HEADS I WIN, TAILS YOU (I.R.S.) LOSE – NOT ANYMORE: HYBRID DIVIDENDS AND CODE §245A(e)

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Tags
Anti-tax Avoidance
Code §245A
Code §245A(e)
Deduction - No Inclusion
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Hybrid Dividends
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INTRODUCTION[1]

Imagine a straight line. Now assume that it represents a timeline – a timeline that divides the tax world into the pre and post T.C.J.A. era. You know the magic date, December 31, 2017.

Now imagine a pizza cut into three large slices. Assume that the pizza represents the earnings and profits of a Controlled Foreign Corporation ("C.F.C.") since inception. The C.F.C. is wholly owned by a U.S. corporation. It conducts an active business and also has income from passive investments. Using the pizza analogy, the U.S. Shareholder of the C.F.C. is subject to the following taxes on undistributed income, each representing one of the three slices of the pizza:

- The Transition Tax[2] on the accumulated untaxed earnings and profits of the C.F.C. prior to January 1, 2018 (Pie 1),
- The Subpart F regime[3] on the foreign earnings and profits post December 31, 2017, attributable to the passive income (Pie 2),[4] and
- The G.I.L.T.I. Tax[5] on the earnings and profits attributable to the income generated from the active business income (Pie 3).

Each tax sucks up one of the three slices of the pizza. Holistically speaking, if a C.F.C. is subject to all three taxes, then, what is left on the table is an empty plate. In other words, after the T.C.J.A., it may be said that all or almost all of the earnings and profits of a C.F.C. are subject to U.S. tax even before they are actually distributed.

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1 See also the sixth article in this edition of *Insights* by Andreas A. Apostolides and Stanley C. Ruchelman, titled "Anti-Abuse Rules of Temp. Reg. §1.245A-5T – A New Cerberus For the U.S. Tax System," addressing the general mechanics of Code §245A and the new D.R.D., including the Temporary Regulations with their anti-abuse focus.

2 The Transition Tax is a tax on the U.S. Shareholders of a C.F.C. on the untaxed foreign earnings as it stood on December 31, 2017 or November 3, 2017, if elected, as if those earnings had been repatriated to the U.S.

3 Generally speaking, Subpart F Income is the tainted income of a C.F.C. which is taxed to U.S. Shareholders on current basis regardless of any actual distributions by the C.F.C.

4 If you are lucky, you may be eligible to the few exceptions available in the Code, such as, the high foreign tax exception to Subpart F income.

5 Broadly speaking, the G.I.L.T.I. Tax is a tax imposed on U.S. Shareholders on their share of a C.F.C.'s income generated from activity outide the U.S. that is not otherwise taxed in the U.S. at the level of a U.S. Shareholder under Subpart F or to the C.F.C. as effectively connected income. The tax is imposed regardless of any actual distributions by the C.F.C.

A subsequent distribution of the previously taxed income (P.T.I.) is received tax free in the hands of a U.S. Shareholder of the C.F.C.[6] In this scenario, the question to be answered is whether Code §245A reflects an important tool for multinationals or, using the pizza analogy, is simply the leftover crumbs once other provisions adopted in the T.C.J.A. have been applied?

CODE §245A(a)

Code §245A, introduced by the T.C.J.A., offers a 100% dividends received deduction ("D.R.D.") for the foreign sourced dividends received by a U.S. corporation which owns at least 10% of the voting rights or value of the stock of a foreign corporation. By making the deduction applicable to a foreign corporation, it extends the benefit to dividends from a C.F.C. However, a careful tax adviser must ask whether any benefit is actually provided when earnings and profits are already subject to U.S. tax in one form or another (*i.e.*, the Transition Tax, Subpart F, and the G.I.L.T.I. Tax) and a subsequent distribution of P.T.I. is received tax-free in the hands of a U.S. Shareholder under Code §959? The answer lies in the P.T.I. ordering rules under Code §959(c).

INTERACTION OF CODE §245A WITH CODE §959

Code §959(c) treats a distribution from a C.F.C. as first being attributable to earnings and profits not in excess of the investments in U.S. property, then attributable to Subpart F income (including the income subject to the G.I.L.T.I. Tax), and then attributable to taxable earnings and profits of the C.F.C. ("non-P.T.E.P."). The first two types of earnings and profits are excluded from U.S. tax when distributed[7] and are not treated as a dividend, other than to reduce earnings and profits.[8] In other words, distributions from a C.F.C. to its U.S. Shareholder out of P.T.E.P. are not eligible for the Code §245A(a) D.R.D. since they already are received tax-free. As a result, Code §245A does not apply to the distributions attributable to P.T.E.P.

However, Code §959(a) does not exclude from income a distribution that is made from non-P.T.E.P. The non-P.T.E.P. is treated as dividends to the extent provided under Code §316.[9] In the absence of Code §245A(a), the distributions treated as dividends under Code §316 will be subject to U.S. Federal income tax in the hands of a U.S. Shareholder. However, Code §245A(a) provides that such dividends are no longer subject to U.S. tax in the hands of a domestic corporation that meets the definition of a U.S. Shareholder under Code §951(b). Therefore, the Code §245A D.R.D. in the context of a C.F.C. applies only when the distribution is made from non-P.T.E.P.

Example

F Co was organized under the laws of Country F on Jan 1, 2018. A U.S. corporation, US Co., is the sole shareholder of F Co. F Co is engaged in an active trade or business in Country F. It also has made investments in other companies that periodically generate dividend

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[6] Code §959 and §951A(f)(1).

[7] Code §959(a).

[8] Code §959(d).

[9] Treas. Reg. §1.959-3(b).

income. In addition to the stock, F Co. issued an instrument to US Co that is treated as debt under the laws of both countries. F Co paid interest of $20 on the debt to US Co. The interest is subject to withholding tax in Country F. US Co pays U.S. tax on the interest income of $20 after claiming a credit of the foreign taxes. At year end, F Co has active income of $400, dividend income of 100, and cash of $800.For 2018, US Co will have a Subpart F inclusion of $100. It will also be liable to pay the G.I.L.T.I. Tax on $400 representing the active trade or business income of F Co. Accordingly, P.T.E.P. of F Co amounts to $500.

In Year 2019, assume F Co., didn't earn any income but made a distribution of $700. Under the ordering rules of Code §959(c), the distribution will be treated as first coming from P.T.E.P. attributable to Subpart F and G.I.L.T.I. Therefore, US Co will receive the first $500 tax-free under Code §959(a). The balance of $200 is treated as dividend income under Code §316 (assuming there is sufficient earnings and profit). Since the recipient is a domestic corporation which meets the definition of a U.S. Shareholder, Code §245A(a) will apply and therefore, the dividend income of $200 will be received tax-free in the U.S.

"Owing to the current U.S. tax regime of C.F.C.s, it is difficult to anticipate circumstances when a C.F.C. may have non P.T.E.P. "

Owing to the current U.S. tax regime of C.F.C.'s, there are relatively few circumstances when a C.F.C. may have non P.T.E.P. Some situations that come to mind include the following situations:

- A U.S. Shareholder claims a high tax exception to Subpart F income.
- A U.S. Shareholder owns more than one C.F.C. engaged in an active trade or business and one incurs losses that exceed the profits of all other C.F.C.'s. Because the G.I.L.T.I. Tax is imposed on an aggregate basis on a shareholder level, no amount is subject to the G.I.L.T.I. Tax. Any subsequent distribution of the profits of C.F.C. 2 will be non-P.T.E.P., and therefore, the benefit of Code section 245A(a) might be available.
- If a U.S. Shareholder is subject to the G.I.L.T.I. Tax, the Code §245A(a) D.R.D. should be available to an amount equal to the return on investment which is excluded for the G.I.L.T.I. Tax computation purposes.

HEADS I WIN, TAILS YOU LOSE – HYBRID DIVIDENDS UNDER CODE §245A(e)

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. Barring a few exceptions, the U.S. tax treatment of a transaction does not take into account foreign tax law. For instance, think of an instrument that is treated as debt under the laws of a foreign country but is treated as equity under U.S. tax law.

Example 2

Assume in Example 1, the instrument issued by F Co is a hybrid instrument, *i.e.*, it is treated as a debt under the laws of Country F but is treated as equity under U.S. tax law. In other words, F Co will be

eligible to claim a deduction of $20 because it is treated as interest under the laws of Country F and US Co will be eligible to the 245A D.R.D. if the application of Code §245A(a) goes unchecked. By allowing so, both, US Co and F Co receive an economic benefit by reason of a deduction for the payer and no income for the recipient.

HEADS I WIN, TAILS YOU LOSE – NOT ANY MORE

The Code §245A(e)-1 final regulations issued by the Treasury on April 8, 2020, aim at eliminating the double tax benefit otherwise available for dividends involving hybrid arrangements. The final regulations neutralize the double nontaxation effect of these dividends by either denying the Code §245A(a) D.R.D. to the U.S. corporate shareholder or requiring an inclusion under Code §951(a) with respect to the dividend where the recipient is a C.F.C. The treatment depends on whether the dividend is a hybrid dividend or a tiered hybrid dividend.

What is a Hybrid Dividend?

In general, a dividend received by a domestic corporation from a C.F.C. is a hybrid dividend if it satisfies the following two conditions:[10]

- The dividend is one for which the C.F.C. (or a related person) is or was allowed a deduction ("Hybrid Deduction") or other tax benefit under a relevant foreign tax law.
- But for Code §245A(e), the dividend would qualify for the Code §245A(a) D.R.D.

Example 3

Under Example 2, the distribution of $20 meets the definition of a Hybrid Dividend. This is because, F Co received a tax deduction of $20 and in the absence of any other contrary provision, US Co will be entitled to claim the Code §245A D.R.D. As a result, Code §245A(e) will apply, thereby, disallowing the deduction.

What is a tiered hybrid dividend?

A tiered hybrid dividend means an amount received by a C.F.C. from another C.F.C. to the extent that the amount would be a Hybrid Dividend if the receiving C.F.C. were a domestic corporation.[11] In other words, whether a dividend is a tiered hybrid dividend is determined without regard to how the amount is treated under the tax law of the country in which the upper-tier C.F.C. is a tax resident. Unless mentioned otherwise, the rules applicable to a hybrid dividend are also applicable to a tiered hybrid dividend.

What is the tax treatment of a hybrid dividend in the hands of a U.S. Shareholder of a C.F.C. for U.S. Federal income tax purposes?

A domestic corporation that is a U.S. Shareholder of a C.F.C. and receives a hybrid dividend from the C.F.C. is ineligible to claim the Code §245A(a) D.R.D. The hybrid

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[10] Code §245A(d); Treas. Reg. §1.245A(e)-1(b) and (d).

[11] Treas. Reg. §1.245A(e)-1(c)(2).

dividends are subject to tax in the U.S. at 21%. Further, the U.S. Shareholder is not entitled to claim a credit or a deduction for the foreign taxes paid, deemed paid, or withheld by the C.FC. or on its behalf.[12]

What is the tax treatment of a tiered hybrid dividend in the hands of a U.S. Shareholder for U.S. Federal income tax purposes?

If a C.F.C. receives a tiered hybrid dividend from another C.F.C. and a domestic corporation is a U.S. Shareholder with respect to both C.F.C.'s, the dividend is treated as Subpart F income of the receiving C.F.C. for the taxable year in which it is received. The U.S. Shareholder of the receiving C.F.C. is required to include in its taxable income the *pro rata* share of the Subpart F income of the receiving C.F.C. and pay tax at 21% in the U.S.[13] Further, the U.S. Shareholder is not entitled to claim a credit (or a deduction) for the foreign taxes paid, deemed paid, or withheld by or on behalf of the C.F.C.[14] This treatment applies notwithstanding any other provision of the Code.[15] Thus, exceptions to Subpart F income such as those provided under Code §954(c)(3) (same country exception for income received from related persons) and Code §954(c)(6) (look-through rule for related C.F.C.s) do not apply.

Example 4

Domestic Corporation, DC, owns 100% of the stock of C.F.C.1, a resident of country X. C.F.C.1 owns 100% of the stock, including preferred instruments, of C.F.C.2, a resident of country Y. Although treated as equity under U.S. tax law and under the law of country X, the preferred instruments are treated as debt under the laws of country Y. C.F.C.2 pays C.F.C.1 $10 under the terms of the preferred instruments, for which it receives a tax deduction in Country Y. The payment is a tiered hybrid dividend, and is treated as Subpart F income of C.F.C.1 for the tax year in which it is received. DC must include its *pro rata* share in its gross income, but is not entitled to a foreign tax credit or deduction for any taxes paid by C.F.C.1 to country X.

The tiered hybrid dividend rule applies only to a domestic corporation that is a U.S. Shareholder of both the upper-tier C.F.C. and the lower-tier C.F.C. Clearly, a U.S. individual is not entitled to the Code §245A D.R.D., and that treatment is passed down to a tiered hybrid group. Thus, for example, if a domestic corporation and a U.S. individual equally own all of the stock of an upper-tier C.F.C., and the upper-tier C.F.C. receives a tiered hybrid dividend from a wholly-owned lower-tier C.F.C., the tiered hybrid dividend rule does not cause a Subpart F inclusion to the individual U.S. Shareholder. As a result, the individual who is a U.S. Shareholder in the foregoing fact pattern may take advantage of exceptions to Foreign Personal Holding Company Income, such as the same country exception.

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[12] Treas. Reg. §1.245A(e)-1(b)(1)(ii) and (c)(1)(iii).

[13] Treas. Reg. §1.245A(e)-1(c)(1)(i)-(ii).

[14] Treas. Reg. §1.245A(e)-1(c)(1)(iii).

[15] Treas. Reg. §1.245A(e)-1(c)(1).

What is the tax treatment of the gains arising from the sale of the stock of a lower tier C.F.C. by an upper-tier C.F.C. which are characterized as dividends under Code §1248(a) read with Code §964(e)?

Under Code §964(e)(1), gain recognized by a C.F.C. on the sale or exchange of stock in another foreign corporation may be treated as a dividend.[16] If certain conditions are satisfied, the dividend is treated as Subpart F income of the selling C.F.C. and the U.S. Shareholder of the selling C.F.C. is required to include in its gross income its *pro rata* share of the Subpart F income. However, at the same time, the U.S. Shareholder is allowed the Code §245A(a) D.R.D. with respect to the Subpart F income. In other words, the dividend portion of the gain is not subject to tax in the U.S. in the hands of the U.S. Shareholder.

However, the final regulations coordinate the tiered hybrid dividend rules and the rules of §964(e) by providing that, to the extent a dividend arising under Code §964(e)(1) is a tiered hybrid dividend, the tiered hybrid dividend rules, rather than the rules of Code §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 Code §245A(a) D.R.D., or foreign tax credits or deductions, for the amount.[17]

What is a hybrid dividend account?

A U.S. Shareholder that holds a share of a C.F.C. is required to maintain a hybrid dividend account (the "H.D.A.") with respect to the share. The H.D.A. reflects the amount of hybrid deductions of the C.F.C. allocated to the share.[18] It is maintained in the functional currency of the C.F.C. Once an amount in a hybrid deduction account gives rise to a hybrid dividend or a tiered hybrid dividend, the account is correspondingly reduced.[19]

Are all shareholders who meet the definition of a U.S. Shareholder under Code §951(b) required to maintain an H.D.A.?

No. The Treasury recognized that in certain cases, Code §245A may not apply to a U.S. Shareholder and therefore it is not required to maintain an H.D.A. For example, if the only U.S. Shareholders of a C.F.C. are individuals, Code §245A doesn't apply. In another example, the upper-tier C.F.C. may be C.F.C. solely by reason of the repeal of the limitation on the downward attribution rule under Code §958(b)(4). Before the repeal, shares in Foreign Company A actually owned by Foreign Company B were not attributed to Foreign Company B's U.S. subsidiary. The repeal allows downward attribution of ownership from a foreign parent to a U.S. subsidiary. Consequently, Foreign Company A can be a C.F.C. if enough of its shares are attributed to the U.S. subsidiary of Foreign Company B. In this fact pattern, however, no abuse is viewed to exist. Even if a dividend received by the upper-tier C.F.C. from the lower-tier C.F.C. were a tiered hybrid dividend, there would be no meaningful U.S. tax

16 Under the provisions of Code §1248. Code §1248(a) characterizes a gain on a sale or exchange of a C.F.C. stock as a dividend to the extent of the earnings and profits of the C.F.C. attributable to that stock, but only to the extent the earnings and profits were accumulated while the seller held the stock and the corporation was a C.F.C.

17 Treas. Reg. §1.245A(e)-1(c)(1) and (4).

18 Treas. Reg. §1.245A(e)-1(d)(1).

19 Treas. Reg. §1.245A(e)-1(d)(4)(i).

consequence because no U.S. Shareholder would have a Subpart F inclusion with respect to the upper-tier C.F.C.

To obviate the need for an H.D.A. in the above cases, an H.D.A. is required to be maintained only by the following two types of specified owners:[20]

- A U.S. corporation that is a U.S. Shareholder under Code §951(b).
- An upper-tier C.F.C. that is a specified owner of shares of stock of a lower-tier C.F.C. if, for Subpart F and G.I.L.T.I. purposes, a domestic corporation that is a U.S. Shareholder of the upper-tier CFC owns directly or indirectly within the meaning of Code §958(a) one or more shares of stock of the upper-tier C.F.C.

Is there a limit on the amount that is treated as a hybrid dividend?

A dividend received by a U.S. Shareholder from a C.F.C. is a hybrid dividend (or a tiered hybrid dividend) to the extent of the sum of the U.S. Shareholder's hybrid deduction account with respect to each share of stock of the C.F.C, even if the dividend is paid on a share that has not had any hybrid deduction allocated to it.[21] Absent such an approach, the purposes of §245A(e) might be avoided by, for example, structuring dividend payments such that they are 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). Example 5 below explains the concept.

"A hybrid deduction means a deduction or other tax benefit (such as an exemption, exclusion, or credit, to the extent equivalent to a deduction) under a relevant foreign tax law with respect to an instrument issued by the C.F.C. which is treated as equity for U.S. tax purposes."

HYBRID DEDUCTION- THE HEART OF CODE §245A(e)

What is a Hybrid Deduction of a C.F.C.?

A hybrid deduction means a deduction or other tax benefit (such as an exemption, exclusion, or credit, to the extent equivalent to a deduction) under a relevant foreign tax law with respect to an instrument issued by the C.F.C. when the instrument is treated as equity for U.S. tax purposes. Examples of such a deduction or other tax benefit include an interest deduction, a dividends paid deduction, and a notional interest deduction (or similar deduction determined with respect to the C.F.C.'s equity).[22]

Does the deduction or tax benefit have to be used currently for it to be treated as a hybrid deduction?

No, the fact that the deduction or other tax benefit is not being used currently or does not currently reduce tax under the relevant foreign tax law is irrelevant.[23] For example, a current use of the deduction or tax benefit might not occur if the C.F.C. has other deductions or losses under the relevant foreign tax law, or all of a C.F.C.'s income is exempt income. An example is that the C.F.C. is a holding company and

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20 Treas. Reg. §1.245A(e)-1(f)(6).

21 Treas. Reg. §1.245A(e)-1(b)(2) and (d).

22 Treas. Reg. §1.245A(e)-1(d)(2)(i).

23 Treas. Reg. §1.245A(e)-1(d)(2)(i)(A).

all of its income benefits from a 100% participation exemption. The Treasury Department is of the view that even though a deduction or other tax benefit may not be used currently, it could be used in another taxable period and thus could produce double nontaxation.[24]

Will a deduction or tax benefit continue to be treated as a hybrid deduction even if the source country withholds income tax on interest payments?

Yes, a deduction or tax benefit will continue to be treated as a hybrid deduction even if the source country withholds income tax on interest payments. The purpose of withholding taxes is not to address mismatches in tax outcomes, but rather to allow the source jurisdiction to retain its right to tax the payment.

Is a deduction or tax benefit allowed to a related party of the C.F.C. included within the meaning of a hybrid deduction of the C.F.C.?

Yes, a deduction allowed to a related party of the C.F.C. is included within the meaning of a hybrid deduction if the following conditions are satisfied:[25]

- The person is related to the C.F.C. under Code §954(d)(3).[26]
- The related person is allowed the deduction under a relevant foreign tax law which also applies to the C.F.C. (*i.e.*, the related person and the C.F.C. are tax residents of the same jurisdictions).[27]

This addresses situations in which the C.F.C. is a member of a foreign affiliated group that files a consolidated return in the name of the foreign parent or group relief benefits are otherwise provided under foreign law.

Is an impairment loss deduction or an M.T.M. deduction (where the foreign law requires the investors to mark their investment to market price) allowed to a shareholder of the C.F.C. with respect to its stock a hybrid deduction of the C.F.C.?

No. Those deductions do not relate to or result from an amount paid, accrued, or distributed with respect to an instrument issued by the C.F.C. and are not deductions allowed to the C.F.C. with respect to equity.

Will an amount be treated as a deduction or tax benefit to the C.F.C. even if it is disallowed under a thin capitalization rule or a rule similar to Code §163(j) – that limits the deduction based on the taxable income?

Yes, an amount will continue to be treated as a hybrid deduction of a C.F.C. even if it is disallowed under a thin capitalization rule or a rule similar to Code §163(j).[28] The Treasury is of the view that those rules suspend rather than disallow a deduction, and thus may not prevent eventual double nontaxation.

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24 Treas. Reg. §1.245A(e)–1(d)(2).

25 Treas. Red. §1.245A(e)–1(f)(4).

26 Code §954(d)(3) - A person is related to the C.F.C. includes a shareholder that controls the C.F.C., any entity controlled by the C.F.C., and any entity that is controlled by the persons who control the C.F.C. Control is based on the ownership of more than 50% of the total voting rights or total value of an entity).

27 Treas. Reg. §1.245A(e)–1(d)(2)(i) and (f)(5).

28 Treas. Reg. §1.245A(e)-1(d)(2)(ii)(A).

Are the hybrid mismatch rules in a foreign country taken into account in determining whether a deduction or a tax benefit is a hybrid deduction of a C.F.C.?

No. Whether a deduction or other tax benefit is a hybrid deduction should be determined without regard to foreign hybrid mismatch rules and thus without regard to whether such rules disallow the deduction. Foreign tax law becomes relevant only for purposes of determining that the deduction or other tax benefit neither gives rise to a dividend for U.S. tax purposes nor, based on all the facts and circumstances, is reasonably expected to give rise to a dividend that will be paid within 12 months from the end of the taxable period for which the deduction or other tax benefit would be allowed but for the hybrid mismatch rules.[29]

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

What is a relevant foreign tax law?

With respect to a C.F.C., the term "relevant foreign tax" law means any regime of any foreign country or possession of the U.S. that imposes an income, war profits, or excess profits tax on the income of the C.F.C. (other than a foreign anti-deferral regime) under which a person that owns an interest in the C.F.C. is liable to tax.

If a foreign country has an income tax treaty with the U.S. that applies to taxes imposed by a political subdivision or other local authority of that country, then the tax law of the political subdivision or other local authority is deemed to be a tax law of a foreign country. Thus, the term includes any regime of a foreign country or possession of the U.S. that imposes income, war profits, or excess profits tax under which (i) the C.F.C. is liable to tax as a resident, (ii) the C.F.C. has a branch that gives rise to a taxable presence in the foreign country or possession of the U.S., or (iii) a person related to the C.F.C. is liable to tax as a resident. In such third instance, the relevent law is the law in the related party's jurisdiction when that party is a shareholder of the C.F.C. and the C.F.C. is fiscally transparent in computing the shareholder's net income.[30]

Example 5:[31] **Hybrid Deduction Account**

US Co holds all the shares of two classes of stock of F Co, a corporation organized under the laws of Country F. One class of shares is treated as indebtedness for Country F tax purposes ("Share A"), and

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[29] Treas. Reg. §1.245A(e)-1(d)(2)(ii)(B).

[30] Treas. Reg. §1.245A(e)-1(f)(5).

[31] Based on Example 1 of Treas. Reg. §1.245A(e)-1(g)(1).

the other is treated as equity for Country F tax purposes (“Share B”). Both classes of shares are treated as equity for U.S. tax purposes. During Year 1, under Country F tax law, F Co accrues $80 of interest to US Co with respect to Share A and is allowed a deduction for the amount (the “Hybrid Instrument Deduction”). During year 2, F Co distributes $30 to US1 with respect to each of Share A and Share B. For U.S. tax purposes, each of the $30 distributions is treated as a dividend for which, without regard to Code §245A(e), US Co would be allowed a deduction under Code §245A(a). For Country F tax purposes, the $30 distribution with respect to Share A represents a payment of interest for which a deduction was already allowed for Year 1 (and thus F Co is not allowed an additional deduction for the amount), and the $30 distribution with respect to Share B is treated as a dividend (for which no deduction is allowed).

Analysis

- At the end of Year 1, US Co’s Hybrid Deduction Accounts with respect to Share A and Share B are $80 and $0, respectively, calculated as follows.
    - The $80 Hybrid Instrument Deduction allowed to F Co under Country F tax law (a relevant foreign tax law) is a Hybrid Deduction of F Co , because the deduction is allowed to F Co and relates to or results from an amount accrued with respect to an instrument issued by F Co and treated as stock for U.S. tax purposes. Thus, F Co’s Hybrid Deductions for Year 1 are $80.
    - At the end of Year 1, US Co’s Hybrid Deduction Account with respect to Share A is increased by $80 (the amount of Hybrid Deductions allocated to Share A). Because F Co did not pay any dividends with respect to either Share A or Share B during Year 1, no further adjustments are made. Therefore, at the end of Year 1, US Co’s Hybrid Deduction Accounts with respect to Share A and Share B are $80 and $0, respectively.
- The entire $30 of each dividend received by US Co from F Co during Year 2 is a Hybrid Dividend. This is because the sum of US Co’s Hybrid Deduction Accounts with respect to each of its shares of F Co stock at the end of Year 2 ($80) is at least equal to the amount of the dividends ($60). This is the case for the $30 dividend with respect to Share B even though there are no hybrid deductions allocated to Share B.
- As a result, US Co is not allowed a deduction under Code §245A(a) for the entire $60 of Hybrid Dividends.
- US Co is not entitled to claim a F.T.C. or deduction with respect to taxes paid or deemed paid to Country F with respect to the dividends. [Code §245A(d)]

At the end of Year 2, US Co's Hybrid Deduction Account with respect to Share A is decreased by $60, the amount of the hybrid deductions in the account that gave rise to a Hybrid Dividend during Year 2. Therefore, at the end of Year 2, US Co's Hybrid Deduction Account with respect to Share A is $20 ($80 less $60) and with respect to Share B is $0.

CONCLUSION

The regulations impose additional compliance burden on U.S. Shareholders as they will be required to maintain Hybrid Deduction Accounts with respect to their hybrid investments. Further, the regulations will likely require a C.F.C. to adequately disclose to its U.S. Shareholders whether or not an instrument is treated as a debt or equity under the law of its organization, whether a deduction is available to the C.F.C., whether the foreign country has hybrid mismatch rules, etc., so that the corporate U.S. Shareholder can adequately rely on the information to determine the eligibility of the Code §245A D.R.D. Although, presumably the controlling U.S. Shareholder would have this information, this regime puts additional reporting pressure on C.F.C.s and their shareholders.

"The regulations impose additional compliance burden on U.S. Shareholders as they will be required to maintain Hybrid Deduction Accounts with respect to their hybrid investments."

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