corporation (or CFC)" by cross-reference to Code Sec. 957 and define the term "United States shareholder" by cross-reference to Code Sec. 951(b). *See* Reg. §1.267A-5(a)(4) and (24).

[28] Reg. §1.267A-5(a)(17). *See also* T.D. 9896 (Apr. 8, 2020), 85 FR 19820.

[29] The term "tax resident" includes a "body corporate or other entity … liable to tax under the tax law of a country as a resident." Reg. §1.267A-5(a)(23)(i). Domestic partnerships currently are treated differently for determining the GILTI and Subpart F income inclusions of their partners. For GILTI purposes, a domestic partnership is treated as a foreign partnership so that GILTI inclusions under Code Sec. 951A bypass the partnership entirely and are included directly in the gross income of the partners that independently qualify as Section 951(b) U.S. Shareholders of the CFC. *See* Reg. §1.951A-1(e). Thus, in this case, domestic partnerships should not be considered a "tax resident" of the United States for purposes of the final Code Sec. 267A regulations. *See* Reg. §1.267A-5(a)(23)(i). However, the same rule has not yet been finalized for purposes of Subpart F income inclusions under Code Sec. 951 (although it has been proposed). *See* Proposed Reg. §1.958-1(d)(1). Thus, domestic partnerships are still treated as having a Code Sec. 951 inclusion for the Subpart F income of a CFC, with such amount flowing through to its partners (whether or not such partner would independently qualify as a Section 951(b) U.S. Shareholder of the CFC). In this context, a domestic partnership generally would be considered a "tax resident" of the United States for purposes of the final Code Sec. 267A regulations. Until domestic partnerships are treated consistently for purposes of Code Secs. 951 and 951A income inclusions, the final Code Sec. 267A regulations have included a special rule that treats domestic partnerships as foreign partnerships for all purposes for determining whether a CFC is a specified party. The Treasury Department and the IRS expect that following the finalization of the proposed Code Sec. 958 regulations, the rule treating a domestic partnership as a foreign partnership for purposes of the definition of a specified party will be removed. *See* T.D. 9896 (Apr. 8, 2020), 85 FR 19820.

[30] For purposes of the definition of a "specified party" or for purposes of the exceptions in Reg. §1.267A-3(b), discussed below, the regulations do not address how mid-year changes in ownership of a CFC (and/or its CFC status) may impact the application of the rules.

[31] Reg. §§1.267A-1(b); 1.267A-5(b)(5)(ii).

[32] *See* T.D. 9896 (Apr. 8, 2020), 85 FR 19819.

[33] Reg. §1.267A-5(a)(12) (providing over 12 different examples of types of interest that are subject to the final Code Sec. 267A regulations). *See also* REG-104352-18, 83 FR 67620.

[34] *See* REG-104352-18, 83 FR 67621.

[35] *See* Reg. §1.267A-5(a)(16)(i) (treating a royalty as an amount paid or accrued as consideration for the use of, or the right to use, copyrights, patents, trademarks, designs or models, plans, secret formulas, or other property, including goodwill). The regulations do, however, exclude from the definition of royalties, amounts paid or accrued for: after-sales services; services rendered by a seller to the purchaser under a warranty; pure technical assistance; and an opinion given by an engineer, lawyer, or accountant. Reg. §1.267A-5(a)(16)(iii).

[36] Reg. §1.267A-5(b)(5). *See also* T.D. 9896 (Apr. 8, 2020), 85 FR 19819.

[37] Reg. §1.267A-5(b)(5)(ii).

[38] This is consistent with the language of Code Sec. 267A(a), which focuses exclusively on transactions between related persons.

[39] *See* Reg. §1.267A-2(f) (imposing a relatedness requirement for four of the five disqualified hybrid amount tests in Reg. §1.267A-2(a), (b), (d), and (e)). The fifth test in Reg. §1.267A-2(c), which involves a deemed branch payment, involves a related home office, thus the relatedness requirement in Reg. §1.267A-2(f) is not necessary. *See* REG-104352-18, 83 FR 67618.

[40] Reg. §1.267A-4(a)(1); -4(c)(3)(ii) and (iv).

[41] Under Code Sec. 954(d)(3), relatedness is measured by control, with control of a corporation representing stock possessing more than 50% of the voting power or value of such corporation, and control of a partnership, trust, or estate representing more than 50% (by value) of the beneficial interests in such partnership, trust, or estate.

[42] Reg. §1.267A-5(a)(14). For purposes of the relatedness test, the final regulations provide a special rule that treats entities disregarded as separate from their owners for U.S. tax purposes under Reg. §§301.7701-1 through 301.7701-3, and taxable branches, as corporations. *Id.*

[43] *See* Reg. §§1.267A-2(f); 1.267A-4(a)(1).

[44] *See* Reg. §1.267A-5(a)(20)(i) (defining a structured arrangement).

[45] Reg. §1.267A-5(b)(6)(i) and (ii). *See also* T.D. 9896 (Apr. 8, 2020), 85 FR 19821.

[46] *See* Reg. §1.267A-3(b)(2).

[47] This should be the case even if such payment is reduced by generally applicable deductions when computing the taxable income of the U.S. corporation. *Cf.* Reg. §1.267A-3(a)(1)(ii). Based on the language of the final regulations, it does not appear that U.S. state or local tax laws (to the extent not completely aligned with the U.S. federal income tax laws) would be taken into account for purposes of applying the exception in Reg. §1.267A-3(b)(2). But *see* Reg. §1.267A-3(a)(21) (taking into account tax laws of political subdivisions of certain foreign countries for determining whether a payment of interest or royalties is included or includible in income).

[48] *See* Reg. §1.267A-4(a)(1) and (2); -4(c)(3).

[49] *See* Reg. §1.267A-5(a)(23)(i).

[50] Payments of interest or royalties by a Specified Party CFC to a U.S. partnership (or entity classified as a U.S. partnership) would require additional analysis because U.S. partnerships are not themselves liable to tax in the United States. Whether or not the Specified Party

CFC's payment would be disallowed under the final Code Sec. 267A regulations depends on several factors with respect to the partners of the U.S. partnership.

51 The final Code Sec. 267A regulations generally view long-term deferral as creating a D/NI outcome. Thus, if a related CFC has not already taken into account, or does not take the specified payment of interest or royalties into account in the tax year the payment is made, but will take it into account at some point, then based on all of the facts and circumstances, the related CFC must be 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 CFC's taxable year in which the payment is made in order for the related CFC to be viewed as including such payment in income within the meaning of Reg. §1.267A-3(a)(1)(i). *See also* T.D. 9896 (Apr. 8, 2020), 85 FR 19810.

52 Reg. §1.267A-3(a)(1)(i) and (ii). The final Code Sec. 267A regulations also include special rules for deemed full inclusions and *de minimis* inclusions. Under these rules, a preferential rate, exemption, exclusion, deduction, credit or similar relief particular to a type of payment that reduces 90% or more of the payment is considered to reduce or offset 100% of the payment. Reg. §1.267A-3(a)(5). On the other hand, if the types of relief described in the preceding sentence reduce or offset 10% or less of the payment, such relief is treated as reducing or offsetting none of the payment. *Id. See also* Reg. §1.267A-3(a)(2) (providing a coordination rule for foreign hybrid mismatch rules) and (a)(3) (providing special rules for inclusions with respect to reverse hybrids).

53 Reg. §1.267A-3(a)(1)(ii). *See* Reg. §1.267A-3(a)(4) (providing special rules for payments treated as a recovery of basis with respect to stock or a recovery of principal with respect to indebtedness).

54 Reg. §1.267A-3(a)(1)(ii).

55 *See id.*

56 *See* Senate Committee on Finance, *Explanation of the Bill*, at 384 (Nov. 22, 2017) ("[T]he Committee believes the hybrid arrangements exploit differences in the tax treatment of a transaction or entity under the laws of two or more jurisdictions to achieve double non-taxation.").

57 *See* Reg. §1.267A-6(c), *Ex.* 1(v) (no disqualified hybrid amount where payment made to a recipient in a country with a pure territorial tax regime). *See also* REG-104352-18, 83 FR 67618.

58 *See* Reg. §1.267A-5(a)(19) (last sentence).

59 *See* Reg. §1.267A-6, *Ex.* 1(iii).

60 *See* T.D. 9896 (Apr. 8, 2020), 85 FR 19813-14 ("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 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 .... 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 ....").

61 *See* Reg. §1.267A-2(a)(4) (providing special rules for interest free loans).

62 Reg. §1.267A-3(b)(3). If the Section 951(b) U.S. Shareholder is a U.S. partnership (or a U.S. entity classified as a partnership), the amount includible in the gross income of the Section 951(b) U.S. 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. *Id.* As a result, there would be no reduction for any portion of the Code Sec. 951(a)(1)(A) inclusion of the U.S. partnership that is allocable to a foreign partner that is not subject to U.S. tax on a flow-through basis.

63 *See* Reg. §§1.267A-2(a) and -3(a).

64 *See* T.D. 9896 (Apr. 8, 2020), 85 FR 19814.

65 Reg. §1.267A-3(b)(4).

66 The reduced relief provided in this scenario may not be a major concern for related party hybrid financing and licensing arrangements because the principal Subpart F FPHCI exception that would convert FPHCI into tested income as part of a hybrid arrangement involving different countries does not apply if the payment would reduce the Subpart F income, or the effectively connected income, of the CFC payor. This conclusion is supported by the preamble to the final regulations, because in discussing the need for this reduction in relief it points to an example involving a structured arrangement between unrelated parties. *See* T.D. 9896, 85 FR 19814.

67 *See* Reg. §§1.267A-2(a) and -3(a).

68 Reg. §1.267A-3(b)(1).

69 *See* Reg. §1.267A-6, *Ex.* 7.

70 *See* Reg. §1.267A-5(a)(19) (last sentence). However, if instead of FW, the other 45% of FX was owned by U.S. persons who did not independently qualify as Section 951(b) U.S. Shareholders and FX qualifies as a passive foreign investment company (a "PFIC"), the tentative disqualified hybrid amount of $85× would be further reduced to the extent FX is treated as a qualified electing fund and the U.S. persons included their share of the interest paid by FZ to FX in income under Code Sec. 1293. *See* Reg. §1.267A-3(b)(5).

71 The exceptions in Reg. §1.267A-3(b) are focused on the recipient of the specified payment and, as noted above, reduce the amount of relief provided as Code Sec. 958(a) ownership of the CFC (or PFIC) decreases. The final regulations are not explicit, however, in applying the regulations where there is only partial Code Sec. 958(a) ownership by the Section 951(b) U.S. Shareholders of the Specified Party CFC and the related CFC. For instance, assume a single Section 951(b) U.S. Shareholder owned 55% and 60% of the Specified Party CFC and the related CFC, respectively, with the remaining ownership owned by foreign persons. Based on the policy to avoid double U.S. taxation, the exceptions in Reg. §1.267A-3(b)(3) and (4) should apply so that the amount taxable to the Section 951(b) U.S. Shareholder with respect to the Specified Party CFC takes into account the amount of the full deduction rather than attributing a portion of the non-disallowed deduction to the interests of the Specified Party CFC owned by foreign persons.

72 T.D. 9896, 85 FR 19815.

73 *See* Reg. §1.267A-4(a)(2) and (b)(1)(i). *But see* Reg. §1.267A-4(b)(1)(ii) (incorporating deductions with respect to equity, such as notional interest deductions, into the definition of a hybrid deduction).

74 Reg. §1.267A-4(a)(1).

75 Reg. §1.267A-4(a)(2)(v).

76 *See* T.D. 9896, 85 FR 19815.

77 Reg. §1.267A-4(b)(1)(i). 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. *Id.* Moreover, a hybrid deduction also includes certain deductions allowed to a foreign tax resident or foreign taxable branch with respect to equity (or deemed equity) such as a notional interest deduction. *See* Reg. §1.267A-4(b)(1)(ii).

78 *See* T.D. 9896, 85 FR 19817.

79 Reg. §1.267A-4(b)(2)(iv).

80 Reg. §1.267A-4(b)(2)(iv)(A) and (B).

81 Reg. §1.267A-4(b)(2)(iv)(B).

82 *See* Reg. §1.951A-2(c)(5)(iii)(B) (defining residual CFC gross income).

83 Reg. §1.267A-4(g). The adjustments in Reg. §1.267A-4(g) also apply to determine the amount of a funded taxable payment that is taken into account for purposes of the set-off rules in Reg. §1.267A-4(c) with respect to whether an imported mismatch payment indirectly funds a hybrid deduction. *See* Reg. §1.267A-4(c)(3)(v)(C).

84 *See* Reg. §§1.267A-2(d); 1.267A-3(a)(3).

85 Because it is assumed that the $100× payment by FW to FZ would qualify for the Subpart F, FPHCI exception under Code Sec. 954(c)(6), the $30× represents the amount by which US1's *pro rata* share of (i) the tested income of FZ would be increased, (ii) the tested loss of FZ would be reduced, or (iii) both (i) and (ii). *See* Reg. §1.267A-3(b)(3).

86 As noted above, we have assumed that the anti-avoidance rule in Reg. §1.267A-5(b)(6) does not apply to any of the examples provided herein.

87 *See* Reg. §1.267A-4(c)(2)(ii).

88 *See* Reg. §1.267A-4(c)(3)(i).

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