INTERNAL REVENUE
BULLETIN

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IRS

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.

ADMINISTRATIVE

NOTICE 2019–06, page 353.

This notice informs taxpayers that the Department of the Treasury and the Internal Revenue Service intend to propose regulations addressing certain special enforcement matters under section 6241(11). Specifically, this Notice explains that proposed rules will be issued that provide the IRS may determine that the centralized partnership audit regime will not apply to adjustments to partnership-related items in certain limited circumstances and that partnerships with a qualified subchapter S subsidiary (QSub) are not eligible to elect out of the centralized partnership audit regime except by applying a rule similar to the rules for S corporations under section 6221(b)(2)(A) to the QSub partner. This notice also requests comments regarding other special enforcement matters that could be the subject of future proposed regulations.

REG–104352–18, page 357.

Proposed 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 proposed 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.

EMPLOYEE PLANS

NOTICE 2019–03, page 350.

This notice sets forth updates on the corporate bond monthly yield curve, the corresponding spot segment rates for December 2018 used under § 417(e)(3)(D), the 24-month average segment rates applicable for December 2018, and the 30-year Treasury rates, as reflected by the application of § 430(h)(2)(C)(iv).

Finding Lists begin on page ii.

EMPLOYMENT TAX

NOTICE 2019–08, page 354.

This Notice provides the maximum fair market value of a vehicle eligible to use the fleet-average and cents-per-mile special valuation rules of Treas. Reg. section 1.61–21(d) and (e), respectively, for 2018. These special valuation rules may be used to value an employee's personal use of an employer-provided vehicle for income and employment tax purposes.

INCOME TAX

NOTICE 2019–08, page 354.

This Notice provides the maximum fair market value of a vehicle eligible to use the fleet-average and cents-per-mile special valuation rules of Treas. Reg. section 1.61–21(d) and (e), respectively, for 2018. These special valuation rules may be used to value an employee's personal use of an employer-provided vehicle for income and employment tax purposes.

Rev. Proc. 2019–08, page 347.

This revenue procedure describes how taxpayers elect to expense under section 179(a) the cost of qualified real property and how taxpayers change their computation of depreciation for certain assets to the alternative depreciation system of section 168(g), for taxable years beginning after 2017. This revenue procedure also defines qualified real property under section 179. Effective date December 21, 2018, Rev. Proc. 87–57 and Rev. Proc. 2018–31 are modified.

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.

Part III. Administrative, Procedural, and Miscellaneous

26 CFR 1.179–5: Time and manner of making election. (Also Part 1, §§ 168, 446; 1.168(i)–4, 1.446–1.)

Rev. Proc. 2019–08

SECTION 1. PURPOSE

This revenue procedure provides guidance under §§ 13101(b), 13204(a)(3), and 13205 of the Tax Cuts and Jobs Act, Pub. L. No. 115–97, 131 Stat. 2054 (Dec. 22, 2017) (the "TCJA"). Section 13101(b) of the TCJA amended § 179 of the Internal Revenue Code by modifying the definition of qualified real property that may be eligible as § 179 property under § 179(d)(1). Section 13204(a)(3) of the TCJA amended § 168 by (i) requiring certain property held by an electing real property trade or business, as defined in § 163(j)(7)(B), to be depreciated under the alternative depreciation system in § 168(g), and (ii) changing the recovery period under the alternative depreciation system from 40 to 30 years for residential rental property. Section 13205 of the TCJA amended § 168 by requiring certain property held by an electing farming business, as defined in § 163(j)(7)(C), to be depreciated under the alternative depreciation system. This revenue procedure also modifies Rev. Proc. 87–57, 1987–2 C.B. 687, to provide an optional depreciation table for residential rental property depreciated under the alternative depreciation system with a 30-year recovery period, and Rev. Proc. 2018–31, 2018–22 I.R.B. 637, to provide guidance for calculating a § 481(a) adjustment for a change in method of accounting due to a change in the use of depreciable tangible property.

SECTION 2. BACKGROUND

.01 *Modifications to § 179.*

(1) Section 179(a) allows a taxpayer to elect to treat the cost (or a portion of the cost) of any § 179 property as an expense for the taxable year in which the taxpayer places the property in service. Sections 179(b)(1) and (2) prescribe a dollar limitation on the aggregate cost of § 179 property that can be treated as an expense under § 179(a). The dollar limitation is the amount under § 179(b)(1) (the § 179(b)(1) limitation), reduced (but not below zero) by the amount by which the cost of § 179 property placed in service during the taxable year exceeds the amount under § 179(b)(2) (the § 179(b)(2) limitation). For taxable years beginning after 2017, the § 179(b)(1) limitation is $1,000,000 and the § 179(b)(2) limitation is $2,500,000. Pursuant to § 179(b)(6), these limitation amounts are adjusted for inflation for taxable years beginning after 2018. For taxable years beginning in 2019, section 3.26 of Rev. Proc. 2018–57, 2018–49 I.R.B. 827, provides that the § 179(b)(1) limitation is $1,020,000 and the § 179(b)(2) limitation is $2,550,000.

(2) Section 179(b)(3)(A) provides that a taxpayer's § 179 deduction for any taxable year, after application of the § 179(b)(1) and (2) limitations, is limited to the taxpayer's taxable income for that taxable year that is derived from the taxpayer's active conduct of any trade or business during that taxable year (taxable income limitation). Section 179(b)(3)(B) provides that the amount of any cost of § 179 property elected to be expensed in a taxable year that is disallowed as a § 179 deduction under the taxable income limitation may be carried forward for an unlimited number of years and may be deducted under § 179(a) in a future year, subject to the same limitations.

(3) Section 179(c) provides the rules for making and revoking elections under § 179 ("§ 179 election"). Pursuant to § 179(c)(1), a § 179 election is made in the manner prescribed by regulations. Section 1.179–5(c)(1) of the Income Tax Regulations provides the manner for making or revoking a § 179 election for any taxable year beginning after 2002 and before 2008. Section 1.179–5(c) was promulgated in 2005 and has not been amended to reflect subsequent amendments to § 179(c). However, in 2017, the Treasury Department and the IRS issued Rev. Proc. 2017–33, 2017–19 I.R.B. 1236. Section 3.02 of Rev. Proc. 2017–33 provides that for a taxable year beginning after 2014, the taxpayer will be permitted to make a § 179 election for any § 179 property without the Commissioner's consent on an amended federal tax return for the taxable year in which the taxpayer places in service the § 179 property. Section 3.02 of Rev. Proc. 2017–33 further provides that until § 1.179–5(c) is amended to incorporate this guidance, taxpayers may rely on such guidance.

(4) Section 179(d) defines the term "§ 179 property." Prior to amendment by the TCJA, § 179(d)(1) defined § 179 property as property that is: (A)(i) tangible property to which § 168 applies, or (ii) computer software, as defined in § 197(e)(3)(B), that is described in § 197(e)(3)(A)(i) and to which § 167 applies; (B) § 1245 property as defined in § 1245(a)(3); and (C) acquired by purchase for use in the active conduct of a trade or business. Prior to amendment by the TCJA, § 179(d)(1) further provided that § 179 property does not include any property described in § 50(b).

Section 13101(b)(1) of the TCJA amended § 179(d)(1)(B) to provide that if the taxpayer elects, § 179 property may include qualified real property as defined in § 179(f). Section 13101(c) of the TCJA also amended the flush language in § 179(d)(1) to allow property used predominantly to furnish lodging or in connection with the furnishing of lodging as described in § 50(b)(2) to be § 179 property. These amendments apply to property placed in service in taxable years beginning after December 31, 2017.

(5) Prior to amendment by the TCJA, § 179(f)(1) provided that § 179 property included qualified real property if the taxpayer elected the application of § 179(f) for the taxable year, and § 179(f)(2) defined "qualified real property" as meaning qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property described in § 168(e)(6), (7), and (8), respectively, as in effect on the day before the date of the enactment of the TCJA. Section 13101(b)(2) of the TCJA amended § 179(f) by defining qualified real property as (1) any qualified improvement property described in § 168(e)(6) and (2) any of the following improvements to nonresidential real property placed in service after the date such property was first placed in service: roofs; heating, ventilation, and air-conditioning property; fire protection and alarm systems; and security systems. These amendments apply to property placed in service in taxable years beginning after December 31, 2017.

Some taxpayers have inquired as to whether the election to treat qualified real property as § 179 property is made in accordance with the § 179 election procedures in § 1.179–5(c) or the procedures in Notice 2013–59, 2013–40 I.R.B. 297, for electing the application of former § 179(f)(1). Section 3 of this revenue procedure addresses this issue.

(6) Section 401(b)(15)(A) of the Consolidated Appropriations Act, 2018, Pub. L. No. 115–141, Div. U, Title IV, 132 Stat. 348 (Mar. 23, 2018) (the "2018 Act"), removed § 179(e), which provided special rules for qualified disaster assistance property, and redesignated § 179(f) as § 179(e).

.02 *Modifications to § 168(g).*

(1) Prior to amendment by the TCJA, § 168(g)(1) provided that the depreciation deduction provided by § 167(a) is determined under the alternative depreciation system for: (A) any tangible property that during the taxable year is used predominantly outside the United States; (B) any tax-exempt use property; (C) any tax-exempt bond financed property; (D) any imported property covered by an Executive order under § 168(g)(6); and (E) any property to which an election under § 168(g)(7) applies. Sections 13204(a)(3)(A)(i) and 13205(a) of the TCJA amended § 168(g)(1) by requiring the depreciation deduction provided by § 167(a) to be determined under the alternative depreciation system for the following additional property: nonresidential real property, residential rental property, and qualified improvement property held by an electing real property trade or business as defined in § 163(j)(7)(B); and any property with a recovery period of 10 years or more that is held by an electing farming business as defined in § 163(j)(7)(C). These amendments apply to taxable years beginning after December 31, 2017, without regard to when the property is or was placed in service.

Some taxpayers that are electing real property trades or businesses or electing farming businesses have inquired about how depreciation is changed from the general depreciation system under § 168(a) to the alternative depreciation system under § 168(g) for property placed in service in taxable years beginning before 2018. Section 4 of this revenue procedure addresses this issue.

(2) Prior to amendment by the TCJA, the table of recovery periods under § 168(g)(2)(C) provided that the recovery period was 40 years for residential rental property. Section 13204(a)(3)(C) of the TCJA amended that table by providing that the recovery period is 30 years for residential rental property. This amendment applies to property placed in service after December 31, 2017.

Some taxpayers have inquired whether residential rental property placed in service before 2018 has a recovery period of 30 or 40 years under the alternative depreciation system. Section 4 of this revenue procedure addresses this issue.

.03 *Optional depreciation table under the alternative depreciation system for residential rental property placed in service after 2017.* Rev. Proc. 87–57 provides guidance for computing depreciation deductions for tangible property under § 168. Sections 2–7 of Rev. Proc. 87–57 prescribe the manner of computing such depreciation deductions. Section 8 of Rev. Proc. 87–57 contains optional depreciation tables that may be used by certain taxpayers in lieu of computing depreciation deductions in the manner described in sections 2–7 of Rev. Proc. 87–57.

Section 8.01 of Rev. Proc. 87–57 provides that the optional depreciation tables may be used for any item of property placed in service in a taxable year. For all items of property placed in service in a taxable year for which the optional depreciation tables are not used, depreciation deductions must be computed in the manner prescribed in sections 2–7 of Rev. Proc. 87–57.

Section 8.02 of Rev. Proc. 87–57 provides that the optional depreciation tables specify schedules of annual depreciation rates to be applied to the unadjusted basis of the property in each taxable year. If a taxpayer uses an optional depreciation table to compute the annual depreciation deduction for any item of property, the taxpayer must use the table to compute the annual depreciation deductions for the entire recovery period of such property. However, a taxpayer may not continue to use the table if there are any adjustments to the basis of such item of property for reasons other than (1) depreciation allowed or allowable, or (2) an addition or an improvement to such property that is subject to depreciation as a separate item of property. Use of the optional depreciation tables to compute depreciation deductions does not require the filing of any notice with the Internal Revenue Service (IRS).

The IRS has not previously published an optional table for property depreciated under the alternative depreciation system with a recovery period of 30 years and the mid-month convention. Some taxpayers have requested the IRS to provide an optional depreciation table for residential rental property that is placed in service after December 31, 2017, and depreciated under the alternative depreciation system of § 168(g) using the straight-line method, the new 30-year recovery period required by the TCJA, and the mid-month convention. This table is provided in section 4 of this revenue procedure.

.04 *Subsequent References.* Unless otherwise specifically stated, all references in the subsequent sections of this revenue procedure to § 168(g) are to § 168(g) as in effect after the enactment of the TCJA and to § 179 are to § 179 as in effect after the enactment of the 2018 Act.

SECTION 3. QUALIFIED REAL PROPERTY UNDER § 179

.01 *Definition.*

(1) *Taxable year beginning after 2017.* For property placed in service by the taxpayer in any taxable year beginning after 2017, the following types of property are qualified real property that may be eligible as § 179 property under § 179(d)(1):

(a) Qualified improvement property, as described in § 168(e)(6), that is placed in service by the taxpayer. The definition of qualified improvement property in § 168(e)(6) is the same definition of that term in § 168(k)(3) as in effect on the day before the date of enactment of the TCJA. Accordingly, see section 4.02 of Rev. Proc. 2017–33 for further guidance on the definition of qualified improvement property; and

(b) An improvement to nonresidential real property, as defined in § 168(e)(2)(B), if the improvement:

(i) Is placed in service by the taxpayer after the date such nonresidential real property was first placed in service by any person;

(ii) Is § 1250 property; and

(iii) Is:

(A) A roof;

(B) Heating, ventilation, and air-conditioning property (HVAC). A central HVAC system includes all components that are in, on, or adjacent to the nonresidential real property. *See* § 1.48–1(e)(2);

(C) A fire protection and alarm system; or

(D) A security system.

(2) *Taxable year beginning in 2017 and ending in 2018.* For property placed in service by the taxpayer in a taxable year beginning in 2017 and ending in 2018, qualified real property is qualified leasehold improvement property, qualified restaurant property, or qualified retail improvement property as described in § 179(f)(1) and (2) as in effect on the day before the date of enactment of the TCJA. Qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property are defined in § 168(e)(6), (e)(7), and (e)(8), respectively, as in effect on the day before the date of the enactment of the TCJA.

.02 *Election to Treat Qualified Real Property as § 179 Property.* A taxpayer may elect to expense under § 179(a) the cost, or a portion of the cost, of qualified real property placed in service by the taxpayer during any taxable year beginning after 2017 by filing an original or amended Federal tax return for that taxable year in accordance with procedures similar to those in § 1.179–5(c)(2) and section 3.02 of Rev. Proc. 2017–33. If a taxpayer elects or elected to expense under § 179(a) a portion of the cost of qualified real property placed in service by the taxpayer during any taxable year beginning after 2017, the taxpayer is permitted to increase the portion of the cost of such property expensed under § 179(a) by filing an amended Federal tax return for that taxable year. Any such increase in the amount expensed under § 179 is not deemed to be a revocation of the prior election for that taxable year.

SECTION 4. ALTERNATIVE DEPRECIATION SYSTEM UNDER § 168(g)

.01 *Recovery period of residential rental property.*

(1) *In general.* The recovery period under the table in § 168(g)(2)(C) is 30 years for residential rental property placed in service by the taxpayer after December 31, 2017, and is 40 years for residential rental property placed in service by the taxpayer before January 1, 2018.

(2) *Optional depreciation table.* Below is the optional depreciation table for residential rental property placed in service by the taxpayer after December 31, 2017, and depreciated by the taxpayer under the alternative depreciation system of § 168(g) using the straight-line method, a 30-year recovery period, and the mid-month convention.

Table—Alternative Depreciation System
Method: Straight line
Convention: Mid-month
Recovery period: 30 years

	Month in the 1st recovery year the property is placed in service											
	1	2	3	4	5	6	7	8	9	10	11	12
Year												
1	3.204%	2.926%	2.649%	2.371%	2.093%	1.815%	1.528%	1.250%	0.972%	0.694%	0.417%	0.139%
2–30	3.333%	3.333%	3.333%	3.333%	3.333%	3.333%	3.333%	3.333%	3.333%	3.333%	3.333%	3.333%
31	0.139%	0.417%	0.694%	0.972%	1.250%	1.528%	1.815%	2.093%	2.371%	2.649%	2.926%	3.204%

.02 *Electing real property trade or business or electing farming business.*

(1) *In general.* Section 168(g)(1)(F) and (G) provide that the depreciation deduction provided by § 167(a) must be determined in accordance with the alternative depreciation system in § 168(g) for the following types of MACRS property (as defined in § 1.168(b)–1(a)(2)):

(a) Any nonresidential real property (as defined in § 168(e)(2)(B)), residential rental property (as defined in § 168(e)(2)(A)), and qualified improvement property (as defined in § 168(e)(6)) held by an electing real property trade or business (as defined in § 163(j)(7)(B) and the regulations thereunder); and

(b) Any property with a recovery period of 10 years or more that is held by an electing farming business (as defined in § 163(j)(7)(C) and the regulations thereunder). For determining what MACRS property has a recovery period of 10 years or more, the recovery period is determined in accordance with § 168(c).

(2) *Changing depreciation of property to the alternative depreciation system.*

(a) *In general.* For the first taxable year for which an electing real property trade or business or an electing farming business makes an election under § 163(j)(7)(B) or (C), respectively, and the regulations thereunder (the "election year"), that trade or business must begin depreciating the properties described in section 4.02(1) of this revenue procedure, as applicable, in accordance with the alternative depreciation system in § 168(g). The preceding sentence applies to such property placed in service by the trade or business in taxable years beginning before the election year ("existing property") and such property placed in service by the trade or business in the election year and subsequent taxable years ("newly-acquired property").

(b) *Existing property.* For existing property described in section 4.02(1) of this revenue procedure, as applicable, a change in use occurs under § 168(i)(5) and § 1.168(i)–4(d) for the election year as a result of the election under § 163(j)(7)(B) or (C), as applicable. Accordingly, depreciation for such property beginning for the election year is determined in accordance with § 1.168(i)–4(d). Pursuant to § 1.168(i)–4(f), a change in computing depreciation for the election year for such existing property is not a change in method of accounting under § 446(e). If any such existing property was qualified property under § 168(k) in the taxable year in which the trade or business placed the property in service, the additional first year depreciation deduction allowable for that property is not redetermined. *See* § 1.168(k)–1(f)(6)(iv)(A).

(c) *Newly-acquired property.* For newly-acquired property described in section 4.02(1) of this revenue procedure, as applicable, the taxpayer determines the depreciation in accordance with the alternative depreciation system for such property for its placed-in-service year and the subsequent taxable years. Because such newly-acquired property is required to be depreciated under the alternative depreciation system, the property is not qualified property for purposes of the additional first year depreciation deduction under § 168(k). *See* § 168(k)(2)(D).

(3) *Failure to change to alternative depreciation system.*

(a) *Existing property.* If an electing real property trade or business or an electing farming business does not depreciate any existing property that is described in section 4.02(1) of this revenue procedure, as applicable, under the alternative depreciation system for the election year and the subsequent taxable year then that trade or business has adopted an impermissible method of accounting for that item of MACRS property. As a result, a change from that impermissible method of accounting to the straight-line method, the applicable recovery period, and/or the applicable convention under the alternative depreciation system for the item of MACRS property is a change in method of accounting under § 446(e). *See* § 1.446–1(e)(2)(ii)(*d*)(*2*)(*i*). The taxpayer requests to make such a method change by filing Form 3115, *Application for Change in Accounting Method*, in accordance with the automatic change procedures or non-automatic change procedures, as applicable, in Rev. Proc. 2015–13, 2015–5 I.R.B. 419 (or any successor). If the taxpayer is eligible to make this method change under the automatic change procedures, the method change is described in section 6.05 of Rev. Proc. 2018–31 (or any successor). The § 481(a) adjustment as of the first day of the year of change is calculated as though the change in use occurred for the item of MACRS property in the election year.

(b) *Newly-acquired property.* If an electing real property trade or business or an electing farming business does not determine its depreciation under the alternative depreciation system for any newly-acquired property that is described in section 4.02(1) of this revenue procedure, as applicable, for its placed-in-service year and the subsequent taxable year then that trade or business has adopted an impermissible method of accounting for that item of MACRS property. As a result, a change from that impermissible method of accounting to the straight-line method, the applicable recovery period, and/or the applicable convention under the alternative depreciation system for the item of MACRS property is a change in method of accounting under § 446(e). *See* § 1.446–1(e)(2)(ii)(*d*)(*2*)(*i*). The taxpayer requests to make such a method change by filing Form 3115 in accordance with the automatic change procedures or non-automatic change procedures, as applicable, in Rev. Proc. 2015–13 (or any successor). If the taxpayer is eligible to make this method change under the automatic change procedures, the method change is described in section 6.01 of Rev. Proc. 2018–31 (or any successor), provided none of the inapplicability provisions in section 6.01(1)(c) of Rev. Proc. 2018–31 (or any successor) apply. The § 481(a) adjustment as of the first day of the year of change is calculated as though the taxpayer determined depreciation under the alternative depreciation system for the item of MACRS property beginning for its placed-in-service year.

SECTION 5. MODIFICATION TO REV. PROC. 2018–31

Section 6.05 of Rev. Proc. 2018–31 provides the procedures for obtaining automatic consent to change the method of accounting for depreciation due to a change in the use of MACRS property. Section 6.05 of Rev. Proc. 2018–31 is modified as follows:

.01 Section 6.05(3), (4), and (5) are redesignated as section 6.05(4), (5), and (6), respectively; and

.02 New section 6.05(3) is added to read as follows:

(3) *Section 481(a) adjustment.* A taxpayer changing its method of accounting under this section 6.05 is required to calculate a § 481(a) adjustment as of the first day of the year of change as if the proposed method of accounting had always been used by the taxpayer beginning with the taxable year in which the change in the use of the MACRS property occurred by the taxpayer.

SECTION 6. EFFECTIVE DATE

This revenue procedure is effective December 21, 2018.

SECTION 7. EFFECT ON OTHER DOCUMENTS

Rev. Proc. 87–57 and Rev. Proc. 2018–31 are modified.

SECTION 8. DRAFTING INFORMATION

The principal author of this revenue procedure is Charles Magee of the Office of Associate Chief Counsel (Income Tax & Accounting). For further information regarding this revenue procedure, contact Mr. Magee at (202) 317-7005 (not a toll-free number).

Update for Weighted Average Interest Rates, Yield Curves, and Segment Rates

Notice 2019–03

This notice provides guidance on the corporate bond monthly yield curve, the corresponding spot segment rates used under § 417(e)(3), and the 24-month average segment rates under § 430(h)(2) of the Internal Revenue Code. In addition, this notice provides guidance as to the interest rate on 30-year Treasury securities under § 417(e)(3)(A)(ii)(II) as in effect for plan years beginning before 2008 and the 30-year Treasury weighted average rate under § 431(c)(6)(E)(ii)(I).

YIELD CURVE AND SEGMENT RATES

Section 430 specifies the minimum funding requirements that apply to single-employer plans (except for CSEC plans under § 414(y)) pursuant to § 412. Section 430(h)(2) specifies the interest rates that must be used to determine a plan's target normal cost and funding target. Under this provision, present value is generally determined using three 24-month average interest rates ("segment rates"), each of which applies to cash flows during specified periods. To the extent provided under § 430(h)(2)(C)(iv), these segment rates are adjusted by the applicable percentage of the 25-year average segment rates for the period ending September 30 of the year preceding the calendar year in which the plan year begins.[1] However, an election may be made under § 430(h)(2)(D)(ii) to use the monthly yield curve in place of the segment rates.

Notice 2007–81, 2007–44 I.R.B. 899, provides guidelines for determining the monthly corporate bond yield curve, and the 24-month average corporate bond segment rates used to compute the target normal cost and the funding target. Consistent with the methodology specified in Notice 2007–81, the monthly corporate bond yield curve derived from November 2018 data is in Table 2018–11 at the end of this notice. The spot first, second, and third segment rates for the month of November 2018 are, respectively, 3.43, 4.46, and 4.88.

The 24-month average segment rates determined under § 430(h)(2)(C)(i) through (iii) must be adjusted pursuant to § 430(h)(2)(C)(iv) to be within the applicable minimum and maximum percentages of the corresponding 25-year average segment rates. For plan years beginning before 2021, the applicable minimum percentage is 90% and the applicable maximum percentage is 110%. The 25-year average segment rates for plan years beginning in 2017, 2018, and 2019 were published in Notice 2016–54, 2016–40 I.R.B. 429, Notice 2017–50, 2017–41 I.R.B. 280, and Notice 2018–73, 2018–40 I.R.B. 526, respectively.

24-MONTH AVERAGE CORPORATE BOND SEGMENT RATES

The three 24-month average corporate bond segment rates applicable for December 2018 without adjustment for the 25-year average segment rate limits are as follows:

24-Month Average Segment Rates Without 25-Year Average Adjustment

Applicable Month	First Segment	Second Segment	Third Segment
December 2018	2.50	3.92	4.50

Based on § 430(h)(2)(C)(iv), the 24-month averages applicable for December 2018, adjusted to be within the applicable minimum and maximum percentages of the corresponding 25-year average segment rates, are as follows:

Adjusted 24-Month Average Segment Rates

For Plan Years Beginning In	Applicable Month	First Segment	Second Segment	Third Segment
2017	December 2018	4.16	5.72	6.48
2018	December 2018	3.92	5.52	6.29
2019	December 2018	3.74	5.35	6.11

30-YEAR TREASURY SECURITIES INTEREST RATES

Section 431 specifies the minimum funding requirements that apply to multiemployer plans pursuant to § 412. Section 431(c)(6)(B) specifies a minimum amount for the full-funding limitation described in § 431(c)(6)(A), based on the plan's current liability. Section 431(c)(6)(E)(ii)(I) provides that the interest rate used to calculate current liability for this purpose must be no more than 5 percent above and no more than 10 percent below the weighted average of the rates of interest on 30-year Treasury securities during the four-year period ending on the last day before the beginning of the plan year. Notice 88–73, 1988–2 C.B. 383, provides guidelines for determining the weighted average interest rate. The rate of interest on 30-year Treasury securities for November 2018 is 3.36 percent. The Service determined this rate as the average of the daily determinations of yield on the 30-year Treasury bond maturing in August 2048 determined each day through November 6, 2018 and the yield on the 30-year Treasury bond maturing in November 2048 determined each day for the balance of the month. For plan years beginning in December 2018, the weighted average of the rates of interest on 30-year Treasury securities and the permissible range of rates used to calculate current liability are as follows:

Treasury Weighted Average Rates

For Plan Years Beginning In	30-Year Treasury Weighted Average	Permissible Range 90% to 105%
December 2018	2.91	2.62 to 3.06

[1]Pursuant to § 433(h)(3)(A), the 3rd segment rate determined under § 430(h)(2)(C) is used to determine the current liability of a CSEC plan (which is used to calculate the minimum amount of the full funding limitation under § 433(c)(7)(C)).

MINIMUM PRESENT VALUE SEGMENT RATES

In general, the applicable interest rates under § 417(e)(3)(D) are segment rates computed without regard to a 24-month average. Notice 2007–81 provides guidelines for determining the minimum present value segment rates. Pursuant to that notice, the minimum present value segment rates determined for November 2018 are as follows:

Minimum Present Value Segment Rates

Month	First Segment	Second Segment	Third Segment
November 2018	3.43	4.46	4.88

DRAFTING INFORMATION

The principal author of this notice is Tom Morgan of the Office of the Associate Chief Counsel (Tax Exempt and Government Entities). However, other personnel from the IRS participated in the development of this guidance. For further information regarding this notice, contact Mr. Morgan at 202-317-6700 or Paul Stern at 202-317-8702 (not toll-free calls).

Table 2018–11
Monthly Yield Curve for November 2018
Derived from November 2018 Data

Maturity	*Yield*	*Maturity*	*Yield*	*Maturity*	*Yield*	*Maturity*	*Yield*	*Maturity*	*Yield*
0.5	2.90	20.5	4.77	40.5	4.89	60.5	4.93	80.5	4.96
1.0	3.08	21.0	4.78	41.0	4.89	61.0	4.93	81.0	4.96
1.5	3.24	21.5	4.78	41.5	4.89	61.5	4.94	81.5	4.96
2.0	3.37	22.0	4.79	42.0	4.90	62.0	4.94	82.0	4.96
2.5	3.46	22.5	4.79	42.5	4.90	62.5	4.94	82.5	4.96
3.0	3.53	23.0	4.80	43.0	4.90	63.0	4.94	83.0	4.96
3.5	3.59	23.5	4.80	43.5	4.90	63.5	4.94	83.5	4.96
4.0	3.64	24.0	4.80	44.0	4.90	64.0	4.94	84.0	4.96
4.5	3.69	24.5	4.81	44.5	4.90	64.5	4.94	84.5	4.96
5.0	3.75	25.0	4.81	45.0	4.90	65.0	4.94	85.0	4.96
5.5	3.81	25.5	4.82	45.5	4.91	65.5	4.94	85.5	4.96
6.0	3.87	26.0	4.82	46.0	4.91	66.0	4.94	86.0	4.96
6.5	3.94	26.5	4.82	46.5	4.91	66.5	4.94	86.5	4.96
7.0	4.00	27.0	4.83	47.0	4.91	67.0	4.94	87.0	4.96
7.5	4.07	27.5	4.83	47.5	4.91	67.5	4.94	87.5	4.96
8.0	4.13	28.0	4.83	48.0	4.91	68.0	4.94	88.0	4.96
8.5	4.19	28.5	4.84	48.5	4.91	68.5	4.94	88.5	4.96
9.0	4.25	29.0	4.84	49.0	4.91	69.0	4.94	89.0	4.96
9.5	4.30	29.5	4.84	49.5	4.91	69.5	4.95	89.5	4.96
10.0	4.36	30.0	4.84	50.0	4.92	70.0	4.95	90.0	4.96
10.5	4.40	30.5	4.85	50.5	4.92	70.5	4.95	90.5	4.96
11.0	4.45	31.0	4.85	51.0	4.92	71.0	4.95	91.0	4.96
11.5	4.49	31.5	4.85	51.5	4.92	71.5	4.95	91.5	4.96
12.0	4.52	32.0	4.86	52.0	4.92	72.0	4.95	92.0	4.96
12.5	4.55	32.5	4.86	52.5	4.92	72.5	4.95	92.5	4.96
13.0	4.58	33.0	4.86	53.0	4.92	73.0	4.95	93.0	4.96
13.5	4.61	33.5	4.86	53.5	4.92	73.5	4.95	93.5	4.97
14.0	4.63	34.0	4.87	54.0	4.92	74.0	4.95	94.0	4.97
14.5	4.65	34.5	4.87	54.5	4.92	74.5	4.95	94.5	4.97
15.0	4.67	35.0	4.87	55.0	4.93	75.0	4.95	95.0	4.97
15.5	4.68	35.5	4.87	55.5	4.93	75.5	4.95	95.5	4.97

Table 2018–11
Monthly Yield Curve for November 2018
Derived from November 2018 Data

Maturity	*Yield*	*Maturity*	*Yield*	*Maturity*	*Yield*	*Maturity*	*Yield*	*Maturity*	*Yield*
16.0	4.70	36.0	4.87	56.0	4.93	76.0	4.95	96.0	4.97
16.5	4.71	36.5	4.88	56.5	4.93	76.5	4.95	96.5	4.97
17.0	4.72	37.0	4.88	57.0	4.93	77.0	4.95	97.0	4.97
17.5	4.73	37.5	4.88	57.5	4.93	77.5	4.95	97.5	4.97
18.0	4.74	38.0	4.88	58.0	4.93	78.0	4.95	98.0	4.97
18.5	4.75	38.5	4.88	58.5	4.93	78.5	4.95	98.5	4.97
19.0	4.75	39.0	4.89	59.0	4.93	79.0	4.95	99.0	4.97
19.5	4.76	39.5	4.89	59.5	4.93	79.5	4.96	99.5	4.97
20.0	4.77	40.0	4.89	60.0	4.93	80.0	4.96	100.0	4.97

Guidance on Special Enforcement Matters Under the Centralized Partnership Audit Regime

Notice 2019–06

SECTION 1. PURPOSE

This notice informs taxpayers that the Department of the Treasury (Treasury Department) and the Internal Revenue Service (IRS) intend to propose regulations addressing certain special enforcement matters under section 6241(11). This notice also requests comments regarding other special enforcement matters that could be the subject of future proposed regulations.

SECTION 2. BACKGROUND

Section 206(l) of the Technical Corrections Act of 2018, contained in Title II of Division U of the Consolidated Appropriations Act of 2018, Public Law 115–141 (TTCA), added section 6241(11) to the Internal Revenue Code (Code), regarding the treatment of special enforcement matters. Under section 6241(11), in the case of partnership-related items involving special enforcement matters, the Secretary may prescribe regulations providing that the centralized partnership audit regime (or any portion thereof) does not apply to such items and that such items are subject to special rules as the Secretary determines to be necessary for the effective and efficient enforcement of the Code. For purposes of section 6241(11), the term "special enforcement matters" means: (1) failure to comply with the requirements of section 6226(b)(4)(A)(ii) (regarding the requirement for a partnership-partner or S corporation partner to furnish statements or compute and pay an imputed underpayment); (2) assessments under section 6851 (relating to termination assessments of income tax) or section 6861 (relating to jeopardy assessments of income, estate, gift, and certain excise taxes); (3) criminal investigations; (4) indirect methods of proof of income; (5) foreign partners or partnerships; and (6) other matters that the Secretary determines by regulation present special enforcement considerations.

Section 6221(a) requires that any adjustment to a partnership-related item shall be determined at the partnership level under the centralized partnership audit regime, except to the extent otherwise provided in subchapter C of chapter 63 of the Code. A partnership-related item is defined in section 6241(2) as any item or amount with respect to the partnership which is relevant in determining the tax liability of any person under chapter 1 of the Code, including any distributive share of such an item or amount.

Certain partnerships may elect out of the centralized partnership audit regime under section 6221(b). A partnership is eligible to make an election out if it has 100 or fewer partners for the taxable year, each partner in the partnership is an eligible partner, the election is timely made in the manner prescribed by the Secretary, and the partnership notifies its partners of the election in the manner prescribed by the Secretary. The number of partners is determined by counting the number of statements required to be furnished by the partnership under section 6031(b) and the number of statements required to be furnished by any S corporation partners of the partnership. Eligible partners are prescribed in section 6221(b)(1)(C) and Treas. Reg. § 301.6221(b)–1(b)(3)(i), and include C corporations.

A qualified subchapter S subsidiary (QSub) is defined in section 1361(b)(3) as a domestic corporation that has 100 percent of its stock held by an S corporation and for which an election has been made to treat it as a QSub. Except as provided by regulation, a QSub is not treated as a corporation separate from its S corporation shareholder and its assets, liabilities, and items of income, deduction and credit are treated as the assets, liabilities, and items of its S corporation shareholder for the taxable year. Section 1361(b)(3)(A). For purposes of the Code, a C corporation is defined under section 1361(a)(2) as a corporation which is not an S corporation. Because a QSub is not an S corporation, it is a C corporation (as defined in section 1361(a)(2)). Because a QSub is a C corporation, it is an eligible partner under section 6221(b).

SECTION 3. GUIDANCE TO BE ISSUED

The Treasury Department and the IRS intend to propose regulations under section 6241(11)(B)(vi) regarding two matters that the Secretary has determined present special enforcement considerations. The first matter concerns certain situations in which an adjustment during an examination of a person other than the partnership requires a change to a partnership-related item. Specifically, the regulations will allow the IRS to effectively and efficiently focus on a single partner or a small group of partners with respect to a limited set of partnership-related items without unduly burdening the partnership and avoiding procedural concerns about the appropriate level at which such items must be examined. Consequently, the regulations will provide that the IRS may determine that the centralized partnership audit regime does not apply to adjustments to partnership-related items when the following conditions are met:

(1) The examination being conducted is of a person other than the partnership;

(2) A partnership-related item must be adjusted, or a determination regarding a partnership-related item must be made, as part of an adjustment to a non-partnership-related item of the person whose return is being examined; and

(3) The treatment of the partnership-related item on the return of the partnership under section 6031(b) or in the partnership's books and records was based in whole or in part on information provided by, or under the control of, the person whose return is being examined.

The second matter concerns situations where a QSub is a partner in a partnership. The regulations will provide that this situation presents special enforcement considerations because partnership structures with QSubs as partners could have far more than 100 ultimate partners, including many thousands, and still potentially elect out of the centralized partnership audit regime. Allowing such a large partnership to elect out of the centralized partnership audit regime would give rise to significant enforcement concerns for the IRS and frustrate the efficiencies introduced by the centralized partnership regime. As a result, the regulations will provide that section 6221(b) generally does not apply to a partnership with a QSub as a partner. The regulations will also provide, however, that if a partnership meets certain requirements as set forth in the regulations, the partnership may make an election under section 6221(b). Specifically, the regulations will apply a rule similar to the rules for S corporations under section 6221(b)(2)(A). The regulations will also provide that for purposes of determining whether a partnership has 100 or fewer partners for the taxable year for purposes of the election under section 6221(b), the partnership must include (1) the statement the partnership is required to furnish to the QSub partner under section 6031(b) and (2) each statement the S corporation that holds 100 percent of the stock of the QSub partner is required to furnish to its shareholders under section 6037(b).

The Treasury Department and the IRS intend to issue proposed and final regulations prior to eighteen months after enactment of the TTCA such that the intended regulations described in this section of the Notice may be applicable to all partnership taxable years beginning after December 31, 2017. Section 7805(b)(2). If final regulations are not issued prior to eighteen months after enactment of the TTCA, the Treasury Department and the IRS intend the regulations to be applicable to partnership taxable years beginning after December 31, 2017 and ending after the date this Notice is issued to the public. Section 7805(b)(1)(C).

SECTION 4. REQUEST FOR COMMENTS

The Treasury Department and the IRS request comments on the intended regulations described in section 3 of this notice and whether any other matters might present special enforcement matters under section 6241(11). Comments must be received by February 22, 2019.

SECTION 5. ADDRESS TO SEND COMMENTS

Taxpayers may submit comments electronically via the Federal eRulemaking Portal at www.regulations.gov (type IRS–2018–0044 in the search field on the regulations.gov homepage to find this notice and submit comments). All recommendations for guidance submitted by the public in response to this notice will be available for public inspection and copying in their entirety.

Alternatively, taxpayers may mail comments to:

Internal Revenue Service
Attn: CC:PA:LPD:PR (Notice 2019–06)
Room 5203
P.O. Box 7604
Ben Franklin Station
Washington, D.C. 20044

or hand deliver comments Monday through Friday between the hours of 8 a.m. and 4 p.m. to:

Courier's Desk
Internal Revenue Service
Attn: CC:PA:LPD:PR (Notice 2019–06)
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

SECTION 6. DRAFTING INFORMATION

The principal author of this notice is Jennifer M. Black of the Office of the Associate Chief Counsel (Procedure and Administration). For further information regarding this notice, contact Ms. Black at (202) 317-6834 (not a toll-free number).

Maximum Values For 2018 For Use with Vehicle Cents-Per-Mile and Fleet-Average Valuation Rules

Notice 2019–08

I. PURPOSE

This notice provides the 2018 maximum values for use with the vehicle cents-per-mile valuation rule under Treas. Reg. § 1.61–21(e) and the fleet-average valuation rule, which is an optional component of the automobile lease valuation rule under Treas. Reg. § 1.61–21(d). These values are adjusted annually for inflation. This notice also provides interim guidance on new procedures for calculating the inflation adjustments to the maximum values for use with the special valuation rules under Treas. Reg. § 1.61–21(d) and (e) using section 280F(d)(7), as modified by sections 11002 and 13202 of the Tax Cuts and Jobs Act, Pub. L. No. 115–97 (the "Act"). The Internal Revenue Service (IRS) and the Department of the Treasury (Treasury Department) anticipate that further guidance on these issues will be issued in the form of proposed regulations and expect that the regulations will be consistent with the rules set forth in this notice.

BACKGROUND

If an employer provides an employee with a vehicle that is available to the employee for personal use, the value of the personal use generally must be included in the employee's income. Internal Revenue Code § 61; Treas. Reg. § 1.61–21.

For employer-provided vehicles made available to employees for personal use that meet the requirements of Treas. Reg. § 1.61–21(e)(1), generally the value of the personal use may be determined under the vehicle cents-per-mile valuation rule of Treas. Reg. § 1.61–21(e). However, Treas. Reg. § 1.61–21(e)(1)(iii)(A) provides that for a vehicle first made available after 1988 to any employee of the employer for personal use, the value of the personal use may not be determined under the vehicle cents-per-mile valuation rule for a calendar year if the fair market value of the vehicle (determined pursuant to Treas. Reg. § 1.61–21(d)(5)(i) through (iv)) on the first date the vehicle is made available to the employee exceeds the sum of the maximum recovery deductions allowable under section 280F(a) for a five-year period for an automobile first placed in service during that calendar year, as adjusted by section 280F(d)(7). The regulation additionally specifies that, with respect to a vehicle placed in service in or after 1989, the limitation on value consists of a base value of $12,800 that is adjusted annually under section 280F(d)(7).

For employer-provided automobiles available to employees for personal use for an entire year, generally the value of the personal use may be determined under the automobile lease valuation rule of Treas. Reg. § 1.61–21(d). Under this valuation rule, the value of the personal use is the Annual Lease Value. Provided the requirements of Treas. Reg. § 1.61–21(d)(5)(v) are met, an employer with a fleet of 20 or more automobiles may use a fleet-average value for purposes of calculating the Annual Lease Values of the automobiles in the employer's fleet. The fleet-average value is the average of the fair market values of all the automobiles in the fleet. However, Treas. Reg. § 1.61–21(d)(5)(v)(D) provides that for an automobile first made available after 1988 to an employee of the employer for personal use, the value of the personal use may not be determined under the fleet-average valuation rule for a calendar year if the fair market value of the automobile (determined pursuant to Treas. Reg. § 1.61–21(d)(5)(i) through (v)) on the first date the automobile is made available to the employee exceeds the base value of $16,500, as adjusted annually for inflation pursuant to section 280F(d)(7).

Thus, the maximum values for applying the vehicle cents-per-mile and the fleet-average valuation rules reflect the automobile price inflation adjustment of section 280F(d)(7)(B). Prior to enactment of the Act, this price inflation amount for automobiles other than trucks and vans was calculated using the "new car" component of the Consumer Price Index (CPI) "automobile component." Beginning in 2005, the IRS began to calculate the price inflation adjustment for trucks and vans separately using the "new truck" component of the CPI and continued using the "new car" component of the CPI for automobiles other than trucks and vans. *See* Rev. Proc. 2005–48, 2005–32 I.R.B. 271.

Section 11002(d)(8) of the Act amended section 280F(d)(7)(B) effective for tax years beginning after December 31, 2017. Pursuant to these amendments, the price inflation amount for automobiles (including trucks and vans) is calculated using both the CPI automobile component and the Chained Consumer Price Index for All Urban Consumers (C-CPI-U) automobile component. The C-CPI-U does not currently have separate components for new cars and new trucks.

For owners of passenger automobiles, section 280F(a), as modified by section 13202(a)(1) of the Act, imposes dollar limitations on the depreciation deduction for the year the taxpayer places the passenger automobile in service and for each succeeding year. The amendments made by the Act substantially increased the maximum annual dollar limitations on the depreciation deductions for passenger automobiles. The new dollar limitations are based on the depreciation, over a five-year recovery period, of a passenger automobile with a cost of $50,000 (formerly $12,800).

II. GUIDANCE

Consistent with the substantial increase in the dollar limitations on depreciation deductions under section 280F(a), as modified by section 13202(a)(1) of the Act, the IRS and the Treasury Department intend to amend Treas. Reg. § 1.61–21(d) and (e) to incorporate a higher base value of $50,000 as the maximum value for use of the vehicle cents-per-mile and fleet-average valuation rules effective for the 2018 calendar year. Further, the IRS and the Treasury Department intend that the regulations will be modified to provide that this $50,000 base value will be adjusted annually using section 280F(d)(7) for 2019 and subsequent years. Consistent with this intention, in the interim:

(1) The maximum value of an employer-provided vehicle first made available to employees for personal use in calendar year 2018 for which the vehicle cents-per-mile valuation rule provided under Treas. Reg. § 1.61–21(e) may be applicable is $50,000.

(2) The maximum value of an employer-provided automobile first made available to employees for personal use in calendar year 2018 for which the fleet-average valuation rule provided under Treas. Reg. § 1.61–21(d) may be applicable is $50,000.

For 2018 and 2019, due to the lack of data, the IRS and the Treasury Department will not publish separate maximum values for trucks and vans for use with the vehicle cents-per-mile and fleet-average valuation rules.

Employer-provided vehicles are noncash fringe benefits that fall within section 3501(b). Announcement 85–113, 1985–31 I.R.B. 31, provides guidelines for withholding, paying, and reporting employment tax on taxable noncash fringe benefits. Announcement 85–113 provides generally that taxpayers may rely on the guidelines in the announcement until the issuance of regulations that supersede the temporary and proposed regulations under section 3501(b). No regulations have been issued under section 3501(b) that supersede the announcement. Thus, Announcement 85–113 generally is applicable to current payments of noncash fringe benefits, including vehicles.

Section 1 of Announcement 85–113 allows payors of certain noncash fringe benefits to treat the benefits as paid on any day(s) during the year so long as they treat benefits provided in a calendar year as paid not later than December 31 of the calendar year. Section 5 of the announcement allows employers to treat certain benefits paid during the last two months of the year (or any shorter period) as paid during the subsequent calendar year.

Employers that wish to use the vehicle cents-per-mile rule or the fleet-average value rule for 2018 based on the maximum values set forth in this notice may use the rules in Announcement 85–113 or the adjustment process under section 6413 or the refund claim process under section 6402 to correct any overpayment of federal employment taxes on these amounts (see the regulations under these sections, Rev. Rul. 2009–39, 2009–52 I.R.B. 951, section 13 of Publication 15 (Circular E), Employer's Tax Guide, and the Instructions for Form 941-X, Adjusted Employer's QUARTERLY Federal Tax Return or Claim for Refund for information on these adjustment and refund claim processes).

III. REQUEST FOR COMMENTS

Interested parties are invited to submit comments on this notice by February 19, 2019. Comments should include a reference to Notice 2019–08. Comments may be submitted electronically via the Federal eRulemaking Portal at *www.regulations.gov* (type IRS–2019–08 in the search field on the ***regulations.*****gov** homepage to find this notice and submit comments). Alternatively, submissions may be sent to CC:PA:LPD:PR (Notice 2019–08), Room 5203, Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions also may be hand delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (Notice 2019–08), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC 20044. All comments submitted by the public in response to this notice will be available for public inspection and copying in their entirety.

IV. DRAFTING INFORMATION

The principal author of this notice is Gabriel Minc of the Office of Associate Chief Counsel (Tax Exempt and Government Entities). For further information regarding this notice contact Mr. Minc at (202) 317-4774 (not a toll-free number).

Part IV. Items of General Interest

Rules Regarding Certain Hybrid Arrangements Notice of Proposed Rulemaking

REG–104352–18

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed regulations implementing sections 245A(e) and 267A of the Internal Revenue Code ("Code") regarding hybrid dividends and certain amounts paid or accrued in hybrid transactions or with hybrid entities. Sections 245A(e) and 267A were added to the Code by the Tax Cuts and Jobs Act, Pub. L. No. 115–97 (2017) (the "Act"), which was enacted on December 22, 2017. This document also contains proposed regulations under 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. Further, this document contains proposed regulations under sections 6038, 6038A, and 6038C to facilitate administration of certain rules in the proposed regulations. The proposed 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: Written or electronic comments and requests for a public hearing must be received by February 26, 2019.

ADDRESSES: Send submissions to: Internal Revenue Service, CC:PA:LPD:PR (REG–104352–18), Room 5203, Post Office Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand-delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (indicate REG–104352–18), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, N.W., Washington, DC 20224, or sent electronically, via the Federal eRulemaking Portal at *www.regulations.gov* (IRS REG–104352–18).

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, contact Tracy Villecco at (202) 317-3800; 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. *In General*

This document contains proposed amendments to 26 CFR parts 1 and 301 under sections 245A(e), 267A, 1503(d), 6038, 6038A, 6038C, and 7701 (the "proposed regulations"). Added to the Code by sections 14101(a) and 14222(a) of the Act, section 245A(e) denies the dividends received deduction under section 245A with respect to hybrid dividends, and section 267A denies certain interest or royalty deductions involving hybrid transactions or hybrid entities. The proposed regulations only include rules under section 245A(e); rules addressing other aspects of section 245A, including the general eligibility requirements for the dividends received deduction under section 245A(a), will be addressed in a separate notice of proposed rulemaking. Section 14101(f) of the Act provides that section 245A, including section 245A(e), applies to distributions made after December 31, 2017. Section 14222(c) of the Act provides that section 267A applies to taxable years beginning after December 31, 2017. Other provisions of the Code, such as sections 894(c) and 1503(d), also address certain hybrid arrangements.

II. *Purpose of Anti-Hybrid Rules*

A cross-border transaction may be treated differently for U.S. and foreign tax purposes because of differences in the tax law of each country. In general, the U.S. tax treatment of a transaction does not take into account foreign tax law. However, in specific cases, foreign tax law is taken into account – for example, in the context of withholdable payments to hybrid entities for which treaty benefits are claimed under section 894(c) and for dual consolidated losses subject to section 1503(d) – in order to address policy concerns resulting from the different treatment of the same transaction or arrangement under U.S. and foreign tax law.

In response to international concerns regarding hybrid arrangements used to achieve double non-taxation, Action 2 of the OECD's Base Erosion and Profit Shifting ("BEPS") project, and two final reports thereunder, address hybrid and branch mismatch arrangements. *See* OECD/G20, *Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2: 2015 Final Report* (October 2015) (the "Hybrid Mismatch Report"); OECD/G20, *Neutralising the Effects of Branch Mismatch Arrangements, Action 2: Inclusive Framework on BEPS* (July 2017) (the "Branch Mismatch Report"). The Hybrid Mismatch Report sets forth recommendations to neutralize the tax effects of hybrid arrangements that exploit differences in the tax treatment of an entity or instrument under the laws of two or more countries (such arrangements, "hybrid mismatches"). The Branch Mismatch Report sets forth recommendations to neutralize the tax effects of certain arrangements involving branches that result in mismatches similar to hybrid mismatches (such arrangements, "branch mismatches"). Given the similarity between hybrid mismatches and branch mismatches, the Branch Mismatch Report recommends that a jurisdiction adopting rules to address hybrid mismatches adopt, at the same time, rules to address branch mismatches. *See* Branch Mismatch Report, at p. 11, Executive Summary. Otherwise, taxpayers might "shift[] from hybrid mismatch to branch mismatch arrangements in order to secure the same tax advantages." *Id.*

The Act's legislative history explains that section 267A is intended to be "consistent with many of the approaches to the same or similar problems [regarding hybrid arrangements] taken in the Code, the OECD base erosion and profit shifting project ("BEPS"), bilateral income tax treaties, and provisions or rules of other countries." *See* Senate Committee on Finance, Explanation of the Bill, at 384 (November 22, 2017). The types of hybrid arrangements of concern are arrangements that "exploit differences in the tax treatment of a transaction or entity under the laws of two or more tax jurisdictions to achieve double non-taxation, including long-term deferral." *Id.* Hybrid arrangements targeted by these provisions are those that rely on a hybrid element to produce such outcomes.

These concerns also arise in the context of section 245A as a result of the enactment of a participation exemption system for taxing foreign income. Under this system, section 245A(e) generally prevents double non-taxation by disallowing the 100 percent dividends received deduction for dividends received from a controlled foreign corporation ("CFC"), or by mandating subpart F inclusions for dividends received from a CFC by another CFC, if there is a corresponding deduction or other tax benefit in the foreign country.

Explanation of Provisions

I. *Section 245A(e) – Hybrid Dividends*

A. *Overview*

The proposed regulations under section 245A(e) address certain dividends involving hybrid arrangements. The proposed regulations neutralize the double non-taxation effects of these dividends by either denying the section 245A(a) dividends received deduction with respect to the dividend or requiring an inclusion under section 951(a) with respect to the dividend, depending on whether the dividend is received by a domestic corporation or a CFC.

The proposed regulations provide that if a domestic corporation that is a United States shareholder within the meaning of section 951(b) ("U.S. shareholder") of a CFC receives a "hybrid dividend" from the CFC, then the U.S. shareholder is not allowed the section 245A(a) deduction for the hybrid dividend, and the rules of section 245A(d) (denial of foreign tax credits and deductions) apply. *See* proposed § 1.245A(e)–1(b). In general, a dividend is a hybrid dividend if it satisfies two conditions: (i) but for section 245A(e), the section 245A(a) deduction would be allowed, and (ii) the dividend is one for which the CFC (or a related person) is or was allowed a deduction or other tax benefit under a "relevant foreign tax law" (such a deduction or other tax benefit, a "hybrid deduction"). *See* proposed § 1.245A(e)–1(b) and (d). The proposed regulations take into account certain deductions or other tax benefits allowed to a person related to a CFC (such as a shareholder) because, for example, certain tax benefits allowed to a shareholder of a CFC are economically equivalent to the CFC having been allowed a deduction.

B. *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). Thus, for example, a relevant foreign tax law includes the tax law of a foreign country of which the CFC is a tax resident, as well as the tax law applicable to a foreign branch of the CFC.

C. *Deduction or other tax benefit*

1. In General

Under the proposed regulations, only deductions or other tax benefits that are "allowed" under the relevant foreign tax law may constitute a hybrid deduction. *See* proposed § 1.245A(e)–1(d). Thus, for example, if the relevant foreign tax law contains hybrid mismatch rules under which a CFC is denied a deduction for an amount of interest paid with respect to a hybrid instrument to prevent a deduction/no-inclusion ("D/NI") outcome, then the payment of the interest does not give rise to a hybrid deduction, because the deduction is not "allowed." This prevents double-taxation that could arise if a hybrid dividend were subject to both section 245A(e) and a hybrid mismatch rule under a relevant foreign tax law.

For a deduction or other tax benefit to be a hybrid deduction, it must relate to or result from an amount paid, accrued, or distributed with respect to an instrument of the CFC that is treated as stock for U.S. tax purposes. That is, there must be a connection between the deduction or other tax benefit under the relevant foreign tax law and the instrument that is stock for U.S. tax purposes. Thus, a hybrid deduction includes an interest deduction under a relevant foreign tax law with respect to a hybrid instrument (stock for U.S. tax purposes, indebtedness for foreign tax purposes). It also includes dividends paid deductions and other deductions allowed on equity under a relevant foreign tax law, such as notional interest deductions ("NIDs"), which raise similar concerns as traditional hybrid instruments. However, it does not, for example, include an exemption provided to a CFC under its tax law for certain types of income (such as income attributable to a foreign branch), because there is not a connection between the tax benefit and the instrument that is stock for U.S. tax purposes.

The proposed regulations provide that deductions or other tax benefits allowed pursuant to certain integration or imputation systems do not constitute hybrid deductions. *See* proposed § 1.245A(e)–1(d)(2)(i)(B). However, a system that has the effect of exempting earnings that fund a distribution from foreign tax at both the CFC and shareholder level gives rise to a hybrid deduction. *See id.*; *see also* proposed § 1.245A(e)–1(g)(2), *Example 2*.

2. Effect of Foreign Currency Gain or Loss

The payment of an amount by a CFC may, under a provision of foreign tax law comparable to section 988, give rise to gain or loss to the CFC that is attributable to foreign currency. The proposed regulations provide that such foreign currency gain or loss recognized with respect to such deduction or other tax benefit is taken into account for purposes of determining hybrid deductions. *See* proposed § 1.245A(e)–1(d)(6); *see also* section II.K.1 of this Explanation of Provisions (requesting comments on foreign currency rules).

D. *Tiered hybrid dividends*

Proposed § 1.245A(e)–1(c) sets forth rules related to hybrid dividends of tiered corporations ("tiered hybrid dividends"), as provided under section 245A(e)(2). A tiered hybrid dividend means an amount received by a CFC from another CFC to the extent that the amount would be a hybrid dividend under proposed § 1.245A(e)–1(b) if the receiving CFC were a domestic corporation. Accordingly, the amount must be treated as a dividend under U.S. tax law to be treated as a tiered hybrid dividend; the treatment of the amount under the tax law in which the receiving CFC is a tax resident (or under any other foreign tax law) is irrelevant for this purpose.

If a CFC receives a tiered hybrid dividend from another CFC, and a domestic corporation is a U.S. shareholder of both CFCs, then (i) the tiered hybrid dividend is treated as subpart F income of the receiving 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). This treatment applies notwithstanding any other provision of the Code. Thus, for example, exceptions to subpart F income such as those provided under section 954(c)(3) ("same country" exception for income received from related persons) and section 954(c)(6) (look-through rule for related CFCs) do not apply. As additional examples, the gross amount of subpart F income cannot be reduced by deductions taken into account under section 954(b)(5) and § 1.954–1(c), and is not subject to the current earnings and profits limitation under section 952(c).

E. *Interaction with section 959*

Distributions of previously taxed earnings and profits ("PTEP") attributable to amounts that have been taken into account by a U.S. shareholder under section 951(a) are, in general, excluded from the gross income of the U.S. shareholder when distributed under section 959(a), and under section 959(d) are not treated as a dividend (other than to reduce earnings and profits). As a result, distributions from a CFC to its U.S. shareholder out of PTEP are not eligible for the dividends received deduction under section 245A(a), and section 245A(e) does not apply. Similarly, distributions of PTEP from a CFC to an upper-tier CFC are excluded from the gross income of the upper-tier CFC under section 959(b), but only for the limited purpose of applying section 951(a). In addition, such amounts continue to be treated as dividends because section 959(d) does not apply to such amounts. Accordingly, distributions out of PTEP could qualify as tiered hybrid dividends that would result in an income inclusion to a U.S. shareholder. To prevent this result, the proposed regulations provide that a tiered hybrid dividend does not include amounts described in section 959(b). *See* proposed § 1.245A(e)–1(c)(2).

F. *Interaction with section 964(e)*

Under section 964(e)(1), gain recognized by a CFC on the sale or exchange of stock in another foreign corporation may be treated as a dividend. In certain cases, section 964(e)(4): (i) treats the dividend as subpart F income of the selling CFC; (ii) requires a U.S. shareholder of the CFC to include in its gross income its pro rata share of the subpart F income; and (iii) allows the U.S. shareholder the section 245A(a) deduction for its inclusion in gross income. As is the case with the treatment of tiered hybrid dividends, the treatment of dividends under section 964(e)(4) applies notwithstanding any other provision of the Code.

The proposed regulations coordinate the tiered hybrid dividend rules and the rules of section 964(e) by providing that, to the extent a dividend arising under section 964(e)(1) is a tiered hybrid dividend, the tiered hybrid dividend rules, rather than the rules of section 964(e)(4), apply. Thus, in such a case, a U.S. shareholder that includes an amount in its gross income under the tiered hybrid dividend rule is not allowed the section 245A(a) deduction, or foreign tax credits or deductions, for the amount. *See* proposed § 1.245A(e)–1(c)(1) and (4).

G. *Hybrid deduction accounts*

1. In General

In some cases, the actual payment by a CFC of an amount that is treated as a dividend for U.S. tax purposes will result in a corresponding hybrid deduction. In many cases, however, the dividend and the hybrid deduction may not arise pursuant to the same payment and may be recognized in different taxable years. This may occur in the case of a hybrid instrument for which under a relevant foreign tax law the CFC is allowed deductions for accrued (but not yet paid) interest. In such a case, to the extent that an actual payment has not yet been made on the instrument, there generally would not be a dividend for U.S. tax purposes for which the section 245A(a) deduction could be disallowed under section 245A(e). Nevertheless, because the earnings and profits of the CFC would not be reduced by the accrued interest deduction, the earnings and profits may give rise to a dividend when subsequently distributed to the U.S. shareholder. This same result could occur in other cases, such as when a relevant foreign tax law allows deductions on equity, such as NIDs.

The disallowance of the section 245A(a) deduction under section 245A(e) should not be limited to cases in which the dividend and the hybrid deduction arise pursuant to the same payment (or in the same taxable year for U.S. tax purposes and for purposes of the relevant foreign tax law). Interpreting the provision in such a manner would result in disparate treatment for hybrid arrangements that produce the same D/NI outcome. Accordingly, the proposed regulations define a hybrid dividend (or tiered hybrid dividend) based, in part, on the extent of the balance of the "hybrid deduction accounts" of the domestic corporation (or CFC) receiving the dividend. *See* proposed § 1.245A(e)–1(b) and (d). This ensures that dividends are subject to section 245A(e) regardless of whether the same payment gives rise to the dividend and the hybrid deduction.

A hybrid deduction account must be maintained with respect to each share of stock of a CFC held by a person that, given its ownership of the CFC and the share, could be subject to section 245A upon a dividend paid by the CFC on the share. *See* proposed § 1.245A(e)–1(d) and (f). The account, which is maintained in the functional currency of the CFC, reflects the amount of hybrid deductions of the CFC (allowed in taxable years beginning after December 31, 2017) that have been allocated to the share. A dividend paid by a CFC to a shareholder that has a hybrid deduction account with respect to the CFC is generally treated as a hybrid dividend or tiered hybrid dividend to the extent of the shareholder's balance in all of its hybrid deduction accounts with respect to the CFC, even if the dividend is paid on a share that has not had any hybrid deductions allocated to it. Absent such an approach, the purposes of section 245A(e) might be avoided by, for example, structuring dividend payments such that they are generally made on shares of stock to which a hybrid deduction has not been allocated (rather than on shares of stock to which a hybrid deduction has been allocated, such as a share that is a hybrid instrument).

Once an amount in a hybrid deduction account gives rise to a hybrid dividend or a tiered hybrid dividend, the account is correspondingly reduced. *See* proposed § 1.245A(e)–1(d). The Treasury Department and the IRS request comments on whether hybrid deductions attributable to amounts included in income under section 951(a) or section 951A should not increase the hybrid deduction account, or, alternatively, the hybrid deduction account should be reduced by distributions of PTEP, and on whether the effect of any deemed paid foreign tax credits associated with such inclusions or distributions should be considered.

2. Transfers of Stock

Because hybrid deduction accounts are with respect to stock of a CFC, the proposed regulations include rules that take into account transfers of the stock. *See* proposed § 1.245A(e)–1(d)(4)(ii)(A). These rules, which are similar to the "successor" PTEP rules under section 959 (*see* § 1.959–1(d)), ensure that section 245A(e) properly applies to dividends that give rise to a D/NI outcome in cases where the shareholder that receives the dividend is not the same shareholder that held the stock when the hybrid deduction was incurred. These rules only apply when the stock is transferred among persons that are required to keep hybrid deduction accounts. Thus, if the stock is transferred to a person that is not required to keep a hybrid deduction account – such as an individual or a foreign corporation that is not a CFC – the account terminates (subject to the anti-avoidance rule, discussed in section I.H of this Explanation of Provisions). Finally, the proposed regulations include rules that take into account certain nonrecognition exchanges of the stock, such as exchanges in connection with asset reorganizations, recapitalizations, and liquidations, as well as transfers and exchanges that occur mid-way through a CFC's taxable year. *See* proposed § 1.245A(e)–1(d)(4)(ii)(B) and (d)(5). The Treasury Department and the IRS request comments on these rules.

3. Dividends from Lower-Tier CFCs

The proposed regulations provide a special rule to address earnings and profits of a lower-tier CFC that are included in a domestic corporation's income as a dividend by virtue of section 1248(c)(2). In these cases, the proposed regulations treat the domestic corporation as having certain hybrid deduction accounts with respect to the lower-tier CFC that are held and maintained by other CFCs. *See* proposed § 1.245A(e)–1(b)(3). This ensures that, to the extent the earnings and profits of the lower-tier CFC give rise to the dividend, hybrid deduction accounts with respect to the lower-tier CFC are taken into account for purposes of the determinations under section 245A(e), even though the accounts are held indirectly by the domestic corporation. A similar rule applies with respect to gains on stock sales treated as dividends under section 964(e)(1). *See* proposed § 1.245A(e)–1(c)(3).

H. *Anti-avoidance rule*

The proposed regulations include an anti-avoidance rule. This rule provides that appropriate adjustments are 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 proposed § 1.245A(e)–1.

II. *Section 267A – Related Party Amounts Involving Hybrid Transactions and Hybrid Entities*

A. *Overview*

As indicated in the Senate Finance Committee's Explanation of the Bill, hybrid arrangements may exploit differences under U.S. and foreign tax law between the tax characterization of an entity as transparent or opaque or differences in the treatment of financial instruments or other transactions. The proposed regulations under section 267A address certain payments or accruals of interest or royalties for U.S. tax purposes (the amount of such interest or royalty, a "specified payment") that involve hybrid arrangements, or similar arrangements involving branches, that produce D/NI (deduction/no inclusion) outcomes or indirect D/NI outcomes. *See also* section II.J.1 of this Explanation of Provisions (discussing certain amounts that are treated as specified payments). The proposed regulations neutralize the double non-taxation effects of the arrangements by denying a deduction for the specified payment to the extent of the D/NI outcome.

B. *Scope*

1. Disallowed Deductions

The proposed regulations generally disallow a deduction for a specified payment if and only if the payment is (i) a "disqualified hybrid amount," meaning that it produces a D/NI outcome as a result of a hybrid or branch arrangement; (ii) a "disqualified imported mismatch amount," meaning that it 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; or (iii) made pursuant to a transaction a principal purpose of which is to avoid the purposes of the regulations under section 267A and it produces a D/NI outcome. *See* proposed § 1.267A–1(b). Thus, the proposed regulations do not address D/NI outcomes that are not the result of hybridity. *See also* section II.E of this Explanation of Provisions (discussing the link between hybridity and a D/NI outcome). In addition, the proposed regulations do not address double-deduction outcomes. Section 267A is intended to address D/NI outcomes; transactions that produce double-deduction outcomes are addressed through other provisions (or doctrines), such as the dual consolidated loss rules under section 1503(d). *See also* section IV.A.1 of this Explanation of Provisions (discussing the dual consolidated loss rules).

2. Parties Subject to Section 267A

The application of section 267A by its terms is not limited to any particular category of persons. The proposed regulations, however, narrow the scope of section 267A so that it applies only to deductions of "specified parties." Deductions of persons other than specified parties are not subject to disallowance under section 267A because the deductions of such other persons generally do not have significant U.S. tax consequences.

A specified party means any of (i) a tax resident of the United States, (ii) a CFC for which there is one or more United States shareholders that own (within the meaning of section 958(a)) at least ten percent of the stock of the CFC, and (iii) a U.S. taxable branch (which includes a U.S. permanent establishment of a tax treaty resident). *See* proposed § 1.267A–5(a). The term generally includes a CFC because, for example, a specified payment made by a CFC to the foreign parent of the CFC's U.S. shareholder, or a specified payment by the CFC to an unrelated party pursuant to a structured arrangement, may indirectly reduce income subject to U.S. tax. Specified payments made by a CFC to other related CFCs or to U.S. shareholders of the CFC, however, typically will not be subject to section 267A because of the rules in proposed § 1.267A–3(b) that exempt certain payments included in income of a U.S. tax resident or taken into account under the subpart F or global intangible low-tax income ("GILTI") rules. *See also* section II.F of this Explanation of Provisions (discussing the relatedness or structured arrangement limitation); section II.H of this Explanation of Provisions (discussing exceptions for amounts included or includible in income). Similarly, the term includes a U.S. taxable branch because a payment made by the home office may be allocable to and thus reduce income subject to U.S. tax under sections 871(b) or 882. *See also* section II.K.2 of this Explanation of Provisions (discussing amounts considered paid or accrued by a U.S. taxable branch for section 267A purposes).

The term specified party does not include a partnership because a partnership generally is not liable to tax and therefore is not the person allowed a deduction. However, a partner of a partnership may be a specified party. For example, in the case of a payment made by a partnership a partner of which is a domestic corporation, the domestic corporation is a specified party and its allocable share of the deduction for the payment is subject to disallowance under section 267A.

C. *Amount of a D/NI outcome*

1. In General

Proposed § 1.267A–3(a) provides rules for determining the "no-inclusion" aspect of a D/NI outcome – that is, the amount of a specified payment that is or is not included in income under foreign tax law. The proposed regulations provide that only "tax residents" or "taxable branches" are considered to include an amount in income. Parties other than tax residents or taxable branches, for example, an entity that is fiscally transparent for purposes of the relevant tax laws, do not include an amount in income because such parties are not liable to tax.

In general, a tax resident or taxable branch includes a specified payment in income for this purpose to the extent that, under its tax law, it includes the payment in its income or tax base at the full marginal rate imposed on ordinary income, and the payment is not reduced or offset by certain items (such as an exemption or credit) particular to that type of payment. *See* proposed § 1.267A–3(a)(1).

Whether a tax resident or taxable branch includes a specified payment in income is determined without regard to any defensive or secondary rule in hybrid mismatch rules (which generally requires the payee to include certain amounts in income, if the payer is not denied a deduction for the amount), if any, under the tax resident's or taxable branch's tax law. Otherwise, in cases in which such tax law contains a secondary response, the analysis of whether the specified payment is included in income could become circular: for example, whether the United States denies a deduction under section 267A may depend on whether the payee includes the specified payment in income, and whether the payee includes it in income (under a secondary response) may depend on whether the United States denies the deduction.

A specified payment may be considered included in income even though offset by a generally applicable deduction or other tax attribute, such as a deduction for depreciation or a net operating loss. For this purpose, a deduction may be treated as being generally applicable even if closely related to the specified payment (for example, if the deduction and payment are in connection with a back-to-back financing arrangement).

If a specified payment is taxed at a preferential rate, or if there is a partial reduction or offset particular to the type of payment, a portion of the payment is considered included in income. The portion included in income is the amount that, taking into account the preferential rate or reduction or offset, is subject to tax at the full marginal rate applicable to ordinary income. *See* proposed § 1.267A–3(a)(1); *see also* proposed § 1.267A–6(c), *Example 2* and *Example 7.*

2. Timing Differences

Some specified payments may never be included in income. For example, a specified payment treated as a dividend under a tax resident's tax laws may be permanently excluded from its income under a participation exemption. Permanent exclusions are always treated as giving rise to a no-inclusion. *See* proposed § 1.267A–3(a)(1).

Other specified payments, however, may be included in income but on a deferred basis. Some of these timing differences result from different methods of accounting between U.S. tax law and foreign tax law. For example, and subject to certain limitations such as those under sections 163(e)(3) and 267(a) (generally applicable to payments involving related parties, but not to payments involving structured arrangements), a specified payment may be deductible for U.S. tax purposes when accrued and later included in a foreign tax resident's income when actually paid. *See also* section II.K.3 of this Explanation of Provisions (discussing the coordination of section 267A with rules such as sections 163(e)(3) and 267(a)). Timing differences may also occur in cases in which all or a portion of a specified payment that is treated as interest for U.S. tax purposes is treated as a return of principal for purposes of the foreign tax law.

In some cases, timing differences reverse after a short period of time and therefore do not provide a meaningful deferral benefit. The Treasury Department and the IRS have determined that routine, short-term deferral does not give rise to the policy concerns that section 267A is intended to address. In addition, subjecting such short-term deferral to section 267A could give rise to administrability issues for both taxpayers and the IRS, because it may be challenging to determine whether the taxable period in which a specified payment is included in income matches the taxable period in which the payment is deductible.

Other timing differences, though, may provide a significant and long-term deferral benefit. Moreover, taxpayers may structure transactions that exploit these differences to achieve long-term deferral benefits. Timing differences that result in long-term deferral have an economic effect similar to a permanent exclusion and therefore give rise to policy concerns that section 267A is intended to address. *See* Senate Explanation, at 384 (expressing concern with hybrid arrangements that "achieve double non-taxation, including long-term deferral."). Accordingly, proposed § 1.267A–3(a)(1) provides that short-term deferral, meaning inclusion during a taxable year that ends no more than 36 months after the end of the specified party's taxable year, does not give rise to a D/NI outcome; inclusions outside of the 36-month timeframe, however, are treated as giving rise to a D/NI outcome.

D. *Hybrid and branch arrangements giving rise to disqualified hybrid amounts*

1. Hybrid Transactions

Proposed § 1.267A–2(a) addresses hybrid financial instruments and similar arrangements (collectively, "hybrid transactions") that result in a D/NI outcome. For example, in the case of an instrument that is treated as indebtedness for purposes of the payer's tax law and stock for purposes of the payee's tax law, a payment on the instrument may constitute deductible interest expense of the payer and excludible dividend income of the payee (for instance, under a participation exemption).

In general, the proposed regulations provide that a specified payment is made pursuant to a hybrid transaction if there is a mismatch in the character of the instrument or arrangement such that the payment is not treated as interest or a royalty, as applicable, under the tax law of a "specified recipient." Examples of such a specified payment include a payment that is treated as interest for U.S. tax purposes but, for purposes of a specified recipient's tax law, is treated as a distribution on equity or a return of principal. When a specified payment is made pursuant to a hybrid transaction, it generally is a disqualified hybrid amount to the extent that the specified recipient does not include the payment in income.

The proposed regulations broadly define specified recipient as (i) any tax resident that under its tax law derives the specified payment, and (ii) any taxable branch to which under its tax law the specified payment is attributable. *See* proposed § 1.267A–5(a)(19). In other words, a specified recipient is any party that may be subject to tax on the specified payment under its tax law. There may be more than one specified recipient of a specified payment. For example, in the case of a specified payment to an entity that is fiscally transparent for purposes of the tax law of its tax resident owners, each of the owners is a specified recipient of a share of the payment. In addition, if the entity is a tax resident of the country in which it is established or managed and controlled, then the entity is also a specified recipient. Moreover, in the case of a specified payment attributable to a taxable branch, both the taxable branch and the home office are specified recipients.

The proposed regulations deem a specified payment as made pursuant to a hybrid transaction if there is a long-term mismatch between when the specified party is allowed a deduction for the payment under U.S. tax law and when a specified recipient includes the payment in income under its tax law. This rule applies, for example, when a specified payment is made pursuant to an instrument viewed as indebtedness under both U.S. and foreign tax law and, due to a mismatch in tax accounting treatment between the U.S. and foreign tax law, results in long-term deferral. In these cases, this rule treats the long-term deferral as giving rise to a hybrid transaction; the rules in proposed § 1.267A–3(a)(1) (discussed in section II.C.2 of this Explanation of Provisions) treat the long-term deferral as creating a D/NI outcome.

Lastly, proposed § 1.267A–2(a)(3) provides special rules to address securities lending transactions, sale-repurchase transactions, and similar transactions. In these cases, a specified payment (that is, interest consistent with the substance of the transaction) might not be regarded under a foreign tax law. As a result, there might not be a specified recipient of the specified payment under such foreign tax law, absent a special rule. To address this scenario, the proposed regulations provide that the determination of the identity of a specified recipient under the foreign tax law is made with respect to an amount connected to the specified payment and regarded under the foreign tax law – for example, a dividend consistent with the form of the transaction. The Treasury Department and the IRS request comments on whether similar rules should be extended to other specific transactions.

2. Disregarded Payments

Proposed § 1.267A–2(b) addresses disregarded payments. Disregarded payments generally give rise to a D/NI outcome because they are regarded under the payer's tax law and are therefore available to offset income not taxable to the payee, but are disregarded under the payee's tax law and therefore are not included in income.

In general, the proposed regulations define a disregarded payment as a specified payment that, under a foreign tax law, is not regarded because, for example, it is a disregarded transaction involving a single taxpayer or between consolidated group members. For example, a disregarded payment includes a specified payment made by a domestic corporation to its foreign owner if, under the foreign tax law, the domestic corporation is a disregarded entity and therefore the payment is not regarded. It also includes a specified payment between related foreign corporations that are members of the same foreign consolidated group (or can otherwise share income or loss) if, under the foreign tax law, payments between group members are not regarded, or give rise to a deduction or similar offset to the payer member that is available to offset the corresponding income of the recipient member.

In general, a disregarded payment is a disqualified hybrid amount only to the extent it exceeds dual inclusion income. For example, if a domestic corporation that for foreign tax purposes is a disregarded entity of its foreign owner makes a disregarded payment to its foreign owner, the payment is a disqualified hybrid amount only to the extent it exceeds the net of the items of gross income and deductible expense taken into account in determining the domestic corporation's income for U.S. tax purposes and the foreign owner's income for foreign tax purposes. This prevents the excess of the disregarded payment over dual inclusion income from offsetting non-dual inclusion income. Such an offset could otherwise occur, for example, through the U.S. consolidation regime, or a sale, merger, or similar transaction.

A disregarded payment could also be viewed as being made pursuant to a hybrid transaction because the payment of interest or royalty would not be viewed as interest or royalty under the foreign tax law (since the payment is disregarded). The proposed regulations address disregarded payments separately from hybrid transactions, however, because disregarded payments are more likely to offset dual inclusion income and therefore are treated as disqualified hybrid amounts only to the extent they offset non-dual inclusion income.

3. Deemed Branch Payments

Proposed § 1.267A–2(c) addresses deemed branch payments. These payments result in 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 and offsets income not taxable to the home office, but the payment is not taken into account under the home office's tax law.

In general, the proposed regulations define a deemed branch payment as interest or royalty considered paid by a U.S. permanent establishment to its home office under an income tax treaty between the United States and the home office country. *See* proposed § 1.267A–2(c)(2). Thus, for example, a deemed branch payment includes an amount allowed as a deduction in computing the business profits of a U.S. permanent establishment with respect to the use of intellectual property developed by the home office. *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.").

When a specified payment is a deemed branch payment, it is a disqualified hybrid amount if the home office's tax law provides an exclusion or exemption for income attributable to the branch. In these cases, a deduction for the deemed branch payment would offset non-dual inclusion income and therefore give rise to a D/NI outcome. If the home office's tax law does not have an exclusion or exemption for income attributable to the branch, then, because U.S. permanent establishments cannot consolidate or otherwise share losses with U.S. taxpayers, there would generally not be an opportunity for a deduction for the deemed branch payment to offset non-dual inclusion income.

4. Reverse Hybrids

Proposed § 1.267A–2(d) addresses payments to reverse hybrids. In general, and as discussed below, 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 its owner. Thus, payments to a reverse hybrid may result in a D/NI outcome because the reverse hybrid is not a tax resident of the country in which it is established, and the owner does not derive the payment under its tax law. Because this D/NI outcome may occur regardless of whether the establishment country is a foreign country or the United States, the proposed regulations provide that both foreign and domestic entities may be reverse hybrids. A domestic entity that is a reverse hybrid for this purpose therefore differs from a "domestic reverse hybrid entity" under § 1.894–1(d)(2)(i), which is defined as "a domestic entity that is treated as not fiscally transparent for U.S. tax purposes and as fiscally transparent under the laws of an interest holder's jurisdiction[.]"

For an entity to be a reverse hybrid under the proposed regulations, two requirements must be satisfied. These requirements generally implement the definition of hybrid entity in section 267A(d)(2), with certain modifications. First, the entity must be fiscally transparent under the tax law of the country in which it is established, whether or not it is a tax resident of another country. For this purpose, the determination of whether an entity is fiscally transparent with respect to an item of income is made using the principles of § 1.894–1(d)(3)(ii) (but without regard to whether there is an income tax treaty in effect between the entity's jurisdiction and the United States).

Second, the entity must not be fiscally transparent under the tax law of an "investor." An investor means a tax resident or taxable branch that directly or indirectly owns an interest in the entity. For this purpose, the determination of whether an investor's tax law treats the entity as fiscally transparent with respect to an item of income is made under the principles of § 1.894–1(d)(3)(iii) (but without regard to whether there is an income tax treaty in effect between the investor's jurisdiction and the United States). If an investor views the entity as not fiscally transparent, the investor generally will not be currently taxed under its tax law on payments to the entity. Thus, the non-fiscally-transparent status of the entity is determined on an investor-by-investor basis, based on the tax law of each investor. In addition, a tax resident or a taxable branch may be an investor of a reverse hybrid even if the tax resident or taxable branch indirectly owns the reverse hybrid through one or more intermediary entities that, under the tax law of the tax resident or taxable branch, are not fiscally transparent. In such a case, however, the investor's no-inclusion would not be a result of the payment being made to the reverse hybrid and therefore would not be a disqualified hybrid amount. *See also* section II.E of this Explanation of Provisions (explaining that the D/NI outcome must be a result of hybridity); proposed § 1.267A–6(c), *Example 5* (analyzing whether a D/NI outcome with respect to an upper-tier investor is a result of the specified payment being made to the reverse hybrid).

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. For this purpose, whether an investor includes the specified payment in income is determined without regard to a subsequent distribution by the reverse hybrid. 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.

In addition, if an investor takes a specified payment into account under an anti-deferral regime, then the investor is considered to include the payment in income to the extent provided under the general rules of proposed § 1.267A–3(a). *See* proposed § 1.267A–6(c), *Example 5*. Thus, for example, if the investor's inclusion under the anti-deferral regime is subject to tax at a preferential rate, the investor is considered to include only a portion of the specified payment in income.

5. Branch Mismatch Payments

Proposed § 1.267A–2(e) addresses branch mismatch payments. These payments give rise to a D/NI outcome due to differences between the home office's tax law and the branch's tax law regarding the allocation of items of income or the treatment of the branch. This could occur, for example, if the home office's tax law views a payment as attributable to the branch and exempts the branch's income, but the branch's tax law does not tax the payment.

Under the proposed regulations, a specified payment is a branch mismatch payment when two requirements are satisfied. First, under a home office's tax law, the specified payment is treated as attributable to a branch of the home office. Second, under the tax law of the branch country, either (i) the home office does not have a taxable presence in the country, or (ii) the specified payment is treated as attributable to the home office and not the branch. When a specified payment is a branch mismatch payment, it is generally a disqualified hybrid amount to the extent that the home office does not include the payment in income.

E. *Link between hybridity and D/NI outcome*

Under section 267A(a), a deduction for a payment is generally disallowed if (i) the payment involves a hybrid arrangement, and (ii) a D/NI outcome occurs. In certain cases, although both of these conditions are satisfied, the D/NI outcome is not a result of the hybridity. For example, in the hybrid transaction context, the D/NI outcome may be a result of the specified recipient's tax law containing a pure territorial system (and thus exempting from taxation all foreign source income) or not having a corporate income tax, or a result of the specified recipient's status as a tax-exempt entity under its tax law.

The proposed regulations provide that a D/NI outcome gives rise to a disqualified hybrid amount only to the extent that the D/NI outcome is a result of hybridity. *See*, for example, proposed § 1.267A–2(a)(1)(ii); *see also* Senate Explanation, at 384 ("[T]he Committee believes that 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 . . .") (emphasis added).

To determine whether a D/NI outcome is a result of hybridity, the proposed regulations generally apply a test based on facts that are counter to the hybridity at issue. For example, in the hybrid transaction context, a 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 payment to be treated as interest or a royalty for purposes of the specified recipient's tax law.

This test also addresses cases in which, for example, a specified payment is made to a fiscally transparent entity (such as a partnership) and owners of the entity that are specified recipients of the payment each derive only a portion of the payment under its tax law. The test ensures that, with respect to each specified recipient, only the no-inclusion that occurs for the portion of the specified payment that it derives may give rise to a disqualified hybrid amount. In addition, as a result of the relatedness or structured arrangement limitation discussed in section II.F of this Explanation of Provisions, the no-inclusion with respect to the specified recipient is taken into account under the proposed regulations only if the specified recipient is related to the specified party or is a party to a structured arrangement pursuant to which the specified payment is made.

F. *Relatedness or structured arrangement limitation*

In determining whether a specified payment is made pursuant to a hybrid or branch mismatch arrangement, the proposed regulations generally only consider the tax laws of tax residents or taxable branches that are related to the specified party. *See* proposed § 1.267A–2(f). For example, in general, only the tax law of a specified recipient that is related to the specified party is taken into account for purposes of determining whether the specified payment is made pursuant to a hybrid transaction. Because a deemed branch payment by its terms involves a related home office, the relatedness limitation in proposed § 1.267A–2(f) does not apply to proposed § 1.267A–2(c).

The proposed regulations provide that related status is determined under the rules of section 954(d)(3) (involving ownership of more than 50 percent of interests) but without regard to downward attribution. *See* proposed § 1.267A–5(a)(14). In addition, to ensure that a tax resident may be considered related to a specified party even though the tax resident is a disregarded entity for U.S. tax purposes, the proposed regulations provide that such a tax resident is treated as a corporation for purposes of the relatedness test. A similar rule applies with respect to a taxable branch.

However, the Treasury Department and the IRS are aware that some hybrid arrangements involving unrelated parties are designed to give rise to a D/NI outcome and therefore present the policy concerns underlying section 267A. Furthermore, it is likely that in such cases the specified party will have, or can reasonably obtain, the information necessary to comply with section 267A. Accordingly, the proposed regulations generally provide that the tax law of an unrelated tax resident or taxable branch is taken into account for purposes of section 267A if the tax resident or taxable branch is a party to a structured arrangement. *See* proposed § 1.267A–2(f). The proposed regulations set forth a test for when a transaction is a structured arrangement. *See* proposed § 1.267A–5(a)(20). In addition, the proposed regulations impute an entity's participation in a structured arrangement to its investors. *See id.* Thus, for example, in the case of a specified payment to a partnership that is a party to a structured arrangement pursuant to which the payment is made, a tax resident that is a partner of the partnership is also a party to the structured arrangement, even though the tax resident may not have actual knowledge of the structured arrangement.

G. *Effect of inclusion in another jurisdiction*

The proposed regulations provide that a specified payment is a disqualified hybrid amount if a D/NI outcome occurs as a result of hybridity in any foreign jurisdiction, even if the payment is included in income in another foreign jurisdiction. *See* proposed § 1.267A–6(c), *Example 1.* Absent such a rule, an inclusion of a specified payment in income in a jurisdiction with a (generally applicable) low rate might discharge the application of section 267A even though a D/NI outcome occurs in another jurisdiction as a result of hybridity.

For example, assume FX, a tax resident of Country X, owns US1, a domestic corporation, and FZ, a tax resident of Country Z that is fiscally transparent for Country X tax purposes. Also, assume that Country Z has a single, low-tax rate applicable to all income. Further, assume that FX holds an instrument issued by US1, a $100x payment with respect to which is treated as interest for U.S. tax purposes and an excludible dividend for Country X tax purposes. In an attempt to avoid US1's deduction for the $100x payment being denied under the hybrid transaction rule, FX contributes the instrument to FZ, and, upon US1's $100x payment, US1 asserts that, although a $100x no-inclusion occurs with respect to FX as a result of the payment being made pursuant to the hybrid transaction, the payment is not a disqualified hybrid amount because FZ fully includes the payment in income (albeit at a low-tax rate). The proposed regulations treat the payment as a disqualified hybrid amount.

This rule only applies for inclusions under the laws of foreign jurisdictions. See proposed § 1.267A–3(b), and section II.H of this Explanation of Provisions, for exceptions that apply when the payment is included or includible in a U.S. tax resident's or U.S. taxable branch's income.

The Treasury Department and IRS request comments on whether an exception should apply if the specified payment is included in income in any foreign jurisdiction, taking into account accommodation transactions involving low-tax entities.

H. *Exceptions for certain amounts included or includible in a U.S. tax resident's or U.S. taxable branch's income*

Proposed § 1.267A–3(b) provides rules that reduce disqualified hybrid amounts to the extent the amounts are included or includible in a U.S. tax resident's or U.S. taxable branch's income. In general, these rules ensure that a specified payment is not a disqualified hybrid amount to the extent included in the income of a tax resident of the United States or a U.S. taxable branch, or taken into account by a U.S. shareholder under the subpart F or GILTI rules.

Source-based withholding tax imposed by the United States (or any other country) on disqualified hybrid amounts does not neutralize the D/NI outcome and therefore does not reduce or otherwise affect disqualified hybrid amounts. Withholding tax policies are unrelated to the policies underlying hybrid arrangements – for example, withholding tax can be imposed on non-hybrid payments – and, accordingly, withholding tax is not a substitute for a specified payment being included in income by a tax resident or taxable branch. *See also* section II.L of this Explanation of Provisions (interaction with withholding taxes and income tax treaties). Furthermore, other jurisdictions applying the defensive or secondary rule to a payment (which generally requires the payee to include the payment in income, if the payer is not denied a deduction for the payment under the primary rule) may not treat withholding taxes as satisfying the primary rule and may therefore require the payee to include the payment in income if a deduction for the payment is not disallowed (regardless of whether withholding tax has been imposed).

Thus, the proposed regulations do not treat amounts subject to U.S. withholding taxes as reducing disqualified hybrid amounts. Nevertheless, the Treasury Department and the IRS request comments on the interaction of the proposed regulations with withholding taxes and whether, and the extent to which, there should be special rules under section 267A when withholding taxes are imposed in connection with a specified payment, taking into account how such a rule could be coordinated with the hybrid mismatch rules of other jurisdictions.

I. *Disqualified imported mismatch amounts*

Proposed § 1.267A–4 sets forth a rule to address "imported" hybrid and branch arrangements. This rule is generally intended to prevent the effects of an "offshore" hybrid arrangement (for example, a hybrid arrangement between two foreign corporations completely outside the U.S. taxing jurisdiction) from being shifted, or "imported," into the U.S. taxing jurisdiction through the use of a non-hybrid arrangement.

Accordingly, the proposed regulations disallow deductions for specified payments that are "disqualified imported mismatch amounts." In general, a disqualified imported mismatch amount is a specified payment: (i) that is non-hybrid in nature, such as interest paid on an instrument that is treated as indebtedness for both U.S. and foreign tax purposes, and (ii) for which the income attributable to the payment is directly or indirectly offset by a hybrid deduction of a foreign tax resident or taxable branch. The rule addresses "indirect" offsets in order to take into account, for example, structures involving intermediaries where the foreign tax resident that receives the specified payment is different from the foreign tax resident that incurs the hybrid deduction. *See* proposed § 1.267A–6(c), *Example 8*, *Example 9*, and *Example 10*.

In general, a hybrid deduction for purposes of the imported mismatch rule is an amount for which a foreign tax resident or taxable branch is allowed an interest or royalty deduction under its tax law, to the extent the deduction would be disallowed if such tax law were to contain rules substantially similar to the section 267A proposed regulations. For this purpose, it is not relevant whether the amount is recognized as interest or a royalty under U.S. law, or whether the amount would be allowed as a deduction under U.S. law. Thus, for example, a deduction with respect to equity (such as a notional interest deduction) constitutes a hybrid deduction even though such a deduction would not be recognized (or allowed) under U.S. tax law. As another example, a royalty deduction under foreign tax law may constitute a hybrid deduction even though for U.S. tax purposes the royalty is viewed as made from a disregarded entity to its owner and therefore is not regarded.

The requirement that the deduction would be disallowed if the foreign tax law were to contain rules substantially similar to those under section 267A is intended to limit the application of the imported mismatch rule to cases in which, had the foreign-to-foreign hybrid arrangement instead involved a specified party, section 267A would have applied to disallow the deduction. In other words, this requirement prevents the imported mismatch rule from applying to arrangements outside the general scope of section 267A, even if the arrangements are hybrid in nature and result in a D/NI (or similar) outcome. For example, in the case of a deductible payment of a foreign tax resident to a tax resident of a foreign country that does not impose an income tax, the deduction would generally not be a hybrid deduction – even though it may be made pursuant to a hybrid instrument – because the D/NI outcome would not be a result of hybridity. *See* section II.E of this Explanation of Provisions (requiring a link between hybridity and the D/NI outcome, for a specified payment to be a disqualified hybrid amount).

Further, the proposed regulations include "ordering" and "funding" rules to determine the extent that a hybrid deduction directly or indirectly offsets income attributable to a specified payment. In addition, the proposed regulations provide that certain payments made by non-specified parties the tax laws of which contain hybrid mismatch rules are taken into account when applying the ordering and funding rules. Together, these provisions are intended to coordinate proposed § 1.267A–4 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.

J. *Definitions of interest and royalty*

1. Interest

There are no generally applicable regulations or statutory provisions addressing when financial instruments are treated as debt for U.S. tax purposes or when a payment is interest. As a general matter, however, the factors that distinguish debt from equity are described in Notice 94–47, 1994–1 C.B. 357, and interest is defined as compensation for the use or forbearance of money. *Deputy v. Dupont*, 308 U.S. 488 (1940).

Using these principles, the proposed regulations define interest broadly to include interest associated with conventional debt instruments, other amounts treated as interest under the Code, as well as transactions that are indebtedness in substance although not in form. *See* proposed § 1.267A–5(a)(12).

In addition, in order to address certain structured transactions, the proposed regulations apply equally to "structured payments." Proposed § 1.267A–5(b)(5) defines structured payments to include a number of items such as an expense or loss predominately incurred in consideration of the time value of money in a transaction or series of integrated or related transactions in which a taxpayer secures the use of funds for a period of time. This approach is consistent with the rules treating such payments similarly to interest under §§ 1.861–9T and 1.954–2.

The definitions of interest and structured payments also provide for adjustments to the amount of interest expense or structured payments, as applicable, to reflect the impact of derivatives that affect the economic yield or cost of funds of a transaction involving interest or structured payments. The definitions of interest and structured payments contained in the proposed regulations apply only for purposes of section 267A. However, solely for purposes of certain other provisions, similar definitions apply. For example, the definition of interest and structured payments under the proposed regulations is similar in scope to the definition of items treated similarly to interest under § 1.861–9T for purposes of allocating and apportioning deductions under section 861 and similar to the items treated as interest expense for purposes of section 163(j) in proposed regulations under section 163(j).

The Treasury Department and the IRS considered three options with respect to the definition of interest for purposes of section 267A. The first option considered was to not provide a definition of interest, and thus rely on general tax principles and case law to define interest for purposes of section 267A. While adopting this option might reduce complexity for some taxpayers, not providing an explicit definition of interest would create its own uncertainty as neither taxpayers nor the IRS might have a clear sense of what types of payments are treated as interest expense subject to disallowance under section 267A. Such uncertainty could increase burdens to the IRS and taxpayers by increasing the number of disputes about whether particular payments are interest for section 267A purposes. Moreover, this option could be distortive as it would provide an incentive to taxpayers to engage in transactions generating deductions economically similar to interest while asserting that such deductions are not described by existing principles defining interest expense. If successful, such strategies could allow taxpayers to avoid the application of section 267A through transactions that are similar to transactions involving interest.

The second option considered would have been to adopt a definition of interest but limit the scope of the definition to cover only amounts associated with conventional debt instruments and amounts that are generally treated as interest for all purposes under the Code or regulations prior to the passage of the Act. This would be equivalent to only adopting the rule that is proposed in § 1.267A–5(a)(12)(i) without also addressing structured payments, which are described in proposed § 1.267A–5(b)(5). While this would clarify what would be deemed interest for purposes of section 267A, the Treasury Department and the IRS have determined that this approach would potentially distort future financing transactions. Some taxpayers would choose to use financial instruments and transactions that provide a similar economic result of using a conventional debt instrument, but would avoid the label of interest expense under such a definition, potentially enabling these taxpayers to avoid the application of section 267A. As a result, under this second approach, there would still be an incentive for taxpayers to engage in the type of avoidance transactions discussed in the first alternative.

The final option considered and the one ultimately adopted in the proposed regulations is to provide a complete definition of interest that addresses all transactions that are commonly understood to produce interest expense, as well as structured payments that may have been entered into to avoid the application of section 267A. The proposed regulations also reduce taxpayer burden by adopting definitions of interest that have already been developed and administered in §§ 1.861–9T and 1.954–2 and that have been proposed for purposes of section 163(j). The definition of interest provided in the proposed regulations applies only for purposes of section 267A and not for other purposes of the Code, such as section 904(d)(3).

The Treasury Department and the IRS welcome comments on the definition of interest for purposes of section 267A contained in the proposed regulations.

2. Royalty

Section 267A does not define the term royalty and there is no universal definition of royalty under the Code. The Treasury Department and the IRS considered providing no definition for royalties. However, similar to the discussion in Section II.J.1 of this Explanation of Provisions with respect to the definition of interest, not providing a definition for royalties and relying instead on general tax principles could create uncertainty as neither taxpayers nor the IRS might have a clear sense of what types of payments are treated as royalties subject to disallowance under section 267A. Such uncertainty could increase burdens to the IRS and taxpayers with respect to disputes about whether particular payments are royalties for section 267A purposes.

Instead, the Treasury Department and the IRS have determined that providing a definition of royalties would increase certainty, and therefore the proposed regulations define the term royalty for purposes of section 267A to include amounts paid or accrued as consideration for the use of, or the right to use, certain intellectual property and certain information concerning industrial, commercial or scientific experience. *See* proposed § 1.267A–5(a)(16). The term does not include amounts paid or accrued for after-sales services, for services rendered by a seller to the purchaser under a warranty, for pure technical assistance, or for an opinion given by an engineer, lawyer or accountant. The definition of royalty provided in the proposed regulations applies only for purposes of section 267A and not for other purposes of the Code, such as section 904(d)(3).

The definition of royalty is generally based on the definition used in tax treaties and, in particular, the definition incorporated into Article 12 of the 2006 U.S. Model Income Tax Treaty. This definition is also generally consistent with the language of section 861(a)(4). In addition, similar to the approach in the technical explanation to Article 12 of the 2006 U.S. Model Income Tax Treaty, the proposed regulations provide certain circumstances where payments are not treated as paid or accrued in consideration for the use of information concerning industrial, commercial or scientific experience. By using definitions that have already been developed and administered in other contexts, the proposed regulations provide an approach that reduces taxpayer burdens and uncertainty. The Treasury Department and the IRS welcome comments on the definition of royalty for purposes of section 267A contained in the proposed regulations.

K. *Miscellaneous issues*

1. Effect of Foreign Currency Gain or Loss

The proposed regulations provide that foreign currency gain or loss recognized under section 988 is not separately taken into account under section 267A. *See* proposed § 1.267A–5(b)(2). Rather, foreign currency gain or loss recognized with respect to a specified payment is taken into account under section 267A only to the extent that the specified payment is in respect of accrued interest or an accrued royalty for which a deduction is disallowed under section 267A. Thus, for example, a section 988 loss recognized with respect to a specified payment of interest is not separately taken into account under section 267A (even though under the tax law of the tax resident to which the specified payment is made the tax resident does not include in income an amount corresponding to the section 988 loss, as the specified payment is made in the tax resident's functional currency).

The Treasury Department and the IRS recognize that additional rules addressing the effect of different foreign currencies may be necessary. For example, a hybrid deduction for purposes of the imported mismatch rule may be denominated in a different currency than a specified payment, in which case a translation rule may be necessary to determine the amount of the specified payment that is subject to the imported mismatch rule. The Treasury Department and the IRS request comments on foreign currency rules, including any rules regarding the translation of amounts between currencies, for purposes of the proposed regulations under sections 245A and 267A.

2. Payments by U.S. Taxable Branches

Certain expenses incurred by a nonresident alien or foreign corporation are allowed as deductions under sections 873(a) and 882(c) in determining that person's effectively connected income. To the extent the deductions arise from transactions involving certain hybrid or branch arrangements, the deductions should be disallowed under section 267A, as discussed in section II.B of this Explanation of Provisions. The proposed regulations do so by (i) treating a U.S. taxable branch (which includes a permanent establishment of a foreign person) as a specified party, and (ii) providing rules regarding interest or royalties considered paid or accrued by a U.S. taxable branch, solely for purposes of section 267A (and thus not for other purposes, such as chapter 3 of the Code). *See* proposed § 1.267A–5(b)(3). The effect of this approach is that interest or royalties considered paid or accrued by a U.S. taxable branch are specified payments that are subject to the rules of proposed §§ 1.267A–1 through 1.267A–4. *See also* proposed § 1.267A–6(c), *Example 4*.

In general, a U.S. taxable branch is considered to pay or accrue any interest or royalties allocated or apportioned to effectively connected income of the U.S. taxable branch. *See* proposed § 1.267A–5(b)(3)(i). However, if a U.S. taxable branch constitutes a U.S. permanent establishment of a treaty resident, then the U.S. permanent establishment is considered to pay or accrue the interest or royalties deductible in computing its business profits. Although interest paid by a U.S. taxable branch may be subject to withholding tax as determined under section 884(f)(1)(A) and § 1.884–4, those rules are not relevant for purposes of section 267A.

The proposed regulations also provide rules to identify the manner in which a specified payment of a U.S. taxable branch is considered made. *See* proposed § 1.267A–5(b)(3)(ii). Absent such rules, it might be difficult to determine whether the specified payment is made pursuant to a hybrid or branch arrangement (for example, made pursuant to a hybrid transaction or to a reverse hybrid). However, these rules regarding the manner in which a specified payment is made do not apply to interest or royalties deemed paid by a U.S. permanent establishment in connection with inter-branch transactions that are permitted to be taken into account under certain U.S. tax treaties – such payments, by definition, constitute deemed branch payments (subject to disallowance under proposed § 1.267A–2(c)) and are therefore made pursuant to a branch arrangement.

3. Coordination with Other Provisions

Proposed § 1.267A–5(b)(1) coordinates the application of section 267A with other provisions of the Code and regulations that affect the deductibility of interest and royalties. This rule provides that, in general, section 267A applies after the application of other provisions of the Code and regulations. For example, a specified payment is subject to section 267A for the taxable year for which a deduction for the payment would otherwise be allowed. Thus, if a deduction for an accrued amount is deferred under section 267(a) (in certain cases, deferring a deduction for an amount accrued to a related foreign person until paid), then the deduction is tested for disallowance under section 267A for the taxable year in which the amount is paid. Absent such a rule, an accrued amount for which a deduction is deferred under section 267(a) could constitute a disqualified hybrid amount even though the amount will be included in the specified recipient's income when actually paid. This coordination rule also provides that section 267A applies to interest or royalties after taking into account provisions that could otherwise recharacterize such amounts, such as § 1.894–1(d)(2).

4. E&P Reduction

Proposed § 1.267A–5(b)(4) provides that the disallowance of a deduction under section 267A does not affect whether or when the amount paid or accrued that gave rise to the deduction reduces earnings and profits of a corporation. 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. This is consistent with the approach in the context of other disallowance rules. *See* § 1.312–7(b)(1) ("A loss . . . may be recognized though not allowed as a deduction (by reason, for example, of the operation of sections 267 and 1211 . . .) 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."); *Luckman v. Comm'r*, 418 F.2d 381, 383–84 (7th Cir. 1969) ("[T]rue expenses incurred by the corporation reduce earnings and profits despite their nondeductibility from current income for tax purposes.").

5. De Minimis Exception

The proposed regulations provide a de minimis exception to make the rules more administrable. *See* proposed § 1.267A–1(c). As a result of this exception, a specified party is excepted 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 any related specified parties) is below $50,000. This rule applies based on any interest or royalty deductions, regardless of whether the deductions would be disallowed under section 267A. In addition, for purposes of this rule, specified parties that are related are treated as a single specified party.

The Treasury Department and the IRS welcome comments on the de minimis exception and whether another threshold would be more appropriate to implement the purposes of section 267A.

L. *Interaction with withholding taxes and income tax treaties*

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 withholding under section 1441 or 1442 or is eligible for a reduced rate of tax under an income tax treaty. Since the U.S. tax characterization of the payment prevails in determining the treaty rate for interest or royalties, regardless of whether the payment is made pursuant to a hybrid transaction, the proposed regulations will generally result in the disallowance of a deduction but treaty benefits may still be claimed, as long as the recipient is the beneficial owner of the payment and otherwise eligible for treaty benefits. On the other hand, if interest or royalties are paid to a fiscally transparent entity that is a reverse hybrid, as defined in proposed

§ 1.267A–2(d), the payment generally will not be deductible under the proposed regulations if the investor does not derive the payment, and will not be eligible for treaty benefits if the interest holder under § 1.894–1(d) does not derive the payment. The proposed regulations will only apply, however, if the investor is related to the specified party, whereas the reduced rate under the treaty may be denied without regard to whether the interest holder is related to the payer of the interest or royalties.

Certain U.S. income tax treaties also address indirectly the branch mismatch rules under proposed § 1.267A–2(e). Special rules, generally in the limitation on benefits articles of income tax treaties, increase the tax treaty rate for interest and royalties to 15 percent (even if otherwise not taxable under the relevant treaty article) if the amount paid to a permanent establishment of the treaty resident is subject to minimal tax, and the foreign corporation that derives and beneficially owns the payment is a resident of a treaty country that excludes or otherwise exempts from gross income the profits attributable to the permanent establishment to which the payment was made.

III. *Information Reporting under Sections 6038, 6038A, and 6038C*

Under section 6038(a)(1), U.S. persons that control foreign business entities must file certain information returns with respect to those entities, which includes information listed in section 6038(a)(1)(A) through (a)(1)(E), as well as information that "the Secretary determines to be appropriate to carry out the provisions of this title." Section 6038A similarly requires 25-percent foreign-owned domestic corporations (reporting corporations) to file certain information returns with respect to those corporations, including information related to transactions between the reporting corporation and each foreign person which is a related party to the reporting corporation. Section 6038C imposes the same reporting requirements on certain foreign corporations engaged in a U.S. trade or business (also, a reporting corporation).

The proposed regulations provide that a specified payment for which a deduction is disallowed under section 267A, as well as hybrid dividends and tiered hybrid dividends under section 245A, must be reported on the appropriate information reporting form in accordance with sections 6038 and 6038A. *See* proposed §§ 1.6038–2(f)(13) and (14), 1.6038–3(g)(3), and 1.6038A–2(b)(5)(iii).

IV. *Sections 1503(d) and 7701 – Application to Domestic Reverse Hybrids*

A. *Overview*

1. Dual Consolidated Loss Rules

Congress enacted section 1503(d) to prevent the "double dipping" of losses. *See* S. Rep. 313, 99th Cong., 2d Sess., at 419–20 (1986). The Senate Report explains that "losses that a corporation uses to offset foreign tax on income that the United States does not subject to tax should not also be used to reduce any other corporation's U.S. tax." *Id.* Section 1503(d) and the regulations thereunder generally provide that, subject to certain exceptions, a dual consolidated loss of a corporation cannot reduce the taxable income of a domestic affiliate (a "domestic use"). *See* §§ 1.1503(d)–2 and 1.1503–4(b). Section 1.1503(d)–1(b)(5) defines a dual consolidated loss as a net operating loss of a dual resident corporation or the net loss attributable to a separate unit (generally defined as either a foreign branch or an interest in a hybrid entity). *See* § 1.1503(d)–1(b)(4).

The general prohibition against the domestic use of a dual consolidated loss does not apply if, pursuant to a "domestic use election," the taxpayer certifies that there has not been and will not be a "foreign use" of the dual consolidated loss during a certification period. *See* § 1.1503(d)–6(d). If a foreign use or other triggering event occurs during the certification period, the dual consolidated loss is recaptured. A foreign use occurs when any portion of the dual consolidated loss is made available to offset the income of a foreign corporation or the direct or indirect owner of a hybrid entity (generally non-dual inclusion income). *See* § 1.1503(d)–3(a)(1). Other triggering events include certain transfers of the stock or assets of a dual resident corporation, or the interests in or assets of a separate unit. *See* § 1.1503(d)–6(e).

The regulations include a "mirror legislation" rule that, in general, prevents a domestic use election when a foreign jurisdiction has enacted legislation similar to section 1503(d) that denies any opportunity for a foreign use of the dual consolidated loss. *See* § 1.1503(d)–3(e). As a result, the existence of mirror legislation may prevent the dual consolidated loss from being put to a domestic use (due to the domestic use limitation) or to a foreign use (due to the foreign "mirror legislation") such that the loss becomes "stranded." In such a case, the regulations contemplate that the taxpayer may enter into an agreement with the United States and the foreign country (for example, through the competent authorities) pursuant to which the losses are used in only one country. *See* § 1.1503(d)–6(b).

2. Entity Classification Rules

Sections 301.7701–1 through 301.7701–3 classify a business entity with two or more members as either a corporation or a partnership, and a business entity with a single owner as either a corporation or a disregarded entity. Certain domestic business entities, such as limited liability companies, are classified by default as partnerships (if they have more than one member) or as disregarded entities (if they have only one owner) but are eligible to elect for federal tax purposes to be classified as corporations. *See* § 301.7701–3(b)(1).

B. *Domestic reverse hybrids*

The Treasury Department and the IRS are aware that structures involving domestic reverse hybrids have been used to obtain double-deduction outcomes because they were not subject to limitation under current section 1503(d) regulations. A domestic reverse hybrid generally refers to a domestic business entity that elects under § 301.7701–3(c) to be treated as a corporation for U.S. tax purposes, but is treated as fiscally transparent under the tax law of its investors. In these structures, a foreign parent corporation typically owns the majority of the interests in the domestic reverse hybrid. Domestic reverse hybrid structures can lead to double-deduction outcomes because, for example, deductions incurred by the domestic reverse hybrid can be used (i) under U.S. tax law to offset income that is not subject to tax in the foreign parent's country, such as income of domestic corporations with which the domestic reverse hybrid files a U.S. consolidated return, and (ii) under the foreign parent's tax law to offset income not subject to U.S. tax, such as income of the foreign parent other than the income (if any) of the domestic reverse hybrid. Taxpayers take the position that these structures are not subject to the current section 1503(d) regulations because the domestic reverse hybrid is neither a dual resident corporation (because it is not subject to tax on a residence basis or on its worldwide income in the foreign parent country) nor a separate unit of a domestic corporation.

A comment on regulations under section 1503(d) that were proposed in 2005 asserted that this result is inconsistent with the policies underlying section 1503(d), which was adopted, in part, to ensure that domestic corporations were not put at a competitive disadvantage as compared to foreign corporations through the use of certain inbound acquisition structures. *See* TD 9315. The comment suggested that the scope of the final regulations be broadened to treat such entities as separate units, the losses of which are subject to the restrictions of section 1503(d). *Id.*

In response to this comment, the preamble to the 2007 final dual consolidated loss regulations stated that the Treasury Department and the IRS acknowledged that this type of structure results in a double dip similar to that which Congress intended to prevent through the adoption of section 1503(d). The final regulations did not address these structures, however, because the Treasury Department and the IRS determined at that time that a domestic reverse hybrid was neither a dual resident corporation nor a separate unit and, therefore, was not subject to section 1503(d). *See* TD 9315. The preamble noted, however, that the Treasury Department and the IRS would continue to study these and similar structures.

The Treasury Department and the IRS have determined that these structures are inconsistent with the principles of section 1503(d) and, as a result, raise significant policy concerns. Accordingly, the proposed regulations include rules under sections 1503(d) and 7701 to prevent the use of these structures to obtain a double-deduction outcome. 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 consent to be treated as a dual resident corporation for purposes of section 1503(d) (such an entity, a "domestic consenting corporation") for taxable years in which two requirements are satisfied. *See* proposed § 301.7701–3(c)(3). The requirements are intended to restrict the application of section 1503(d) to cases in which it is likely that losses of the domestic consenting corporation could result in a double-deduction outcome.

The requirements are satisfied if (i) a "specified foreign tax resident" (generally, a body corporate that is a tax resident of a foreign country) under its tax law derives or incurs items of income, gain, deduction, or loss of the domestic consenting corporation, and (ii) the specified foreign tax resident is related to the domestic consenting corporation (as determined under section 267(b) or 707(b)). *See* proposed § 1.1503(d)–1(c). For example, the requirements are satisfied if a specified foreign tax resident directly owns all the interests in the domestic consenting corporation and the domestic consenting corporation is fiscally transparent under the specified foreign tax resident's tax law. In addition, an item of the domestic consenting corporation for a particular taxable year is considered derived or incurred by the specified tax resident during that year even if, under the specified foreign tax resident's tax law, the item is recognized in, and derived or incurred by the specified foreign tax resident in, a different taxable year.

Further, if a domestic entity filed an election to be treated as a corporation before December 20, 2018 such that the entity was not required to consent to be treated as a dual resident corporation, then the entity is deemed to consent to being treated as a dual resident corporation as of its first taxable year beginning on or after the end of a 12-month transition period. This deemed consent can be avoided if the entity elects, effective before its first taxable year beginning on or after the end of the transition period, to be treated as a partnership or disregarded entity such that it ceases to be a corporation for U.S. tax purposes. For purposes of such an election, the 60 month limitation under § 301.7701–3(c)(1)(iv) is waived.

Finally, the proposed regulations provide that the mirror legislation rule does not apply to dual consolidated losses of a domestic consenting corporation. *See* proposed § 1.1503(d)–3(e)(3). This exception is intended to minimize cases in which dual consolidated losses could be "stranded" when, for example, the foreign parent jurisdiction has adopted rules similar to the recommendations in Chapter 6 of the Hybrid Mismatch Report. The exception does not apply to dual consolidated losses attributable to separate units because, in such cases, the United States is the parent jurisdiction and the dual consolidated loss rules should neutralize the double-deduction outcome.

V. *Triggering Event Exception for Compulsory Transfers*

As noted in section IV.A.1 of this Explanation of Provisions, certain triggering events require a dual consolidated loss that is subject to a domestic use election to be recaptured and included in income. The dual consolidated loss regulations also include various exceptions to these triggering events, including an exception for compulsory transfers involving foreign governments. *See* § 1.1503(d)–6(f)(5).

A comment on the 2007 final dual consolidated loss regulations stated that the policies underlying the triggering event exception for compulsory transfers involving foreign governments apply equally to compulsory transfers involving the United States government. Accordingly, the comment requested guidance under § 1.1503(d)–3(c)(9) to provide that the exception is not limited to foreign governments. The comment suggested, as an example, that the exception should apply to a divestiture of a hybrid entity engaged in proprietary trading pursuant to the "Volcker Rule" contained in the Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111–203 (2010).

The Treasury Department and the IRS agree with this comment and, accordingly, the proposed regulations modify the compulsory transfer triggering event exception such that it will also apply with respect to the United States government.

VI. *Disregarded Payments Made to Domestic Corporations*

As discussed in sections II.D.2 and 3 of this Explanation of Provisions, the proposed regulations under section 267A address D/NI outcomes resulting from actual and deemed payments of interest and royalties that are regarded for U.S. tax purposes but disregarded for foreign tax purposes. The proposed regulations under section 267A do not, however, address similar structures involving payments to domestic corporations that are regarded for foreign tax purposes but disregarded for U.S. tax purposes.

For example, USP, a domestic corporation that is the parent of a consolidated group, borrows from a bank to fund the acquisition of the stock of FT, a foreign corporation that is tax resident of Country X. USP contributes the loan proceeds to USS, a newly formed domestic corporation that is a member of the USP consolidated group, in exchange for all the stock of USS. USS then forms FDE, a disregarded entity that is tax resident of Country X, USS lends the loan proceeds to FDE, and FDE uses the proceeds to acquire the stock of FT. For U.S. tax purposes, USP claims a deduction for interest paid on the bank loan, and USS does not recognize interest income on interest payments made to it from FDE because the payments are disregarded. For Country X tax purposes, the interest paid from FDE to USS is regarded and gives rise to a loss that can be surrendered (or otherwise used, such as through a consolidation regime) to offset the operating income of FT.

Under the current section 1503(d) regulations, the loan from USS to FDE does not result in a dual consolidated loss attributable to USS's interest in FDE because interest paid on the loan is not regarded for U.S. tax purposes; only items that are regarded for U.S. tax purposes are taken into account for purposes of determining a dual consolidated loss. *See* § 1.1503(d)–5(c)(1)(ii). In addition, the regarded interest expense of USP is not attributed to USS's interest in FDE because only regarded items of USS, the domestic owner of FDE, are taken into account for purposes of determining a dual consolidated loss. *Id.* The result would generally be the same, however, even if USS, rather than USP, were the borrower on the bank loan. *See* § 1.1503(d)–7(c), *Example 23.*

The Treasury Department and the IRS have determined that these transactions raise significant policy concerns that are similar to those relating to the D/NI outcomes addressed by sections 245A(e) and 267A, and the double-deduction outcomes addressed by section 1503(d). The Treasury Department and the IRS are studying these transactions and request comments.

VII. *Applicability Dates*

Under section 7805(b)(2), and consistent with the applicability date of section 245A, proposed § 1.245A(e)–1 applies to distributions made after December 31, 2017. Under section 7805(b)(2), proposed §§ 1.267A–1 through 1.267A–6 generally apply to specified payments made in taxable years beginning after December 31, 2017. This applicability date is consistent with the applicability date of section 267A. The Treasury Department and the IRS therefore expect to finalize such provisions by June 22, 2019. *See* section 7805(b)(2). However if such provisions are finalized after June 22, 2019, then the Treasury Department and the IRS expect that such provisions will apply only to taxable years ending on or after December 20, 2018. *See* section 7805(b)(1)(B).

As provided in proposed § 1.267A–7(b), certain rules, such as the disregarded payment and deemed branch payment rules as well as the imported mismatch rule, apply to specified payments made in taxable years beginning on or after December 20, 2018. *See* section 7805(b)(1)(B).

Proposed §§ 1.6038–2, 1.6038–3, and 1.6038A–2, which require certain reporting regarding deductions disallowed under section 267A, as well as hybrid dividends and tiered hybrid dividends under section 245A, apply with respect to information for annual accounting periods or tax years, as applicable, beginning on or after December 20, 2018. *See* section 7805(b)(1)(B).

Proposed §§ 1.1503(d)–1 and -3, treating domestic consenting corporations as dual resident corporations, apply to taxable years ending on or after December 20, 2018. *See* section 7805(b)(1)(B).

Proposed § 1.1503(d)–6, amending the compulsory transfer triggering event exception, applies to transfers that occur on or after December 20, 2018, but taxpayers may apply the rules to earlier transfers. *See* section 7805(b)(1)(B).

Proposed § 301.7701–3(a) and (c)(3) 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). These provisions also apply to certain domestic eligible entities the interests in which are transferred or issued on or after December 20, 2018. *See* section 7805(b)(1)(B).

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 EO 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 (OIRA) as subject to review under Executive Order 12866 pursuant to the Memorandum of Agreement (April 11, 2018) between the Treasury Department and the Office of Management and Budget regarding review of tax regulations ("MOA"). OIRA has determined that the proposed rulemaking is economically significant and subject to review under EO 12866 and section 1(c) of the Memorandum of Agreement. Accordingly, the proposed regulations have been reviewed by the Office of Management and Budget.

A. *Background*

Hybrid arrangements include both "hybrid entities" and "hybrid instruments." A hybrid entity is generally an entity which is treated as a flow-through or disregarded entity for U.S. tax purposes but as a corporation for foreign tax purposes or vice versa. Hybrid instruments are financial instruments that share characteristics of both debt and equity and are treated as debt for U.S. tax purposes and equity in the foreign jurisdiction or vice versa.

Before the Act, U.S. subsidiaries of foreign-based multinational enterprises could employ cross-border hybrid arrangements as legal tax-avoidance techniques by exploiting differences in tax treatment across jurisdictions. These arrangements allowed taxpayers to claim tax deductions in the United States without a corresponding inclusion in another jurisdiction.

The United States has a check-the-box regulatory provision, under which some taxpayers can choose whether they are treated as corporations, where they may face a separate entity level tax, or as partnerships, where there is no such separate entity tax (but rather only owner-level tax), under the U.S. tax code. This choice allows taxpayers the ability to become hybrid entities that are viewed as corporations in one jurisdiction, but not in another. For example, a foreign parent could own a domestic subsidiary limited liability partnership (LLP) that, under the check-the-box rules, elects to be treated as a corporation under U.S. tax law. However, this subsidiary could be viewed as a partnership under foreign tax law. The result is that the domestic subsidiary could be entitled to a deduction for U.S. tax purposes for making interest payments to the foreign parent, but the foreign country would see a payment between a partnership and a partner, and therefore would not tax the interest income. That is, the corporate structure would enable the business entity to avoid paying U.S. tax on the interest by allowing a deduction attributable to an intra-group loan, despite the interest income never being included under foreign tax law.

In addition, there are hybrid instruments, which share characteristics of both debt and equity. Because of these shared characteristics, countries may be inconsistent in their treatment of such instruments. One example is perpetual debt, which many countries treat as debt, but the United States treats as equity. If a foreign affiliate of a U.S.-based multinational issued perpetual debt to a U.S. holder, the interest payments would be tax deductible in a foreign jurisdiction that treats the instrument as debt, while the payments are treated as dividends in the United States and potentially eligible for a dividends received deduction (DRD).

The Act adds section 245A(e) to the Code to address issues of hybridity by introducing a hybrid dividends provision, which disallows the DRD for any dividend received by a U.S. shareholder from a controlled foreign corporation if the dividend is a hybrid dividend. 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. Hybrid dividends between controlled foreign corporations with a common U.S. shareholder are treated as subpart F income.

The Act also adds section 267A of the Code to deny 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 other tax jurisdiction or the related party is allowed a deduction with respect to such amount in the other 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 for U.S. tax purposes but not for purposes of the foreign tax jurisdiction, or vice versa.

B. *Overview*

The hybrids provisions in the Act and the proposed regulations are anti-abuse measures. Taxpayers have been taking aggressive tax positions to take advantage of tax treatment mismatches between jurisdictions in order to achieve favorable tax outcomes at the detriment of tax revenues (see OECD/G20 Hybrid Mismatch Report, October 2015 and OECD/G20 Branch Mismatch Report, July 2017). The statute and the proposed regulations serve to conform the U.S. tax system to recently agreed-upon international tax principles (see OECD/G20 Hybrids Mismatch Report, October 2015 and OECD/G20 Branch Mismatch Report, July 2017), consistent with statutory intent, while protecting U.S. interests and the U.S. tax base. International tax coordination is particularly advantageous in the context of hybrids as it has the potential to greatly curb opportunities for hybrid arrangements, while avoiding double taxation. The anticipated effect of the statute and proposed regulations is a reduction in tax revenue loss due to hybrid arrangements, at the cost of an increase in compliance burden for a limited number of sophisticated taxpayers, as explained below.

C. *Need for the proposed regulations*

Because the Act introduced new sections to the Code to address hybrid entities and hybrid instruments, a large number of the relevant terms and necessary calculations that taxpayers are currently required to apply under the statute can benefit from greater specificity. Taxpayers will lack clarity on which types of arrangements are subject to the statute without the additional interpretive guidance and clarifications contained in the proposed regulations. This lack of clarity could lead to a shifting of corporate income overseas through hybrid arrangements, further eroding U.S. tax revenues. Without accompanying rules to cover branches, structured arrangements, imported mismatches, and similar structures, the statute would be extremely easy to avoid, a pathway that is contrary to Congressional intent. It could also lead to otherwise similar taxpayers interpreting the statute differently, distorting the equity of tax treatment for otherwise similarly situated taxpayers. Finally, the lack of clarity could cause some taxpayers unnecessary compliance burden if they misinterpret the statute.

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 tax-related behavior and other economic behavior in the absence of the proposed regulations.

The baseline includes the Act, which effectively cut the top statutory corporate income tax rate from 35 to 21 percent. This change lowered the value of using hybrid arrangements for multinational corporations, because the value of such arrangements is proportional to the tax they allow the corporation to avoid. As such, some firms with an incentive to set up hybrid arrangements prior to the Act would no longer find it profitable to maintain these arrangements. The Act also modified section 163(j), and regulations interpreting this provision are expected to be finalized soon, which together further limit the deductibility of interest payments. These statutory and regulatory changes further curb the incentive to set up and maintain hybrid arrangements for multinational corporations, since interest payments are a primary vehicle through which hybrid arrangements generated deductions prior to the Act. Further, prior to the Act, the Treasury Department and the IRS issued a series of regulations that reduced or eliminated the incentive for multinational corporations to invert, or change their tax residence to avoid U.S. taxes (including setting up some hybrid arrangements). As a result, under the baseline, the value of hybrid arrangements reflects the existing regulatory framework and the Act and its associated soon-to-be-finalized regulations, all of which strongly affect the value of hybrid arrangements as a tax avoidance technique.

2. Anticipated Costs and Benefits

i. Economic Effects

The Treasury Department has determined that the discretionary non-revenue impacts of the proposed hybrid regulations will reduce U.S. Gross Domestic Product (GDP) by less than $100 million per year ($2018).

To evaluate this effect, the Treasury Department considered the share of interest deductions that would be disallowed by the proposed regulations. Using Treasury Department models applied to confidential 2016 tax data, the Treasury Department calculated the average effective tax rate for potentially affected taxpayers under a range of levels of interest payment deductibility, including the level of deductibility under the Act without the proposed regulations. The difference between the estimated effective tax rate under the Act and without the discretionary elements of the proposed regulations and the range of estimated effective tax rates that include the proposed regulations provides a range of estimates of the net increase in the effective tax rate due to the discretion exercised in the proposed regulations. The Treasury Department next applied an elasticity of taxable income to the range of estimated increases in the effective tax rate to estimate the reduction in taxable income for each of the affected taxpayers in the sample. The Treasury Department then examined a range of estimates of the relationship between the change in taxable income and the real change in economic activity. Finally, the Treasury Department extrapolated the results through 2027.

The Treasury Department concludes from this evaluation that the discretionary aspects of the proposed rules will reduce GDP annually by less than $100 million ($2018). The projected effects reflect the proposed regulations alone and do not include non-revenue economic effects stemming from the Act in the absence of the proposed regulations. More specifically, the analysis did not estimate the impacts of the statutory requirement that hybrid dividends shall be treated as subpart F income of the receiving controlled foreign corporations for purposes of section 951(a)(1)(A) for the taxable year and shall not be permitted a foreign tax credit. *See* section 245A(e).

The Treasury Department solicits comments on the methodology used to evaluate the non-revenue economic effects of the proposed regulations and anticipates that further analysis will be provided at the final rule stage.

ii. Anticipated Costs and Benefits of Specific Provisions

a. 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 and tracking such hybrid deductions. These rules set forth common standards for identifying hybrid deductions and therefore clarify what is deemed a hybrid dividend by the statute and ensure equitable tax treatment of otherwise similar taxpayers.

The proposed regulations also address timing differences to ensure that there is parity between economically similar transactions. Absent such rules, similar transactions may be treated differently due to timing differences. For example, if a CFC paid out a dividend in a given taxable year for which it received a deduction or other tax benefit in a prior taxable year, the taxpayer might claim the dividend is not a hybrid dividend, since the taxable year in which the dividend is paid for U.S. tax purposes and the year in which the tax benefit is received do not overlap. Absent rules, such as the proposed regulations, the purpose of section 245A(e) might be avoided and economically similar transactions might be treated differently.

Finally, these rules excuse certain taxpayers from having to track hybrid deductions (namely taxpayers without a sufficient connection to a section 245A(a) dividends received deduction). The utility of requiring these taxpayers to track hybrid deductions would be outweighed by the burdens of doing so. The proposed regulations reduce the compliance burden on taxpayers that are not directly dealing with hybrid dividends.

b. 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, dubbed a "deduction/no-inclusion outcome" (D/NI outcome). See Senate Explanation, at 384. This affects taxpayers that attempt to use hybrid arrangements to strip income out of the United States taxing jurisdiction.

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. Note that under the statute but without the proposed regulations, a deduction would be disallowed simply if a D/NI outcome occurs and a hybrid arrangement exists (see section II.E of the Explanation of Provisions). For example, a royalty payment made to a hybrid entity in the U.K. qualifying for a low tax rate under the U.K. patent box regime could be denied a deduction in the U.S. under the statute. However, the low U.K. rate is a result of the lower tax rate on patent box income and not a result of any hybrid arrangement. In this example, there is no link between hybridity and the D/NI outcome, since it is the U.K. patent box regime that yields the D/NI outcome and the low U.K. patent box rate is available to taxpayers regardless of whether they are organized as hybrid entities or not. The proposed regulations limit the application of section 267A to cases where the D/NI outcome occurs as a result of hybrid arrangements and not due to a generally applicable feature of the jurisdiction's tax system.

The proposed regulations also provide several exceptions to section 267A in order to refine the scope of the provision and minimize burdens on taxpayers. First, the proposed regulations generally exclude from section 267A payments that are included in a U.S. tax resident's or U.S. taxable branch's income or are taken into account for purposes of the subpart F or global intangible low-taxed income (GILTI) provisions. While the exception for income taken into account for purposes of subpart F is in the statute, the proposed regulations expand the exception to cover GILTI. This avoids potential double taxation on that income. In addition, as a refinement compared with the statute, the extent to which a payment is taken into account under subpart F is determined without regard to allocable deductions or qualified deficits. The proposed regulations also provide a de minimis rule that excepts small taxpayers from section 267A, minimizing the burden on small taxpayers.

Finally, the proposed regulations address a comprehensive set of transactions that give rise to D/NI outcomes. The statute, as written, does not apply to certain hybrid arrangements, including branch arrangements and certain reverse hybrids, as described above (see section II.D of the Explanation of Provisions). The exclusion of these arrangements could have large economic and fiscal consequences due to taxpayers shifting tax planning towards these arrangements to avoid the new anti-abuse statute. The proposed regulations close off this potential avenue for additional tax avoidance by applying the rules of section 267A to 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.

3. Alternatives Considered

i. Addressing 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. The Treasury Department and the IRS considered four options with regards to conduit arrangement rules.

The first option was to not implement any conduit rules, and thus rely on existing and established judicial doctrines (such as conduit principles and substance-over-form principles) to police these transactions. A second option considered was to address conduit arrangement concerns through a broad anti-abuse rule. On the one hand, both of these approaches might reduce complexity by eliminating the need for detailed regulatory rules addressing conduit arrangements. On the other hand, such approaches could create uncertainty (as neither taxpayers nor the IRS might have a clear sense of what types of transactions might be challenged under the judicial doctrines or anti-abuse rule) and could increase burdens to the IRS (as challenging under judicial doctrines or anti-abuse rules are generally difficult and resource intensive). Significantly, such approaches could result in double non-taxation (if judicial doctrines or anti-abuse rules were to not be successfully asserted) or double-taxation (if judicial doctrines or anti-abuse rules were to not take into account the application of foreign tax law, such as a foreign imported mismatch rule).

A third option considered was to implement rules modeled off existing U.S. anti-conduit rules under § 1.881–3. On the positive side, such an approach would rely on an established and existing framework that taxpayers are already familiar with and thus there would be a lesser need to create and apply a new framework or set of rules. On the negative side, existing anti-conduit rules are limited in certain respects as they apply only to certain financing arrangements, which exclude certain stock, and they address only withholding tax policies, which pose separate concerns from section 267A policies (D/NI policies). Furthermore, taxpayers have implemented structures that attempt to avoid the application of the existing anti-conduit rules. Detrimental to tax equity, such an approach could also lead to double-taxation, as the existing anti-conduit rules do not take into account the application of foreign tax law, such as a foreign imported mismatch rule.

The final option considered was to implement rules that are generally consistent with the BEPS imported mismatch rule. The first advantage of such an approach is that it provides certainty about when a deduction will or will not be disallowed under the rule. The second advantage of this approach is that it neutralizes the risk of double non-taxation, while also neutralizing the risk of double taxation. This is because this option is modeled off the BEPS approach, which is being implemented by other countries, and also contains explicit rules to coordinate with foreign tax law. Coordinating with the global tax community reduces opportunities for economic distortions. Although such an approach involves greater complexity than the alternatives, 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 the available alternative approaches. Thus, this is the approach adopted in the proposed regulations.

ii. De minimis rules

The proposed regulations provide a de minimis exception that exempts taxpayers from the application of section 267A for any taxable year for which the sum of the taxpayer's interest and royalty deductions (plus interest and royalty deductions of any related specified parties) is below $50,000. The exception's $50,000 threshold looks to a taxpayer's amount of 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.

The Treasury Department and the IRS considered not providing a de minimis exception because hybrid arrangements are highly likely to be tax-motivated structures undertaken only by mostly sophisticated investors. However, it is possible that, in limited cases, small taxpayers could be subject to these rules, for example, as a result of timing differences or a lack of familiarity with foreign law. Furthermore, section 267A is intended to stop base erosion and tax avoidance, and in the case of small taxpayers, it is expected that the revenue gains from applying these rules would be minimal since few small taxpayers are expected to engage in hybrid arrangements.

The Treasury Department and IRS also considered a de minimis exception based on a dollar threshold with respect to the amount of interest or royalties involving hybrid arrangements. However, such an approach would require a taxpayer to first apply the rules of section 267A to identify its interest or royalty deductions involving hybrid arrangements in order to determine whether the de minimis threshold is satisfied and thus whether it is subject to section 267A for the taxable year. This would therefore not significantly reduce burdens on taxpayers with respect to applying the rules of section 267A.

Therefore, the proposed regulations adopt a rule that looks to the overall amount of interest and royalty payments, whether or not such payments involve hybrid arrangements. This has the effect of exempting, in an efficient manner, small taxpayers that are unlikely to engage in hybrid arrangements, and therefore such taxpayers do not need to consider the application of these rules.

iii. Deemed branch payments and branch mismatch payments

The proposed regulations expand the application of section 267A to certain transactions involving branches. This was necessary in order 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. For example, assume that a related party payment is made to a foreign entity in Country X that is owned by a parent company in Country Y. Further assume that there is a mismatch between how Country X views the entity (fiscally transparent) versus how Country Y views it (not fiscally transparent). In general, section 267A's hybrid entity rules prevent a D/NI outcome in this case. However, assume instead that the parent company forms a branch in Country X instead of a foreign entity, and Country Y (the parent company's jurisdiction) exempts all branch income under its territorial system. On the other hand, due to a mismatch in laws governing whether a branch exists, Country X does not view the branch as existing and therefore does not tax payments made to the branch. Absent regulations, taxpayers could easily avoid section 267A through use of branch structures, which are economically similar to the foreign entity structure in the first example.

In the absence of the proposed regulations, taxpayers may have found it valuable to engage in transactions that are economically similar to hybrid arrangements but that avoided the application of 267A. Such transactions would have resulted in a loss in U.S. tax revenue without any accompanying efficiency gain. Furthermore, to the extent that these transactions were structured specifically to avoid the application of section 267A and were not available to all taxpayers, they would generally have led to an efficiency loss in addition to the loss in U.S. tax revenue.

iv. 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).

The Treasury Department and the IRS considered providing no additional exception for payments included in the U.S. tax base (either directly or under GILTI), therefore the only exception available would be the exception provided in the statute for payments included in the U.S tax base by subpart F inclusions. This approach was rejected in the case of a payment to a U.S. taxpayer since it would result in double taxation by the United States, as the United States would both deny a deduction for a payment as well as fully include such payment in income for U.S. tax purposes. Similarly, in the case of hybrid payments made by one CFC to another CFC with the same United States shareholders, a payment would be included in tested income of the recipient CFC and therefore taken into account under GILTI. If section 267A were to apply to also disallow the deduction by the payor CFC, this could also lead to the same amount being subject to section 951A twice because the payor CFC's tested income would increase as a result of the denial of deduction, and the payee would have additional tested income for the same payment.

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, it is consistent with the policy of section 267A and the grant of authority in section 267A(e) to exempt them from disallowance under section 267A. Therefore, the proposed regulations provide that such payments are not subject to disallowance under section 267A.

v. Link between hybridity and D/NI

As discussed in section II.E of the Explanation of Provisions and section I.D.2.ii of this Special Analyses, the proposed regulations limit 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.

Under the language of the statute, no link between hybridity and the no-inclusion outcome appears to be required. The Treasury Department and the IRS considered following this approach, which would have resulted in a deduction being disallowed even though if the transaction had been a non-hybrid transaction, the same no-inclusion outcome would have resulted. However, the Treasury Department and the IRS rejected this option because it would lead to inconsistent and arbitrary results. In particular, such an approach would incentivize taxpayers to restructure to eliminate hybridity in order to avoid the application of section 267A in cases where hybridity does not cause a D/NI outcome. Such restructuring would eliminate the hybridity without actually eliminating the D/NI outcome since the hybridity did not cause the D/NI outcome. Interpreting section 267A in a manner that incentivizes taxpayers to engage in restructurings of this type would generally impose costs on taxpayers to retain deductions where hybridity is irrelevant to a D/NI outcome, without furthering the statutory purpose of section 267A to neutralize hybrid arrangements.

Furthermore, the policy of section 267A is not to address all situations that give rise to no-inclusion outcomes, but to only address a subset of such situations where they arise due to hybrid arrangements. When base erosion or double non-taxation arises due to other features of the international tax system (such as the existence of low-tax jurisdictions or preferential regimes for certain types of income), there are other types of rules that are better suited to address these concerns (for example, through statutory impositions of withholding taxes, revisions to tax treaties, or new statutory provisions such as the base erosion and anti-abuse tax under section 59A). Moreover, the legislative history to section 267A makes clear that the policy of the provision is to eliminate the tax-motivated hybrid structures that lead to D/NI outcomes, and was not a general provision for eliminating all cases of D/NI outcomes. *See* Senate Explanation, at 384 ("[T]he Committee believes that 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 . . .") (emphasis added). In addition, to the extent that regulations limit disallowance to those cases in which the no-inclusion portion of the D/NI outcome is a result of hybridity, the scope of section 267A is limited and the burden on taxpayers is reduced without impacting the core policy underlying section 267A. Therefore, the proposed regulations provide that a deduction is disallowed under section 267A only to the extent that the no-inclusion portion of the D/NI outcome is a result of hybridity.

vi. Timing differences under section 245A

In some cases, 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 for the amount in a foreign jurisdiction. Timing differences may raise issues about whether a deduction is a hybrid deduction and thus whether a dividend is considered a hybrid dividend. The Treasury Department and the IRS considered three options with respect to this timing issue.

The first option considered was to not address timing differences, and thus not treat such transactions as giving rise to hybrid dividends. Not addressing the timing differences would raise policy concerns, since failure to treat the deduction as giving rise to a hybrid dividend would result in the section 245A(a) DRD applying to the dividend, allowing the amount to permanently escape both foreign tax (through the deduction) and U.S. tax (through the DRD).

The second option considered was to not address the timing difference directly under section 245A(e), but instead address it under another Code section or regime. For example, one method that would be consistent with the BEPS Report would be to mandate an income inclusion to the U.S. parent corporation at the time the deduction is permitted under foreign law. This would rely on a novel approach that deems an inclusion at a particular point in time despite the fact that the income has otherwise not been recognized for U.S. tax purposes.

The final option was to address the timing difference by providing rules requiring the establishment of hybrid deduction accounts. These hybrid deduction accounts will be maintained across years so that deductions that accrue in one year will be matched up with income arising in a different year, thus addressing the timing differences issue. This approach appropriately addresses the timing differences under section 245A of the Code. The Treasury Department and IRS expect the benefits of this option's comprehensiveness and clarity to be substantially greater than the tax administration and compliance costs it imposes, relative to the alternative options. This is the approach adopted by the proposed regulations.

vii. Timing differences under section 267A

A similar timing issue arises under section 267A. Here, there is 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. In the context of section 267A, the Treasury Department and the IRS considered three options with respect to this timing issue.

The first option considered was to not address timing differences, because they will eventually reverse over time. Although such an approach would result in a relatively simple rule, it would raise significant policy concerns because, as indicated in the legislative history, long-term deferral can be equivalent to a permanent exclusion.

The second option considered was to address all timing differences, because even a timing difference that reverses within a short period of time provides a tax benefit during the short term. Although such an approach might be conceptually pure, it would raise significant practical and administrative difficulties. It could also lead to some double-tax, absent complicated rules to calibrate the disallowed amount to the amount of tax benefit arising from the timing mismatch.

The final option considered was to address only certain timing differences – namely, long-term timing differences, such as timing differences that do not reverse within a 3 taxable year period. The Treasury Department and IRS expect that the net benefits of this option's comprehensiveness, clarity, and tax administrability and compliance burden are substantially higher than those of the available alternatives. Thus, this option is adopted in the proposed regulations.

4. Anticipated impacts on administrative and compliance costs

The Treasury Department and the IRS estimate that there are approximately 10,000 taxpayers in the current population of taxpayers affected by the proposed regulations or about 0.5% of all corporate filers. This is the best estimate of the number of sophisticated taxpayers with capabilities to structure a hybrid arrangement. However, the Treasury Department and the IRS anticipate that fewer taxpayers would engage in hybrid arrangements going forward as the statute and the proposed regulations would make such arrangements less beneficial to taxpayers. As such, the taxpayer counts provided in section II of this Special Analyses are an upper bound of the number of affected taxpayers by the proposed regulations.

It is important to note that the population of taxpayers affected by section 267A and the proposed 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 proposed regulations apply predominantly to foreign-headquartered companies that employ hybrid arrangements to strip income out of the U.S., undermining the collection of U.S. tax revenue. In addition, although section 245A(e) applies primarily to U.S.-based companies, the amounts of dividends affected are limited 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).

II. *Paperwork Reduction Act*

The collections of information in the proposed regulations are in proposed §§ 1.6038–2(f)(13) and (14), 1.6038–3(g)(3), and 1.6038A–2(b)(5)(iii).

The collection of information in proposed § 1.6038–2(f)(13) and (14) is mandatory for every U.S. person that controls a foreign corporation that has a deduction disallowed under section 267A, or that pays or receives a hybrid dividend or tiered hybrid dividend under section 245A, respectively, during an annual accounting period and files Form 5471 for that period (OMB control number 1545-0123, formerly, OMB control number 1545-0704). The collection of information in proposed § 1.6038–2(f)(13) is satisfied by providing information about the disallowance of the deduction for any interest or royalty under section 267A for the corporation's accounting period as Form 5471 and its instructions may prescribe, and the collection of information in proposed § 1.6038–2(f)(14) is satisfied by providing information about hybrid dividends or tiered hybrid dividends under section 245A(e) for the corporation's accounting period as Form 5471 and its instructions may prescribe. For purposes of the PRA, the reporting burden associated with proposed § 1.6038–2(f)(13) and (14) will be reflected in the IRS Form 14029, Paperwork Reduction Act Submission, associated with Form 5471. As provided below, the estimated number of respondents for the reporting burden associated with proposed § 1.6038–2(f)(13) and (14) is 1,000 and 2,000, respectively.

The collection of information in proposed § 1.6038–3(g)(3) is mandatory for every U.S. person that controls a foreign partnership that paid or accrued any interest or royalty for which a deduction is disallowed under section 267A during the partnership tax year and files Form 8865 for that period (OMB control number 1545-1668). The collection of information in proposed § 1.6038–3(g)(3) is satisfied by providing information about the disallowance of the deduction for any interest or royalty under section 267A for the partnership's tax year as Form 8865 and its instructions may prescribe. For purposes of the PRA, the reporting burden associated with proposed § 1.6038–3(g)(3) will be reflected in the IRS Form 14029, Paperwork Reduction Act submission, associated with Form 8865. As provided below, the estimated number of respondents for the reporting burden associated with proposed § 1.6038–3(g)(3) is less than 1,000.

The collection of information in proposed § 1.6038A–2(b)(5)(iii) is mandatory for every reporting corporation that has a deduction disallowed under section 267A and files Form 5472 (OMB control number 1545-0123, formerly, OMB control number 1545-0805) for the tax year. The collection of information in proposed § 1.6038A–2(b)(5)(iii) is satisfied by providing information about the disallowance of the reporting corporation's deduction for any interest or royalty under section 267A for the tax year as Form 5472 and its instructions may prescribe. For purposes of the PRA, the reporting burden associated with proposed § 1.6038A–2(b)(5)(iii) will be reflected in the IRS Form 14029, Paperwork Reduction Act submission, associated with Form 5472. As provided below, the estimated number of respondents for the reporting burden associated with proposed § 1.6038A–2(b)(5)(iii) is 7,000.

The revised tax forms are as follows:

	New	Revision of existing form	Number of respondents (estimated, rounded to nearest 1,000)
Schedule G (Form 5471)		✓	1,000
Schedule I (Form 5471)		✓	2,000
Form 5472		✓	7,000
Form 8865		✓	<1,000

The current status of the Paperwork Reduction Act submissions related to the tax forms that will be revised as a result of the information collections in the proposed regulations is provided in the accompanying table. As described above, the reporting burdens associated with the information collections in proposed §§ 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 in 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 numbers are therefore unrelated to the future calculations needed to assess the burden imposed by the proposed regulations. They are further identical to numbers provided for the proposed regulations relating to foreign tax credits (83 FR 63200). The Treasury Department and IRS urge readers to recognize that these numbers are duplicates and to guard against overcounting the burden that international tax provisions imposed prior to the Act. No burden estimates specific to the proposed regulations are currently available. The Treasury Department has not identified any burden estimates, including those for new information collections, related to the requirements under the proposed regulations. Those estimates would 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. In addition, when available, drafts of IRS forms are posted for comment at https://apps.irs.gov/app/picklist/list/draftTaxForms.htm.

Form	Type of Filer	OMB Number(s)	Status
Form 5471	All other Filers (mainly trusts and estates) (Legacy system)	1545-0121	Approved by OMB through 10/30/2020.
	Link: https://www.reginfo.gov/public/do/PRAViewICR?ref_nbr=201704-1545-023		
	Business (NEW Model)	1545-0123	Published in the Federal Register Notice (FRN) on 10/8/18. Public Comment period closed on 12/10/18.
	Link: https://www.federalregister.gov/documents/2018/10/09/2018-21846/proposed-collection-comment-request-for-forms-1065-1065-b-1066-1120-1120-c-1120-f-1120-h-1120-nd		
	Individual (NEW Model)	1545-0074	Limited Scope submission (1040 only) on 10/11/18 at OIRA for review. Full ICR submission (all forms) scheduled in 3/2019. 60 Day FRN not published yet for full collection.
	Link: https://www.reginfo.gov/public/do/PRAViewICR?ref_nbr=201808-1545-031		
Form 5472	Business (NEW Model)	1545-0123	Published in the FRN on 10/8/18. Public Comment period closed on 12/10/18.
	Link: https://www.federalregister.gov/documents/2018/10/09/2018-21846/proposed-collection-comment-request-for-forms-1065-1065-b-1066-1120-1120-c-1120-f-1120-h-1120-nd		

Form	Type of Filer	OMB Number(s)	Status
	Individual (NEW Model)	1545-0074	Limited Scope submission (1040 only) on 10/11/18 at OIRA for review. Full ICR submission for all forms in 3/2019. 60 Day FRN not published yet for full collection.
	Link: https://www.reginfo.gov/public/do/PRAViewICR?ref_nbr=201808-1545-031		
Form 8865	All other Filers (mainly trusts and estates) (Legacy system)	1545-1668	Published in the FRN on 10/1/18. Public Comment period closed on 11/30/18. ICR in process by Treasury as of 10/17/18.
	Link: https://www.federalregister.gov/documents/2018/10/01/2018-21288/proposed-collection-comment-request-for-regulation-project		
	Business (NEW Model)	1545-0123	Published in the FRN on 10/8/18. Public Comment period closed on 12/10/18.
	Link: https://www.federalregister.gov/documents/2018/10/09/2018-21846/proposed-collection-comment-request-for-forms-1065-1065-b-1066-1120-1120-c-1120-f-1120-h-1120-nd		
	Individual (NEW Model)	1545-0074	Limited Scope submission (1040 only) on 10/11/18 at OIRA for review. Full ICR submission for all forms in 3/2019. 60 Day FRN not published yet for full collection.
	Link: https://www.reginfo.gov/public/do/PRAViewICR?ref_nbr=201808-1545-031		

III. *Regulatory Flexibility Act*

It is hereby certified that this notice of proposed rulemaking 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 proposed §§ 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 proposed § 1.6038–2(f)(14) are controlling U.S. shareholders of a CFC that pays or received 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 do not have data readily available to assess the number of small entities potentially affected by proposed §§ 1.6038–2(f)(13) or (14), 1.6038–3(g)(3), or 1.6038A–2(b)(5)(iii). However, entities potentially affected by these sections are generally not small businesses, because the resources and investment necessary for an entity to be a controlling U.S. shareholder, a controlling fifty-percent partner, or a 25 percent foreign-owned domestic corporation are generally significant. Moreover, 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) is below $50,000. Therefore, the Treasury Department and the IRS do not believe that a substantial number of domestic small business entities will be subject to proposed §§ 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 do not believe that proposed §§ 1.6038–2(f)(13) or (14), 1.6038–3(g)(3), or 1.6038A–2(b)(5)(iii) will have a significant economic impact on a substantial number of small entities. Therefore, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act is not required.

The Treasury Department and the IRS do not believe that the proposed regulations have a significant economic impact on domestic small business entities. Based on published information from 2012 from form 5472, interest and royalty amounts paid to related foreign entities by foreign-owned U.S. corporations over total receipts is 1.6 percent. (https://www.irs.gov/statistics/soi-tax-stats-transactions-of-foreign-owned-domestic-corporations#_2, Classified by Industry 2012) This is substantially less than the 3 to 5 percent threshold for significant economic impact. The calculated percentage is likely to be an upper bound of the related party payments affected by the proposed hybrid regulations. In particular, this is the ratio of the potential income affected and not the tax revenues, which would be less than half this amount. While 1.6 percent is only for foreign-owned domestic corporations with total receipts of $500 million or more, these are entities that are more likely to have related party payments and so the percentage would be higher. Moreover, hybrid arrangements are only a subset of these related party payments; therefore this percentage is higher than what it would be if only considering hybrid arrangements.

Notwithstanding this certification, Treasury 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 a 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 "ADDRESSES" 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 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, notice of the date, time, and place for the public hearing will be published in the **Federal Register**.

Drafting Information

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

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.

Proposed Amendments to the Regulations

Accordingly, 26 CFR parts 1 and 301 are proposed to be 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–

(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.

(2) *Definition of hybrid dividend.* The term *hybrid dividend* means an amount received by a United States shareholder from a CFC for which but for section 245A(e) and this section 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 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)) shares of stock of the lower-tier CFC, the hybrid deduction accounts with respect to those shares are treated as hybrid deduction accounts of the domestic corporation. 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) 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 must include 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.

(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 under section 245A as contained in 26 CFR part 1 (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 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, rules similar to the rules of paragraph (b)(3) of this section apply.

(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 and, therefore, the 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.

(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. Examples of such a deduction or other tax benefit include an interest deduction, a dividends paid deduction, and a deduction with respect to equity (such as a notional interest deduction). *See* paragraph (g)(1) of this section. However, a deduction or other tax benefit relating to or resulting from a distribution by the CFC with respect to an instrument treated as stock for purposes of the relevant foreign tax law is considered a hybrid deduction only to the extent it has the effect of causing the earnings that funded the distribution to not be included in income (determined under the principles of § 1.267A–3(a)) or otherwise subject to tax under the CFC's tax law. Thus, for example, a refund to a shareholder of a CFC (including through a credit), upon a distribution by the CFC to the shareholder, of taxes paid by the CFC on the earnings that funded the distribution results in a hybrid deduction of the CFC, but only to the extent that the shareholder, if a tax resident of the CFC's country, does not include the distribution in income under the CFC's tax law or, if not a tax resident of the CFC's country, is not subject to withholding tax (as defined in section 901(k)(1)(B)) on the distribution under the CFC's tax law. *See* paragraph (g)(2) of this section.

(ii) *Application limited to items allowed in taxable years beginning after December 31, 2017.* A deduction or other tax benefit allowed to a CFC (or a person related to the CFC) under a relevant foreign tax law is taken into account for purposes of this section only if it was allowed with respect to a taxable year under the relevant foreign tax law beginning after December 31, 2017.

(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 allocable to the share for the taxable year.

(B) Second, the account is decreased by the amount of hybrid deductions in the account that gave rise to a hybrid dividend or tiered hybrid dividend during the taxable year. If a specified owner has more than one hybrid deduction account with respect to its stock of the CFC, then a pro rata amount in each hybrid deduction account is considered to have given rise to the hybrid dividend or tiered hybrid dividend, based on the amounts in the accounts before applying this paragraph (d)(4)(i)(B).

(ii) *Acquisition of account*–(A) *In general.* The following rules apply when a person (the *acquirer*) 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 eliminated 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)(ii)(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 *distributing CFC*) in which a controlled foreign corporation is the acquiring corporation (the *distributee CFC*), then each hybrid account with respect to a share of stock of the distributee CFC is increased pro rata by the sum of the hybrid accounts with respect to shares of stock of the distributing 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.

(5) *Determinations and adjustments made on transfer date 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 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 upper-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, 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. 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, the sum of the United States shareholder's hybrid deduction accounts with respect to each share of stock of the CFC is determined, and the accounts are adjusted, as of the close of the date of the exchange. For this purpose, the principles of § 1.1502–76(b)(2)(ii) apply to determine amounts in hybrid deduction accounts at the close of the date of the transfer.

(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 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.

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

(3) The term *related* has the meaning provided in this paragraph (f)(3). A person is related to a CFC if the person is a related person within the meaning of section 954(d)(3).

(4) 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. 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, for example, the CFC is fiscally transparent under the person's tax law).

(5) The term *specified owner* means, with respect to a share of stock of a CFC, a person for which the requirements of paragraphs (f)(5)(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.

(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.

(6) 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. 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.

(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, but for section 245A(e) and this section, 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 id.* 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)(B) 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)(B) 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)(B) 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)(B) 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)(B) of this section. Therefore, at the end of year 2 and taking into account the adjustments under paragraph (d)(4)(i)(B) 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, but for section 245A(e) and this section, 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) 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)(B) 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)(B) 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)(B) 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 $90x/$100x). *See id.* 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 $10x/$100x). *See id.* 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)(4) 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)(B) 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)(B) 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. 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, but for section 245A(e) and this section, 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.* $937.5x of the $1,000x of dividends received by FX from FZ during year 2 is a tiered hybrid dividend, because 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. *See* paragraphs (b)(2) and (c)(2) of this section. As a result, 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. In addition, the rules of section 245A(d) (disallowance of foreign tax credits and deductions) apply with respect to US1's inclusion. *Id.* 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 purposes, 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) 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) Thus, at the end of year 2, and before the adjustments described in paragraph (d)(4)(i)(B) 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) Lastly, 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)(B) 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)(B) of this section) less $9.375x (the adjustment described in paragraph (d)(4)(i)(B) 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 $1,000 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.

(h) *Applicability date.* This section applies to distributions made after December 31, 2017.

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

§ 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 specified payments). 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 interest and royalty deductions (determined without regard to 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 this purpose, 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).

(2) *Definition of hybrid transaction.* 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 return of principal. In addition, a specified payment is deemed to be made pursuant to a hybrid transaction if the taxable year in which a specified recipient recognizes the payment under its tax law ends more than 36 months after the end of the taxable year in which the specified party would be allowed a deduction for the payment under U.S. tax law. *See also* § 1.267A–6(c)(8). Further, a specified payment is not considered made pursuant to a hybrid transaction if the payment is a disregarded pay-

ment, 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 this purpose, 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. *See* § 1.267A–6(c)(2). 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.

(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).

(2) *Definition of disregarded payment.* 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 disregarded transaction involving a single taxpayer or between group members) 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). In addition, 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. Moreover, a disregarded payment does not include a deemed branch payment, or a specified payment pursuant to a repo transaction or similar transaction described in paragraph (a)(3) of this section.

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

(i) The sum of the specified party's items of income or gain for U.S. tax purposes, 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

(ii) 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.

(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) 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 payment 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).

(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) and is not regarded (or otherwise taken into account) under the home office's tax law (or the other branch's tax law). A deemed branch payment may be otherwise taken into account for this purpose 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 of the reverse hybrid 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 this purpose, 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).

(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) 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).

(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 this purpose, 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).

(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 includes (or it will include during a taxable year that ends no more than 36 months after the end of the specified party's taxable year) the payment in its income or tax base at the full marginal rate imposed on ordinary income; 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), and a credit for underlying taxes paid by a corporation from which a dividend is received. 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 this purpose, a deduction may be treated as being generally applicable even if it is 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 this purpose, 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 applicable tax law.

(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 right to a distribution from the reverse hybrid triggered by the payment).

(4) *De minimis inclusions and deemed full 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*–(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).

(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 its gross income.

(3) *Includible in income under section 951(a)(1).* 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) (determined without regard to properly allocable deductions of the CFC and qualified deficits under section 952(c)(1)(B)) in the gross income of a United States shareholder of the CFC. However, the tentative disqualified hybrid amount is reduced only if the United States shareholder is a tax resident of the United States or, if the United States shareholder is not a tax resident of the United States, then only to the extent that a tax resident of the United States would take into account the amount includible under section 951(a)(1) in the gross income of the United States shareholder.

(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 (within the meaning of section 951A(c)(2)(A)) with respect to a CFC, reduces the shareholder's pro rata share of tested loss (within the meaning of section 951A(c)(2)(B)) of the CFC, or both. However, the tentative disqualified hybrid amount is reduced only if the United States shareholder is a tax resident of the United States or, if the United States shareholder is not a tax resident of the United States, then only to the extent that a tax resident of the United States would take into account the amount that increases the United States shareholder's pro rata share of tested income with respect to the CFC, reduces the shareholder's pro rata share of tested loss of the CFC, or both.

§ 1.267A–4 Disqualified imported mismatch amounts.

(a) *Disqualified imported mismatch amounts.* A specified payment (to the extent not a disqualified hybrid amount, as described in § 1.267A–2) 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 tax resident or taxable branch that is related to the specified party (or that is a party to a structured arrangement pursuant to which the payment is made). For purposes of this section, any specified payment (to the extent not a disqualified hybrid amount) is referred to as an *imported mismatch payment*; the specified party is referred to as an *imported mismatch payer*; and a tax resident or taxable branch that includes the imported mismatch payment in income (or a tax resident or taxable branch the tax law of which otherwise prevents the imported mismatch payment from being a disqualified hybrid amount, for example, because under such tax law the tax resident's no-inclusion is not a result of hybridity) is referred to as the *imported mismatch payee. See* § 1.267A–6(c)(8), (9), and (10).

(b) *Hybrid deduction.* A hybrid deduction means, with respect to a tax resident or taxable branch that is not a specified party, a deduction allowed to the tax resident or 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 (regardless of whether or how such amounts would be recognized under U.S. 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. In addition, with respect to a tax resident that is not a specified party, a hybrid deduction includes a deduction allowed to the tax resident with respect to equity, such as a notional interest deduction. Further, a hybrid deduction for a particular accounting period includes a loss carryover from another accounting period, to the extent that a hybrid deduction incurred in an accounting period beginning 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.

(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 this purpose, 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.

(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 deduction.

(ii) The imported mismatch payment indirectly funds a hybrid deduction to the extent that the imported mismatch payee is allocated the deduction.

(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 tax resident or taxable branch that incurs the hybrid deduction.

(iv) An imported mismatch payee indirectly makes a funded taxable payment to the tax resident or taxable branch that incurs a hybrid deduction to the extent that a chain of funded taxable payments exists connecting the imported mismatch payee, each intermediary tax resident or taxable branch, and the tax resident or taxable branch that incurs the hybrid deduction.

(v) The term *funded taxable payment* means, with respect to a tax resident or taxable branch that is not a specified party, a deductible amount paid or accrued by the tax resident or taxable branch under its tax law, other than an amount that gives rise to a hybrid deduction. However, a funded taxable payment does not include an amount deemed to be an imported mismatch payment pursuant to paragraph (f) of this section.

(vi) If, with respect to a tax resident or taxable branch that is not a specified party, a deduction or loss that is not incurred by the tax resident or taxable branch is directly or indirectly made available to offset income of the tax resident or taxable branch under its tax law, then, for purposes of this paragraph (c), the tax resident or taxable branch to which the deduction or loss is made available and the tax resident or branch that incurs the deduction or loss are treated as a single tax resident or taxable branch. For example, if a deduction or loss of one tax resident is made available to offset income of another tax resident under a tax consolidation, fiscal unity, group relief, loss sharing, or any similar regime, then the tax residents are treated as a single tax resident for purposes of paragraph (c) of 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 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 particular imported mismatch payee, the amount of such payments exceeds the hybrid deduction incurred by the payee, and the payments are not factually-related imported mismatch payments, then a pro rata portion of each payer's payment is considered to directly fund the hybrid deduction. *See* § 1.267A–6(c)(9).

(f) *Certain amounts deemed to be imported mismatch payments for certain purposes.* For purposes of determining the extent that income attributable to an imported mismatch payment is directly or indirectly offset by a hybrid deduction, an amount paid or accrued by a tax resident or taxable branch that is not a specified party is deemed to be an imported mismatch payment (and such tax resident or taxable branch and a specified recipient of the amount, determined under § 1.267A–5(a)(19), 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–

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

(2) Under a provision of the hybrid mismatch rules substantially similar to this section, the tax resident or taxable branch is denied a deduction for all or a portion of the amount. *See* § 1.267A–6(c)(10).

§ 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 that section 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 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.

(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 (as adjusted by amounts described in paragraph (a)(12)(iii) 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 (as adjusted by amounts described in paragraph (a)(12)(iii) 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 under 26 CFR part 1. Thus, for example, interest includes–

(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 or received in connection with a sale-repurchase agreement treated as indebtedness under Federal tax principles; in the case of a sale-repurchase agreement relating to tax-exempt bonds, however, the amount is not tax-exempt interest;

(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) *Non-cleared swaps.* A swap that is not a cleared swap and that has 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) [Reserved]

(C) *Definition of 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.

(iii) *Amounts affecting the effective cost of borrowing that adjust the amount of interest expense.* Income, deduction, gain, or loss from a derivative, as defined in section 59A(h)(4)(A), that alters a person's effective cost of borrowing with respect to a liability of the person is treated as an adjustment to interest expense of the person. For example, a person that is obligated to pay interest at a floating rate on a note and enters into an interest rate swap that entitles the person to receive an amount that is equal to or that closely approximates the interest rate on the note in exchange for a fixed amount is, in effect, paying interest expense at a fixed rate by entering into the interest rate swap. Income, deduction, gain, or loss from the swap is treated as an adjustment to interest expense. Similarly, any gain or loss resulting from a termination or other disposition of the swap is an adjustment to interest expense, with the timing of gain or loss subject to the rules of § 1.446–4.

(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) 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 that section and the tax resident or taxable branch as the "person" referred to in that section. In addition, for these purposes, 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. Further, for these purposes neither section 318(a)(3), nor § 1.958–2(d) or the principles thereof, applies to attribute stock or other interests to a tax resident, taxable branch, or specified party.

(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 United States shareholder that owns (within the meaning of section 958(a)) 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 or a CFC that is a partner of the partnership is a specified party whose 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. The principles of § 1.894–1(d)(1) apply for purposes of determining whether a tax resident derives a specified payment under its tax law, without regard to whether the tax resident is a resident of a country that has an income tax treaty with the United States. There may be more than one specified recipient with respect to a specified payment.

(20) The term *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) if the specified payment were analyzed without regard to the relatedness limitation in § 1.267A–2(f) (or without regard to the language "that is related to the specified party" in § 1.267A–4(a)) (either such outcome, a *hybrid mismatch*), provided that either paragraph (a)(20)(i) or (ii) of this section is satisfied. A *party to a structured arrangement* means a tax resident or taxable branch that participates in the structured arrangement. For this purpose, an entity's participation in a structured arrangement is imputed to its investors.

(i) The hybrid mismatch is priced into the terms of the arrangement.

(ii) Based on all the facts and circumstances, the hybrid mismatch is a principal purpose of the arrangement. Facts and circumstances that indicate the hybrid mismatch is a principal purpose of the arrangement include–

(A) Marketing the arrangement as tax-advantaged where some or all of the tax advantage derives from the hybrid mismatch;

(B) Primarily marketing the arrangement to tax residents of a country the tax law of which enables the hybrid mismatch;

(C) Features that alter the terms of the arrangement, including the return, in the event the hybrid mismatch is no longer available; or

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

(21) The term *tax law* of a country includes statutes, regulations, administrative or judicial rulings, and treaties of the 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 this purpose, a body corporate or other entity or body of persons may be considered liable to tax under the tax law of a country as a resident even though such tax law does not impose a corporate income tax. 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.* Except as otherwise provided in the Code or in regulations under 26 CFR part 1, section 267A applies to a specified payment after the application of any other applicable provisions of the Code and regulations under 26 CFR part 1. 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 royalty, such as § 1.894–1(d)(2), govern the treatment of such amounts and therefore such amounts would not be treated as specified payments.

(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 this purpose, the proportionate amount is the amount of the foreign currency gain or loss under section 988 with respect to the specified payment multiplied by the amount of the specified payment for which a deduction is disallowed under section 267A.

(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–

(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 deductible in computing the business profits attributable to the U.S. permanent establishment, if such amounts differ from the amounts allocable under paragraph (b)(3)(i)(A) of this section.

(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 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) (resulting in directly allocable interest) or with respect to a U.S. booked liability, as defined in § 1.882–5(d)(2). If the amount of interest allocable to the U.S. taxable branch exceeds the interest paid or accrued on its 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 for purposes of the calculations described in paragraph (b)(3)(i) of this section, excluding any interest treated as already paid directly by the branch.

(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, rules analogous to 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 or when the amount paid or accrued that gave rise to the deduction reduces earnings and profits of a corporation.

(5) *Application to structured payments*–(i) *In general.* For purposes of section 267A and the regulations under section 267A as contained in 26 CFR part 1, a structured payment (as defined in paragraph (b)(5)(ii) of this section) is treated as a specified payment.

(ii) *Structured payment.* A structured payment means any amount described in paragraphs (b)(5)(ii)(A) or (B) of this section (as adjusted by amounts described in paragraph (b)(5)(ii)(C) of this section).

(A) *Certain payments related to the time value of money (structured interest amounts)*–(*1*) *Substitute interest payments.* A substitute interest payment described in § 1.861–2(a)(7).

(*2*) *Certain amounts labeled as fees*–(*i*) *Commitment fees.* Any fees in respect of a lender commitment to provide financing if any portion of such financing is actually provided.

(*ii*) [Reserved]

(*3*) *Debt issuance costs.* Any debt issuance costs subject to § 1.446–5.

(*4*) *Guaranteed payments.* Any guaranteed payments for the use of capital under section 707(c).

(B) *Amounts predominately associated with the time value of money.* Any expense or loss, to the extent deductible, incurred by a person in a transaction or series of integrated or related transactions in which the person secures the use of funds for a period of time, if such expense or loss is predominately incurred in consideration of the time value of money.

(C) *Adjustment for amounts affecting the effective cost of funds.* Income, deduction, gain, or loss from a derivative, as defined in section 59A(h)(4)(A), that alters a person's effective cost of funds with respect to a structured payment described in paragraph (b)(5)(ii)(A) or (B) of this section is treated as an adjustment to the structured payment of the person.

(6) *Anti-avoidance rule.* A specified party's deduction for a specified payment is disallowed to the extent that both of the following requirements are satisfied:

(i) The payment (or income attributable to the payment) is not included in the income of a tax resident or taxable branch, as determined under § 1.267A–3(a) (but without regard to the de minimis and full inclusion rules in § 1.267A–3(a)(3)).

(ii) A principal purpose of the plan or arrangement is to avoid the purposes of the regulations under section 267A.

§ 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.

(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 nonresident 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 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 id.*

(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.

(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 return for $1,000x paid from FX to US1, 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 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 id.* 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 considered to be $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 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 is a disregarded transaction involving 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 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. tax purposes and equity for Country X tax purposes (the US1-FZ instrument). In addition, the $80x is treated as interest for U.S. tax purposes and 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 such 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's dual inclusion income for taxable year 1 is $0 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).

(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 FX'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, $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 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) 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 the payment 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). 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 amount 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. *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 includes in its income $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 includes the amount 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 no-inclusion does not occur with respect to FZ, but a $100x no-inclusion occurs with respect to FX. 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.

(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 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–3(a). Accordingly, in such a case, only $20x of US1's payment would be 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 County 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 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 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. Further, under section 951A, the payment is included in FX's tested income. 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 id.* 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 not a tax resident of the United States.* 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 a foreign individual that is a nonresident alien (as defined in section 7701(b)(1)(B)). As is the case in paragraph (c)(7)(ii) of this section, $48x of the $80x tentative disqualified hybrid amount increases US1's pro rata share of the tested income of FX. However, US1 is not a tax resident of the United States. Thus, the $48x reduces the tentative disqualified hybrid amount only to the extent that the $48x would be taken into account by a tax resident of the United States. *See* § 1.267A–3(b)(4). US2 (a tax resident of the United States) would take into account $43.2x of such amount (calculated as $48x 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 id.*

(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. The $100x payment is not a disqualified hybrid amount. 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 X 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), US1's payment is an imported mismatch payment, US1 is an imported mismatch payer, and FW (the 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 FX (a tax resident that is related to US1). *See* § 1.267A–4(a). 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) 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 recognize income under the FX-FW instrument until 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 the accounting period. The results are the same as in paragraph (c)(8)(ii) of this section. That is, FW's $100x deduction 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).

(iv) *Alternative facts – notional interest deduction.* The facts are the same as in paragraph (c)(8)(i) of this section, except that the FX-FW instrument does not exist 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), 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).

(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 on 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 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–2(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. 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 amount is equal to $80x during accounting period 1. 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 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 for Country Z tax purposes. 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. 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), each of US1's and US2's payments is an imported mismatch payment, US1 and US2 are imported mismatch payers, and FZ (the 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 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) did 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 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 id.* 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, is a disqualified imported mismatch amount under § 1.267A–4(a) and, as a result, a deduction for such amounts is 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 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 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 advances money to FW pursuant to an instrument that is treated as equity for Country X tax purposes and indebtedness for Country W tax purposes (the FX-FW instrument). In a transaction that is pursuant to the same plan pursuant to which the FX-FW instrument is entered into, FW advances money to US1 pursuant to an instrument that is treated as indebtedness for Country W and U.S. tax purposes (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 deductible 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 respective specified recipient's income. 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. Under § 1.267A–4(a), each of the payments is thus an imported mismatch payment, US1, US2, and US3 are imported mismatch payers, and FW and FZ (the 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) 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).

(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. § 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).

(C) Third, the $25x remaining 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. § 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). § 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. § 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. § 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).

(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, under a provision of such rules substantially similar to § 1.267A–4, FE is denied a deduction for the $50x it pays to FW under the FW-FE instrument. Pursuant to § 1.267A–4(f), 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 US2's and US3's imported mismatch payments is offset by FW's hybrid deduction. 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, FW's hybrid deduction offsets the income attributable to US2's and US3's imported mismatch payments to the same extent as described in paragraphs (c)(10)(ii)(B) and (C) of this section.

(iv) *Alternative facts – amount deemed to be an imported mismatch payment not treated as a funded taxable payment.* The facts are the same as in paragraph (c)(10)(i) of this section, except that FZ holds its 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); US3's $50x payment is treated as interest for Country E tax purposes and FE includes the payment in income. In addition, during accounting period 1, FE pays $50x of interest to FZ pursuant to an instrument and such amount is included in FZ's income. Further, the tax law of Country E contains hybrid mismatch rules and, under a provision of such rules substantially similar to § 1.267A–4, FE is denied a deduction for $25x of the $50x it pays to FZ, because under such provision $25x of the income attributable to FE's payment is considered offset against $25x of FW's hybrid deduction. With respect to US1 and US2, the results are the same as described in paragraphs (c)(10)(ii)(A) and (B) of this section. However, no portion of US3's payment is a disqualified imported mismatch amount. This is because the $50x that FE pays to FZ is not considered to be a funded taxable payment, because under a provision of Country E's hybrid mismatch rules that is substantially similar to § 1.267A–4, FE is denied a deduction for a portion of the $50x. *See* § 1.267A–4(c)(3)(v) and (f). Therefore, there is no chain of funded taxable payments connecting US3 (the imported mismatch payer) and FW (the tax resident that incurs the hybrid deduction); as a result, US3's payment does not indirectly fund the hybrid deduction. *See* § 1.267A–4(c)(3)(ii) through (iv).

§ 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 beginning after December 31, 2017.

(b) *Special rules.* Sections 1.267A–2(b), (c), (e), 1.267A–4, and 1.267A–5(b)(5) apply to taxable years beginning on or after December 20, 2018. In addition, § 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 this paragraph (b), apply to taxable years beginning on or after December 20, 2018.

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 the first sentence of newly-redesignated paragraph (d)(2)(ii), 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).

* * * * *

(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).

(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 (e)(3)" after the language "paragraph (e)(2)" in paragraph (e)(1), 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 redesignating Examples 1 through 40 as paragraphs (c)(1) through (40), respectively, and adding paragraph (c)(41) to read as follows:

§ 1.1503(d)–7 Examples.

* * * * *

(c) * * *

(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), (c), and (d), as well § 1.1503(d)–3(e)(1) and (e)(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)–1(c) (previous version of § 1.1503(d)–1(d)) and 1.1503(d)–3(e)(1) (previous version of § 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.* Sections 1.1503(d)–6(f)(5)(i) through (iii) apply 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 adding a sentence at the end of paragraph (m) to read as follows:

§ 1.6038–2 Information returns required of United States persons with respect to annual accounting periods of certain foreign corporations beginning after December 31, 1962.

* * * * *

(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 under section 267A as contained in 26 CFR part 1, 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 published in the Internal Revenue Bulletin.

(14) *Hybrid dividends under section 245A.* If for the annual accounting period, the corporation pays or receives a hybrid dividend or a tiered hybrid dividend under section 245A and the regulations under section 245A as contained in 26 CFR part 1, 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 published in the Internal Revenue Bulletin.

* * * * *

(m) *Applicability dates.* * * * 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 the final paragraph (l) of the section as paragraph (l), revising the paragraph heading for newly-designated paragraph (l), and adding a sentence to the end of newly-designated paragraph (l).

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 under section 267A as contained in 26 CFR part 1, 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 published in the Internal Revenue Bulletin.

(l) *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 under section 267A as contained in 26 CFR part 1, 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 published in the Internal Revenue Bulletin.

(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 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.

Kirsten Wielobob,
Deputy Commissioner for Services and Enforcement.

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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.
F.R.—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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[1]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[1]

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[1]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.

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