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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[REG-106013-19]

RIN 1545-BP22

Guidance Involving Hybrid Arrangements and the Allocation of Deductions Attributable to Certain Disqualified Payments under Section 951A (Global Intangible Low-Taxed Income)

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed regulations that adjust hybrid deduction accounts to take into account earnings and profits of a controlled foreign corporation that are included in income by a United States shareholder. This document also contains proposed regulations that address, for purposes of the conduit financing rules, arrangements involving equity interests that give rise to deductions (or similar benefits) under foreign law. Further, this document contains proposed regulations relating to the treatment of certain payments under the global intangible low-taxed income (GILTI) provisions. The proposed regulations affect United States shareholders of foreign corporations and persons that make payments in connection with certain hybrid arrangements.

DATES: Written or electronic comments and requests for a public hearing must be received by [**INSERT DATE 60 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER**].

ADDRESSES: Submit electronic submissions via the Federal eRulemaking Portal at www.regulations.gov (indicate IRS and REG-106013-19) by following the online instructions for submitting comments. Once submitted to the Federal eRulemaking Portal, comments cannot be edited or withdrawn. The Department of the Treasury (Treasury Department) and the IRS will publish for public availability any comment received to its public docket, whether submitted electronically or in hard copy. Send hard copy submissions to: CC:PA:LPD:PR (REG-106013-19), Room 5203, Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Washington, DC 20044.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations under section 951A, Jorge M. Oben at (202) 317-6934; concerning all other proposed regulations, Richard F. Owens at (202) 317-6501; concerning submissions of comments or requests for a public hearing, Regina L. Johnson at (202) 317-6901 (not toll free numbers).

SUPPLEMENTARY INFORMATION:

Background

I. <u>Section 245A(e) – Hybrid Dividends</u>

Section 245A(e) was added to the Internal Revenue Code ("Code") by the Tax Cuts and Jobs Act, Pub. L. No. 115-97 (2017) (the "Act"), which was enacted on December 22, 2017. Section 245A(e) and the final regulations under section 245A(e), which are published in the Rules and Regulations section of this issue of the **Federal Register** (the "section 245A(e) final regulations"), neutralize the double non-taxation effects of a hybrid dividend or tiered hybrid dividend through either denying the section 245A(a) dividends received deduction with respect to the dividend or requiring an inclusion under section 951(a)(1)(A) with respect to the dividend, depending on whether the dividend is received by a domestic corporation or a controlled foreign corporation ("CFC"). The section 245A(e) final regulations require that certain shareholders of a CFC maintain a hybrid deduction account with respect to each share of stock of the CFC that the shareholder owns, and provide that a dividend received by the shareholder from the CFC is a hybrid dividend or tiered hybrid dividend to the extent of the sum of those accounts. A hybrid deduction account with respect to a share of stock of a CFC reflects the amount of hybrid deductions of the CFC that have been allocated to the share, reduced by the amount of hybrid deductions that gave rise to a hybrid dividend or tiered hybrid dividend.

II. Section 1.881-3 – Conduit Financing Arrangements

A. In general

Section 7701(l) of the Code authorizes the Secretary to prescribe regulations recharacterizing any multiple-party financing transaction as a transaction directly among any two or more of such parties where the Secretary determines that such recharacterization is appropriate to prevent the avoidance of any tax imposed by the Code. In prescribing such regulations, the legislative history to section 7701(l) states that "it would be within the proper scope of the provision for the Secretary to issue regulations dealing with multi-party financing transactions involving . . . equity investments." H.R. Conf. Rep. No. 103-213, at 655 (1993).

On August 11, 1995, the Treasury Department and the IRS published in the **Federal Register** final regulations (TD 8611, 60 FR 40997) that allow the IRS to disregard the participation of one or more intermediate entities in a financing arrangement where such entities are acting as conduit entities, and to recharacterize the financing arrangement as a transaction directly between the remaining parties to the financing arrangement for purposes of imposing tax under sections 871, 881, 1441 and 1442.

B. Limited treatment of equity interests as financing transactions

Section 1.881-3(a)(2)(i)(A) defines a financing arrangement to mean a series of transactions by which one person (the “financing entity”) advances money or other property, or grants rights to use property, and another person (the “financed entity”) receives money or other property, or rights to use property, if the advance and receipt are effected through one or more other persons (“intermediate entities”). Except in cases in which §1.881-3(a)(2)(i)(B) applies (special rule to treat two or more related persons as a single intermediate entity in the absence of a financing transaction between the related persons), the regulations apply only if “financing transactions,” as defined in §1.881-3(a)(2)(ii), link the financing entity, each of the intermediate entities, and the financed entity. Section 1.881-3(a)(2)(ii)(A) and (B) limit the definition of financing transaction in the case of equity investments to stock in a corporation (or a similar interest in a partnership, trust, or other person) that is subject to certain redemption, acquisition, or payment rights or requirements (“redeemable equity”).

If it is determined that an intermediate entity is participating as a conduit entity in a conduit financing arrangement, the financing arrangement may be recharacterized as a transaction directly between the remaining parties (in most cases, the financing entity and the financed entity). See §1.881-3(a)(3)(ii)(A). The portion of the financed entity’s payments subject to this recharacterization is determined under §1.881-3(d)(1)(i). Under §1.881-3(d)(1)(i), if the aggregate principal amount of the financing transactions to which the financed entity is a party exceeds the aggregate principal amount linking any of the parties to the financing arrangement, then the recharacterized portion is determined by multiplying the payment by a fraction the numerator of which is the lowest aggregate principal amount of the financing transactions linking any of the parties to the financing transaction and the denominator of which is the aggregate principal amounts linking the financed entity to the financing arrangement. Conversely, if the aggregate principal amount of the financing transactions to which the financed entity is a party is less than or equal to the aggregate principal amount of the financing transactions linking any of the parties to the financing arrangement, the entire amount of the payment is recharacterized.

C. Hybrid instruments

On December 22, 2008, the Treasury Department and the IRS published in the **Federal Register** (73 FR 78252) a notice of proposed rulemaking (REG-113462-08) ("2008 proposed regulations") that proposed adding §1.881-3(a)(2)(i)(C) to the conduit financing regulations to treat an entity disregarded as an entity separate from its owner for U.S. tax purposes as a person for purposes of determining whether a conduit financing arrangement exists. The preamble to the 2008 proposed regulations provides that the Treasury Department and the IRS are also studying transactions where a financing entity advances cash or other property to an intermediate entity in exchange for a hybrid instrument (that is, an instrument treated as debt under the tax laws of the foreign country in which the intermediary is resident and equity for U.S. tax purposes), and states that they may issue separate guidance to address the treatment under §1.881-3 of certain hybrid instruments.

The preamble to the 2008 proposed regulations presents two possible approaches to hybrid instruments and requests comments on those and other possible approaches and factors that should be considered. The first approach would treat all transactions involving hybrid instruments between a financing entity and an intermediate entity as per se financing transactions under §1.881-3(a)(2)(ii)(A). The second approach would treat only certain hybrid instruments as financing transactions based on specific factors or criteria. Only one comment was received. The comment suggested that the Treasury Department and the IRS take a more targeted approach in identifying specific transactions where there is evidence of limited taxation in the intermediary jurisdiction as a direct consequence of the hybrid instrument.

On December 9, 2011, the Treasury Department and the IRS published in the **Federal Register** final regulations (TD 9562, 76 FR 76895) that adopted the 2008 proposed regulations' treatment of disregarded entities under §1.881-3 without substantive changes. The preamble to the final regulations states that the Treasury Department and the IRS would continue to study the treatment of hybrid instruments in financing transactions.

III. Section 951A – Global Intangible Low-Taxed Income

Section 951A, added to the Code by the Act, requires a United States shareholder of any CFC for any taxable year to include in gross income the shareholder's global intangible low-taxed income (''GILTI inclusion amount") for such taxable year. On October 10, 2018, the Treasury Department and the IRS published in the **Federal Register** proposed regulations (REG-104390-18, 83 FR 51072) implementing section 951A. On June 21, 2019, the Treasury Department and the IRS published in the **Federal Register** final regulations ("GILTI final regulations") (TD 9866, 84 FR 29288) that adopted the proposed regulations, with revisions.

The GILTI final regulations include a rule that provides that a deduction or loss attributable to basis created by reason of a transfer of property from a CFC to a related

CFC during the period after December 31, 2017, the final date for measuring earnings and profits ("E&P") for purposes of section 965, and before the date on which section 951A first applies with respect to the transferor CFC's income (for example, December 1, 2018, for a CFC with a taxable year ending November 30) (the "disqualified period," and such basis, "disqualified basis"), is allocated and apportioned solely to residual CFC gross income. See §1.951A-2(c)(5)(i). Residual CFC gross income is gross income other than gross tested income, subpart F income, or income effectively connected with a trade or business in the United States. See §1.951A-2(c)(5)(iii)(B). The rule also provides that any depreciation, amortization, or cost recovery allowances attributable to disqualified basis are not properly allocable to property produced or acquired for resale under section 263, 263A, or 471. See §1.951A-2(c)(5)(i). The purpose of the rule is to ensure that taxpayers cannot take advantage of the disqualified period to engage in transactions that allowed taxpayers to enhance their tax attributes, including by reducing their tested income or increasing their tested loss over time, without resulting in any current tax cost. See 84 FR 29299.

Explanation of Provisions

I. Rules Under Section 245A(e) to Reduce Hybrid Deduction Accounts

A. In general

As discussed in part II.C.2 of the Summary of Comments and Explanation of Revisions of the section 245A(e) final regulations, the Treasury Department and the IRS have determined that hybrid deduction accounts with respect to stock of a CFC should be reduced in certain cases. In particular, the accounts should generally be reduced to the extent that earnings and profits of the CFC that have not been subject to foreign tax as a result of certain hybrid arrangements are, by reason of certain provisions (not including section 245A(e)), “included in income” in the United States (that is, taken into account in income and not offset by, for example, a deduction or credit particular to the inclusion). By adjusting the accounts in this manner, section 245A(e) neutralizes the double non-taxation effects of certain hybrid arrangements in a manner consistent with the results that would arise were the sheltered earnings and profits (that is, the earnings and profits that were not subject to foreign tax as a result of the arrangement) distributed as a dividend for which the section 245A(a) deduction is not allowed. In such a case, the dividend consisting of the sheltered earnings and profits would generally be taken into account in a United States shareholder’s gross income, and the United States shareholder would generally be taxed at the U.S. corporate statutory rate and allowed neither a dividends received deduction for the dividend nor other relief particular to the dividend (such as foreign tax credits).

The proposed regulations thus provide a new rule that, as part of the end-of-the-year adjustments to a hybrid deduction account, reduces the account by three categories of amounts included in the gross income of a domestic corporation with respect to the share. See proposed §1.245A(e)-1(d)(4)(i)(B). The first category relates to an inclusion under section 951(a)(1)(A) (“subpart F inclusion”) with respect to the share, and the second relates to a GILTI inclusion amount with respect to the share. See proposed §1.245A(e)-1(d)(4)(i)(B)(1) and (2). The third category is for inclusions under sections 951(a)(1)(B) and 956 with respect to the share, to the extent the inclusion occurs by reason of the application of section 245A(e) to the hypothetical distribution described in §1.956-1(a)(2). See proposed §1.245A(e)-1(d)(4)(i)(B)(3). An amount in the third category provides a dollar-for-dollar reduction of the account because, due to the lack of an availability of deductions or credits particular to the amount (including foreign tax credits) to offset or reduce such amount, the entirety of such amount is assumed to be included in income in the United States. See, for example, §1.960-2(b)(1) (no foreign income taxes are deemed paid under section 960(a) with respect to an inclusion under section 951(a)(1)(B)).

As discussed in part I.B of this Explanation of Provisions, the entirety of an amount in the first or second category may not be included in income in the United States and, as a result, such an amount does not provide a dollar-for-dollar reduction of the account. In addition, the reduction of the account for these amounts cannot exceed the hybrid deductions allocated to the share for the taxable year multiplied by the ratio of the subpart F income or tested income, as applicable, of the CFC for the taxable year to the CFC's taxable income. See proposed §1.245A(e)-1(d)(4)(i)(B)(1)(ii) and (d)(4)(i)(B)(2)(ii); see also proposed §1.245A(e)-1(d)(4)(i)(B)(1)(iii) and (d)(4)(i)(B)(2)(iii) (in certain cases, excess amounts are allocated to other hybrid deduction accounts and reduce those accounts). This limitation is, for example, intended to prevent a subpart F inclusion for a taxable year from removing from the account hybrid deductions incurred in a prior taxable year, because such hybrid deductions generally represent an amount of prior year earnings that were not subject to foreign tax as a result of a hybrid arrangement, and the subpart F inclusion in the current year does not subject such earnings to U.S. tax (but rather, subjects certain current year earnings to U.S. tax). In addition, because hybrid deductions incurred in the current taxable year may ratably shelter from foreign tax each type of earnings of a CFC (as opposed to, for example, only sheltering from foreign tax earnings of a type that the United States views as attributable to subpart F income), the limitation is generally intended to ensure that, for example, a subpart F inclusion does not remove from the account hybrid deductions that sheltered from foreign tax current year earnings of a type that the United States views as attributable to income other than subpart F income.

B. Adjusted subpart F and GILTI inclusions

The proposed regulations generally reduce a hybrid deduction account with respect to a share of stock of a CFC by an "adjusted subpart F inclusion" or an "adjusted GILTI inclusion" (or both) with respect to the share. See proposed §1.245A(e)-1(d)(4)(i)(B)(1) and (2). An adjusted subpart F inclusion or an adjusted GILTI inclusion is intended to measure, in an administrable manner, the extent to which a domestic corporation's subpart F inclusion or GILTI inclusion amount is likely included in income in the United States, taking into account foreign tax credits associated with the inclusion and, in the case of a GILTI inclusion amount, the deduction under section 250(a)(1)(B).

The starting point in determining an adjusted subpart F inclusion with respect to a share of stock of a CFC is identifying a domestic corporation's pro rata share of the CFC's subpart F income, and then attributing such inclusion to particular shares of stock of the CFC. See proposed §1.245A(e)-1(d)(4)(ii)(A). For purposes of attributing the inclusion, the proposed regulations provide that the principles of section 951(a)(2) and §1.951-1(b) and (e) apply.

Once the amount of the subpart F inclusion attributable to the share is determined, the "associated foreign income taxes" with respect to the amount must be determined. See proposed §1.245A(e)-1(d)(4)(ii)(A) and (D). The term associated foreign income taxes means the amount of current year tax allocated and apportioned to the subpart F income groups of the CFC, to the extent allocated to the share. See proposed §1.245A(e)-1(d)(4)(ii)(D)(1) and (d)(4)(ii)(E). The computation of associated foreign income taxes does not take into account any limitations on foreign tax credits, such as under section 904, because doing so would involve considerable complexity. These rules are intended to approximate, in an administrable manner, deemed paid credits resulting from the application of section 960(a) that are eligible to be claimed with respect to the subpart F inclusion attributable to the share.

The final step is to adjust, pursuant to a two-step process, the subpart F inclusion attributable to the share, to approximate the tax effect of the associated foreign income taxes. See proposed §1.245A(e)-1(d)(4)(ii)(A). First, the associated foreign income taxes are added to the subpart F inclusion, to reflect that when a domestic corporation claims section 960 credits it includes in gross income under section 78 an amount equal to such credits. See proposed §1.245A(e)-1(d)(4)(ii)(A)(1). Second, an amount equal to the amount of income offset by the associated foreign income taxes – calculated as the associated foreign tax credits divided by the corporate tax rate – is subtracted from the sum of the amounts described in the previous sentence. See proposed §1.245A(e)-1(d)(4)(ii)(A)(2). The difference of the amounts is the adjusted subpart F inclusion with respect to the share.[1]

Similar rules apply for purposes of determining an adjusted GILTI inclusion with respect to a share of stock of a CFC. However, special rules account for the fact that the computation of foreign tax credits under section 960(d) takes into account a

[1] Thus, for example, in a case in which the subpart F inclusion attributable to a share is $94.75x and the associated foreign income taxes with respect to such is $5.25x, the adjusted subpart F inclusion with respect to the share would be $75x, calculated as $100x ($94.75x + $5.25x) less $25x ($5.25x ÷ 21%).

domestic corporation's inclusion percentage (as described in §1.960-2(c)(2)) and the 80 percent limit in section 960(d)(1). See proposed §1.245A(e)-1(d)(4)(ii)(B)(3) and (d)(4)(ii)(D)(2). In addition, a special rule accounts for the effect of a section 250 deduction that a domestic corporation may claim related to GILTI. See proposed §1.245A(e)-1(d)(4)(ii)(B)(2).

C. Applicability date

The proposed rules relating to hybrid deduction accounts are proposed to apply to taxable years ending on or after the date that final regulations are published in the **Federal Register**. For taxable years before taxable years covered by such final regulations, a taxpayer may apply the rules set forth in the final regulations, provided that it consistently applies the rules to those taxable years. See section 7805(b)(7). In addition, a taxpayer may rely on the proposed rules with respect to any period before the date that the proposed regulations are published as final regulations in the **Federal Register**, provided that it consistently does so.

II. Conduit Regulations under §1.881-3 to Address Equity Interests that Give Rise to Deductions or other Benefits under Foreign Law

A. Overview

Under the current conduit financing regulations, an instrument that is treated as equity for U.S. tax purposes (and is not redeemable equity described in §1.881-3(a)(2)(ii)(B)) generally will not be characterized as a financing transaction, even though the instrument gives rise to a deduction or other benefit under the tax laws of the issuer's jurisdiction. For example, an instrument that is treated as stock (that is not redeemable equity) for U.S. tax purposes, but as indebtedness under the laws of the issuer's jurisdiction, would not be characterized as a financing transaction under the current regulations.

The Treasury Department and the IRS have determined that these types of instruments can be used to inappropriately avoid the application of the conduit financing regulations and, therefore, the proposed regulations expand the definition of equity interests treated as a financing transaction by taking into account the tax treatment of the instrument under the tax law of the relevant foreign country, which is generally the country where the equity issuer resides. The Treasury Department and the IRS have determined that, while these types of instruments are characterized as equity for U.S. tax purposes, they still raise conduit financing concerns if they are either indebtedness under the issuer's tax law or provide benefits similar to indebtedness under the issuer's tax law. For example, a financing company may have an incentive to form a corporation in a country that allows a tax benefit, such as a notional interest deduction with respect to equity, that encourages the routing of income through the intermediary issuer in functionally the same manner as when an intermediate entity issues a debt instrument that is treated as a financing transaction under the current regulations. Similarly, a financing entity may form an intermediate corporation in a country to take advantage of the country's purported integration regime that provides a substantial refund of the issuer's corporate tax paid upon a distribution to a related shareholder, and the shareholder is not taxable on that distribution under the laws of the intermediate country. The Treasury Department and IRS have concluded that these structures raise concerns similar to those Congress intended to address when it enacted sections 267A and 245A(e) regarding arrangements that "exploit differences in the treatment of a transaction or entity under the laws of two or more tax jurisdictions…" See S. Comm. on the Budget, Reconciliation Recommendations Pursuant to H. Con. Res. 71, S. Print No. 115-20, at 389 (2017).

The Treasury Department and the IRS have determined that the conduit regulations should apply in these cases generally based on benefits that are associated with an equity interest, rather than targeting only particular transactions based on specific factors or criteria as recommended by a comment, because these arrangements are often deliberately structured and a more limited approach could be easily circumvented or difficult to administer. However, even if the equity interests of an intermediate entity are treated as a financing transaction under the proposed regulations, the intermediate entity will not be a conduit entity if, for example, its participation in the financing arrangement is not pursuant to a tax avoidance plan. See §1.881-3(b).

B. Treatment of equity interests that give rise to deductions or other benefits under foreign law

The proposed regulations expand the types of equity interests treated as a financing transaction to include stock or a similar interest if under the tax laws of a foreign country where the issuer is a resident, the issuer is allowed a deduction or another tax benefit for an amount paid, accrued or distributed with respect to the stock or similar interest. Similarly, if the issuer maintains a taxable presence, referred to as a permanent establishment ("PE") under the laws of many foreign countries without regard to a treaty, and such country allows a deduction (including a notional deduction) for an amount paid, accrued or distributed with respect to the deemed equity or capital of the PE, the amount of the deemed equity or capital will be treated as a financing transaction. See proposed §1.881-3(a)(2)(ii)(B)(1)(iv). The proposed regulations also treat stock or a similar interest as a financing transaction if a person related to the issuer, generally a shareholder or other interest holder in an entity, is entitled to a refund (including a credit) or similar tax benefit for taxes paid by the issuer to its country of residence, without regard to the person's tax liability with respect to the payment, accrual or distribution under the laws of the issuer. See proposed §1.881-3(a)(2)(ii)(B)(1)(v).

An equity interest treated as a financing transaction under the proposed regulations would include, for example, stock that gives rise to a notional interest deduction under the tax laws of the foreign country in which the issuer is a tax resident or the tax laws of the country in which the issuer maintains a permanent establishment to which a financing payment is attributable. However, if an equity interest constitutes a financing transaction because the issuer is allowed a notional interest deduction and is one of the financing transactions that links a party to the financing arrangement, the proposed regulations limit the portion of the financed entity's payment that is recharacterized under §1.881-3(d)(1)(i) to the financing transaction's principal amount as determined under §1.881-3(d)(1)(ii), multiplied by the applicable rate used to compute the issuer's notional interest deduction in the year of the financed entity's payment. See proposed § 1.881-3(d)(1)(iii). This limitation is intended to recharacterize only the portion of the payment that can be traced to the notional interest deduction on the principal amount of the equity on which the notational deduction is based. Notional interest deductions may also accrue with respect to equity composed of retained earnings, not related to the financing transaction, and therefore are not taken into account under this rule.

The proposed regulations also make conforming changes to reflect the application of these rules in the context of Chapter 4 withholding (sections 1471 and 1472).

C. Interaction with section 267A

While the proposed conduit regulations may apply to many of the same instruments identified in the final regulations under section 267A issued in the Rules and Regulations section of this issue of the **Federal Register** (the “section 267A final regulations”), in some respects the proposed conduit regulations have a broader scope than those rules in order to prevent the use of conduit entities from inappropriately obtaining the benefits of an applicable U.S. income tax treaty. For example, the imported mismatch rules in the section 267A final regulations, in determining whether a deduction for an interest or royalty payment is disallowed by reason of the income attributable to the payment being offset by an offshore deduction, only take into account offshore deductions that produce a deduction/no inclusion (“D/NI”) outcome as a result of hybridity. A D/NI outcome is not a result of hybridity if, for example, the no-inclusion occurs because the foreign tax law does not impose a corporate income tax.

The existing conduit regulations, in contrast, already apply whether or not there is a D/NI outcome with respect to an offshore financing transaction. The proposed regulations will now also cover, without regard to how the transaction is treated for U.S. tax purposes (as debt or equity), any financing transaction where the intermediate entity is allowed a deduction or other tax benefit similar to those described in the section 267A final regulations and applicable in the imported mismatch context.

D. Applicability date

The proposed rules relating to conduit transactions are proposed to apply to payments made on or after the date that final regulations are published in the **Federal Register**.

III. Rules under Section 951A to Address Certain Disqualified Payments Made During the Disqualified Period

A. In general

As discussed in part III of the Background of this preamble, the GILTI final regulations provide that (i) a deduction or loss attributable to disqualified basis created by reason of a transfer from a CFC to a related CFC during the disqualified period is allocated and apportioned solely to residual CFC gross income, and (ii) any depreciation, amortization, or cost recovery allowances attributable to disqualified basis are not properly allocable to property produced or acquired for resale under section 263, 263A, or 471. See §1.951A-2(c)(5)(i).

The Treasury Department and the IRS understand that, in addition to the transactions circumscribed by the rules in §1.951A-2(c)(5), taxpayers also may have entered into transactions in which, for example, a CFC that licensed property to a related CFC received pre-payments of royalties due under the license from the related CFC, which did not constitute subpart F income. Although the recipient of the pre-payments ("related recipient CFC") would generally have been required to include the royalties in income upon payment during the disqualified period, when they would not have affected amounts included under section 965 with respect to the related recipient

CFC and also would not have given rise to gross tested income under section 951A, the related CFC that made the pre-payment would generally only be allowed to deduct the payment over time as economic performance occurred. See section 461. Accordingly, the related CFC that made the pre-payment would claim deductions that reduce tested income (or increase tested loss) during taxable years to which section 951A applies, even though the corresponding income would not have been subject to tax under section 951 (including as a result of section 965) or section 951A.

The Treasury Department and the IRS have determined that the deductions attributable to pre-payments (including, but not limited to, deductions attributable to prepaid rents and royalties) should be subject to similar treatment as the final GILTI regulations' treatment of deductions or loss attributable to disqualified basis. Accordingly, proposed §1.951A-2(c)(6) treats a deduction by a CFC related to a deductible payment to a related recipient CFC during the disqualified period as allocated and apportioned solely to residual CFC gross income, as defined in §1.951A-2(c)(5)(iii)(B), and provides that any deduction related to such a payment is not properly allocable to property produced or acquired for resale under section 263, 263A, or 471, consistent with §1.951A-2(c)(5)(i) and the authority therefor described in the preamble to the final GILTI regulations. See 84 FR 29298-29300. This rule applies only to the extent the payments would constitute income described in section 951A(c)(2)(A)(i) and §1.951A-2(c)(1), without regard to whether section 951A applies. See proposed §1.951A-2(c)(6)(ii)(A).

B. Applicability date

The proposed rules relating to section 951A are proposed to apply to taxable years of foreign corporations ending on or after **[INSERT DATE OF FILING WITH THE**

FEDERAL REGISTER], and to taxable years of United States shareholders in which or with which such taxable years end. See section 7805(b)(1)(B). Given the applicability date, these rules would effectively be limited to payments made during the disqualified period that give rise to deductions or loss in taxable years of foreign corporations ending on or after **[INSERT DATE OF FILING WITH THE FEDERAL REGISTER]** and would not, for example, affect payments made during the disqualified period for which the associated deduction or loss is taken into account in the year paid.

Special Analyses

I. Regulatory Planning and Review

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

The proposed regulations have been designated by the Office of Management and Budget's Office of Information and Regulatory Affairs as significant under Executive Order 12866 pursuant to section 1(b) the Memorandum of Agreement (April 11, 2018) between the Treasury Department and the Office of Management and Budget regarding review of tax regulations.

A. Background

The Act introduced two new provisions, sections 245A(e) and 267A, that affect the treatment of hybrid arrangements and a new section, 951A, which imposes tax on

United States shareholders with respect to certain earnings of their CFCs.[2] The Treasury Department and the IRS previously issued proposed regulations under sections 245A(e) and 267A and are issuing final regulations simultaneously with these current proposed regulations. The Treasury Department and IRS have also previously issued final regulations (REG-104390-18, 83 FR 51072), which provided additional rules implementing section 951A. In addition to these rules, the Treasury Department and the IRS previously provided guidance regarding conduit financing arrangements under sections 881 and 7701(l). See TD 8611, 60 FR 40997 and TD 9562, 76 FR 76895.

Section 245A(e) disallows the dividends received deduction (DRD) for any dividend received by a U.S. shareholder from a CFC if the dividend is a hybrid dividend. In addition, section 245A(e) treats hybrid dividends between CFCs with a common U.S. shareholder as subpart F income. The statute defines a hybrid dividend as an amount received from a CFC for which a deduction would be allowed under section 245A(a) and for which the CFC received a deduction or other tax benefit in a foreign country. This disallowance of the DRD for hybrid dividends and the treatment of hybrid dividends as subpart F income neutralizes the double non-taxation that these dividends might otherwise be produced by these dividends.[3] The section 245A(e) final regulations require that taxpayers maintain "hybrid deduction accounts" to track a CFC's (or a person related to a CFC's) hybrid deductions allowed in foreign jurisdictions across

[2] Hybrid arrangements are tax-avoidance tools used by certain multinational corporations (MNCs) that have operations both in the U.S. and a foreign country. These hybrid arrangements use differences in tax treatment by the U.S. and a foreign country to reduce taxes in one or both jurisdictions. Hybrid arrangements can be "hybrid entities," in which a taxpayer is treated as a flow-through or disregarded entity in one country but as a corporation in another, or "hybrid instruments," which are financial transactions that are treated as debt in one country and as equity in another.

[3] The tax treatment under which certain payments are deductible in one jurisdiction and not included in income in a second jurisdiction is referred to as a deduction/no-inclusion outcome ("D/NI outcome".)

sources and years. The section 245A(e) final regulations then provide that a dividend received by a U.S. shareholder from the CFC is a hybrid dividend to the extent of the sum of those accounts.

These proposed regulations also include rules regarding conduit financing arrangements.[4] Under the current conduit financing regulations, a "financing arrangement" means a series of transactions by which one entity (the financing entity) advances money or other property to another entity (the financed entity) through one or more intermediaries. If the IRS determines that a principal purpose of such an arrangement is to avoid U.S. tax, the IRS may disregard the participation of intermediate entities. As a result, U.S.-source payments from the financed entity are, for U.S. withholding tax purposes, treated as being made directly to the financing entity.

For example, consider a foreign entity that is seeking to finance its U.S. subsidiary but is not entitled to U.S. tax treaty benefits; thus, U.S.-source payments made to this entity are not entitled to reduced withholding tax rates. Instead of lending money directly to the U.S. subsidiary, the foreign entity might loan money to an affiliate residing in a treaty jurisdiction and have the affiliate lend on to the U.S. subsidiary in order to access U.S. tax treaty benefits.

Under the current conduit financing regulations, if the IRS determines that a principal purpose of such an arrangement is to avoid U.S. tax, the IRS may disregard

[4] On December 22, 2008, the Treasury Department and the IRS published a notice of proposed rulemaking (REG-113462-08) ("2008 proposed regulations") that proposed adding §1.881-3(a)(2)(i)(C) to the conduit financing regulations. The preamble to the 2008 proposed regulations provides that the Treasury Department and the IRS are also studying transactions where a financing entity advances cash or other property to an intermediate entity in exchange for a hybrid instrument (that is, an instrument treated as debt under the tax laws of the foreign country in which the intermediary is resident and equity for U.S. tax purposes), and states that they may issue separate guidance to address the treatment under §1.881-3 of certain hybrid instruments.

the participation of the affiliate. As a result, U.S.-source interest payments from the U.S. subsidiary are, for U.S. withholding tax purposes, treated as being made directly to the foreign entity.

In general, the current conduit financing regulations apply only if “financing transactions,” as defined under the regulations, link the financing entity, the intermediate entities, and the financed entity. Under the current conduit financing regulations, an instrument that is equity for U.S. tax purposes generally will not be treated as a “financing transaction” unless it provides the holder significant redemption rights. This is the case even if the instrument gives rise to a deduction under the laws of the foreign jurisdiction (e.g., perpetual debt). As a result, the current conduit financing regulations would not apply, and the U.S.-source payment might be entitled to a lower rate of U.S. withholding tax.

The proposed regulations also implement items in section 951A of the Act. Section 951A provides for the taxation of global intangible low-taxed income (GILTI), effective beginning with the first taxable year of a CFC that begins after December 31. 2017. The GILTI final regulations address the treatment of a deduction or loss attributable to basis created by certain transfers of property from one CFC to a related CFC after December 31, 2017, but before the date on which section 951A first applies to the transferring CFC’s income. Those regulations state that such a deduction or loss is allocated to residual CFC gross income; that is, income that is not attributable to tested income, subpart F income, or income effectively connected with a trade or business in the United States.

B. <u>Overview of proposed regulations</u>

These proposed regulations address three main issues: (i) adjustments to hybrid deduction accounts under section 245A(e) and the final regulations; (ii) conduit financing arrangements that use certain equity interests that allow the issuer a deduction or other tax benefit under foreign tax law; and (iii) certain payments between related CFCs during a disqualified period under section 951A and the GILTI final regulations.

First, the proposed regulations address adjustments to hybrid deduction accounts under section 245A(e) and the final regulations. The section 245A(e) final regulations stipulate that hybrid deduction accounts should generally be reduced to the extent that earnings and profits of the CFC that have not been subject to foreign tax as a result of certain hybrid arrangements are included in income in the United States by some provision other than section 245A(e). The proposed regulations provide new rules for reducing hybrid deduction accounts by reason of income inclusions attributable to subpart F, GILTI, and sections 951(a)(1)(B) and 956. An inclusion due to subpart F or GILTI reduces a hybrid deduction account only to the extent that the inclusion is not offset by a deduction or credit, such as a foreign tax credit, that likely will be afforded to the inclusion. Because deductions and credits are typically not available to offset income inclusions under section 951(a)(1)(B) and 956, these inclusions reduce a hybrid deduction account dollar-for-dollar.

Second, the proposed regulations address conduit financing arrangements under §1.881-3 by expanding the types of transactions classified as financing transactions. The proposed rules state that if the issuer of a financial instrument is allowed a deduction or tax benefit for an amount paid, accrued, or distributed with respect to a stock or similar interest under the tax law of the foreign jurisdiction where the issuer is a resident, then it may now be characterized as a financing transaction even though the instrument is equity for U.S. tax purposes. Accordingly, the conduit financing regulations would apply to multiple-party financing arrangements using these types of instruments, which include certain types of hybrid instruments. This change essentially aligns the conduit regulations with the policy of section 267A by discouraging the exploitation of differences in treatment of financial instruments across jurisdictions. While section 267A and the final regulations apply only if the D/NI outcome is a result of the use of a hybrid entity or instrument, the conduit financing regulations apply regardless of causation and instead look to whether there is a tax avoidance plan. Thus, this new rule will address economically similar transactions that section 267A and the section 267A final regulations do not cover.

Finally, the proposed regulations address certain payments made after December 31, 2017, but before the date of the start of the first fiscal year for the transferor CFC for which 951A applies (the “disqualified period”) in which payments, such as pre-payments of royalties, create income during the disqualified period and a corresponding deduction or loss claimed in taxable years after the disqualified period. Absent the proposed regulations, those deductions or losses could have been used to reduce tested income or increase tested losses, among other benefits. However, under the proposed regulations, these deductions will no longer provide such a tax benefit, and will instead be allocated to residual CFC income, similar to deductions or losses from certain property transfers in the disqualified period under the GILTI final regulations.

C. Need for the proposed regulations

A failure to reduce hybrid deduction accounts by certain earnings of a CFC that are indirectly included in the income of a U.S. shareholder may result in double taxation for some taxpayers—for example, those which have subpart F or GILTI income inclusions.

Failure to address certain equity interests under the conduit financing regulations may allow some MNCs to avoid U.S. tax by shifting additional income towards conduit financing arrangements that use financial instruments treated as equity for U.S. tax purposes but as debt in a foreign jurisdiction. These arrangements are economically similar to the hybrid arrangements that are addressed by the Act and by the section 267A final regulations and to other arrangements covered by the conduit financing regulations, but they have not yet been addressed themselves.

The Treasury Department and IRS are aware that certain transactions that accelerate income, but do not give rise to a disposition of property (e.g., prepayments of royalties from a related CFC) fall outside the purview of the GILTI final regulations. In order for the Code to treat similar transactions similarly, these types of transactions need to be addressed by regulation.

D. Economic analysis

1. Baseline

The Treasury Department and the IRS have assessed the benefits and costs of the proposed regulations relative to a no-action baseline reflecting anticipated federal income tax-related behavior in the absence of these regulations.

2. Economic Analysis of Specific Provisions and Alternatives Considered

i. Section 245A(e) – Adjustment of hybrid deduction account

Under the final regulations, taxpayers must maintain hybrid deduction accounts to track income of a CFC that was sheltered from foreign tax due to hybrid arrangements, so that it may be included in U.S. income under section 245A(e) when paid as a dividend. The proposed regulations address how hybrid deduction accounts should be adjusted to account for earnings and profits of a CFC included in U.S. income due to certain provisions other than section 245A(e). The proposed regulations provide rules reducing a hybrid deduction account for three categories of inclusions: subpart F inclusions, GILTI inclusions, and inclusions under sections 951(a)(1)(B) and 956.

One option for addressing the treatment of earnings and profits included in U.S. income due to provisions other than section 245A(e) would be to not issue additional guidance beyond current tax rules and thus not to adjust hybrid deduction accounts to account for such inclusions. This would be the simplest approach among those considered, but under this approach, some income could be subject to double taxation in the United States. For example, if no adjustment is made, to the extent that a CFC's earnings and profits were sheltered from foreign tax as a result of certain hybrid arrangements, the section 245A DRD would be disallowed for an amount of dividends equal to the amount of the sheltered earnings and profits, even if some of the sheltered earnings and profits were included in the income of a U.S. shareholder under the subpart F rules. The U.S. shareholder would be subject to tax on both the dividends and on the subpart F inclusion. Owing to this double taxation, this approach is not proposed by the Treasury Department and the IRS.

A second option would be to reduce hybrid deduction accounts by amounts included in gross income under the three categories; that is, without regard to deductions or credits that may offset the inclusion. While this option is also relatively simple, it could lead to double non-taxation and thus would give rise to results not intended by the statute. Subpart F and GILTI inclusions may be offset by – and thus may not be fully taxed in the United States as a result of – foreign tax credits and, in the case of GILTI, the section 250 deduction.[5] Therefore, this option for reducing hybrid deduction accounts may result in some income that was sheltered from foreign tax due to hybrid arrangements also escaping full U.S. taxation. This double non-taxation is economically inefficient because otherwise similar activities are taxed differently, incentivizing wasteful avoidance activities.

A third option, which is the option proposed by the Treasury Department and the IRS, is to reduce hybrid deduction accounts by the amount of the inclusions from the three categories, but only to the extent that the inclusions are likely not offset by foreign tax credits or, in the case of GILTI, the section 250 deduction. For subpart F and GILTI inclusions, the proposed regulations stipulate adjustments to be made to account for the foreign tax credits and the section 250 deduction available to GILTI income. These adjustments are intended to provide a precise, administrable manner for measuring the

[5] Typically, deductions or credits are not available to offset income inclusions under sections 951(a)(1)(B) and 956, the third category addressed by the proposed regulations.

extent to which a subpart F or GILTI inclusion is included in U.S. income and not shielded by foreign tax credits or deductions. This option results in an outcome aligned with statutory intent, as it generally ensures that the section 245A DRD is disallowed (and thus a dividend is included in U.S. income without any regard for foreign tax credits) only for amounts that were sheltered from foreign tax by reason of a hybrid arrangement but that have not yet been subject to U.S. tax.

Relative to a no-action baseline, the proposed regulations provide taxpayers with new instruction regarding how to adjust hybrid deduction accounts to account for earnings and profits that are included in U.S. income by reason of certain provisions other than section 245A(e). This new instruction avoids possible double taxation. Double taxation is inconsistent with the intent and purpose of the statute and is economically inefficient because it may result in otherwise similar income streams facing different tax treatment, incentivizing taxpayers to finance operations with specific income streams and activities that may not be the most economically productive.

The Treasury Department and IRS estimate that this provision will impact an upper bound of approximately 2,000 taxpayers. This estimate is based on the top 10 percent of taxpayers (by gross receipts) that filed a domestic corporate income tax return for tax year 2017 with a Form 5471 attached, because only domestic corporations that are U.S. shareholders of CFCs are potentially affected by section 245A(e).[6]

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

This estimate is an upper bound on the number of large corporations affected because it is based on all transactions, even though only a portion of such transactions involve hybrid arrangements. The tax data do not report whether these reported dividends were part of a hybrid arrangement because such information was not relevant for calculating tax prior to the Act. In addition, this estimate is an upper bound because the Treasury Department and the IRS anticipate that fewer taxpayers would engage in hybrid arrangements going forward as the statute and §1.245A(e)-1 would make such arrangements less beneficial to taxpayers.

ii. Conduit financing regulations to address equity interests that give rise to deductions or other benefits under foreign law

The conduit financing regulations allow the IRS to disregard intermediate entities in a multiple-party financing arrangement for the purposes of determining withholding tax rates if the instruments used in the arrangement are considered "financing transactions." Financing transactions generally exclude instruments that are treated as equity for U.S. tax purposes unless they have significant redemption features. Thus, in the absence of further guidance, the conduit financing regulations would not apply to certain arrangements using certain hybrid instruments or other instruments that are eligible for deductions in the jurisdiction of the issuer but treated as equity under U.S. law. This would allow payments made under these arrangements to continue to be eligible for reduced withholding tax rates through a conduit structure.

One option for addressing the current disparate treatment would be to not change the conduit financing regulations, which currently treat equity as a financing transaction only if it has specific redemption features; this is the no-action baseline. This option is not proposed by the Treasury Department and the IRS, since it is inconsistent with the Treasury Department's and the IRS's ongoing efforts to address financing transactions that use hybrid instruments, as discussed in the 2008 proposed regulations.

A second option considered would be to treat as a financing transaction an instrument that is equity for U.S. tax purposes but debt for purposes of the issuer's jurisdiction of residence. This approach would prevent taxpayers from using this type of hybrid instrument to engage in treaty shopping through a conduit jurisdiction. However, this approach would not cover certain cases, such as if a jurisdiction offers a tax benefit to non-debt instruments (e.g., a notional interest deduction with respect to equity).

A third option, which is adopted in these proposed regulations, is to treat as a financing transaction any instrument that is equity for U.S. tax purposes and which entitles its issuer or its shareholder a deduction or similar tax benefit in the issuer's resident jurisdiction or in the jurisdiction where the resident has a permanent establishment. This rule is broader than the second option. It covers all instruments that give rise to deductions or similar tax benefits, such as credits, rather than only those instruments that are treated as debt. This rule also covers instruments where a financing payment is attributable to a permanent establishment of the issuer, and the tax laws of the permanent establishment's jurisdiction allow a deduction or similar treatment for the instrument. This will prevent issuers from routing transactions through their permanent establishments to avoid the anti-conduit rules. The Treasury Department and the IRS adopted this third option since it will most efficiently, and in a manner that is clear and administrable, prevent inappropriate avoidance of the conduit financing regulations. The Treasury Department and the IRS project that this third option will ensure that similar financing arrangements are treated similarly by the tax system.

Relative to a no-action baseline, the proposed regulations are likely to incentivize some taxpayers to shift away from conduit financing arrangements and hybrid arrangements. The Treasury Department and the IRS project little to no overall economic loss, or even an economic gain, from this shift because conduit arrangements are generally not economically productive arrangements and are typically pursued only for tax-related reasons. The Treasury Department and the IRS recognize, however, that as a result of these provisions, some taxpayers may face a higher effective tax rate, which may lower their economic activity.

The Treasury Department and the IRS have not undertaken more precise quantitative estimates of either of these economic effects because we do not have readily available data or models to estimate with reasonable precision: (i) the types or volume of conduit arrangements that taxpayers would likely use under the proposed regulations or under the no-action baseline; or (ii) the effects of those arrangements on businesses' overall economic performance, including possible differences in compliance costs. In the absence of such quantitative estimates, the Treasury Department and the IRS project that the proposed regulations will best enhance U.S. economic performance relative to the no-action baseline and relative to other alternative regulatory approaches and because they most comprehensively ensure that similar financing arrangements are treated similarly by the tax system.

The Treasury Department and the IRS estimate that the number of taxpayers potentially affected by the proposed conduit financing regulations will be an upper bound of approximately 7,000 taxpayers. This estimate is based on the top 10 percent of taxpayers (by gross receipts) that filed a domestic corporate income tax return with a Form 5472, "Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business," attached because primarily foreign entities that advance money or other property to a related U.S. entity through one or more foreign intermediaries are potentially affected by the conduit financing regulations.[7]

This estimate is an upper bound on the number of large corporations affected because it is based on all domestic corporate arrangements involving foreign related parties, even though only a portion of such arrangements are conduit financing arrangements that use hybrid instruments. The tax data do not report whether these arrangements were part of a conduit financing arrangement because such information is not provided on tax forms. In addition, this estimate is an upper bound because the Treasury Department and the IRS anticipate that fewer taxpayers would engage in conduit financing arrangements that use hybrid instruments going forward as the proposed conduit financing regulations would make such arrangements less beneficial to taxpayers.

iii. Rules under section 951A to address certain disqualified payments made during the disqualified period

The final 951A regulations include a rule that addresses certain transactions involving asset transfers between related CFCs during the disqualified period that may

[7] Because of the complexities involved, primarily only large taxpayers engage in conduit financing arrangements. The estimate that the top 10 percent of otherwise-relevant taxpayers (by gross receipts) are likely to engage in conduit financing arrangements is based on the judgment of the Treasury Department and IRS.

have the effect of reducing GILTI inclusions due to timing differences between when a transaction occurs and when resulting deductions are claimed. The disqualified period of a CFC is the period between December 31, 2017, which is the last earnings and profits measurement date under section 965, and the beginning of the CFC's first taxable year that begins after December 31, 2017, which is the first taxable year with respect to which section 951A is effective.

The proposed regulations refine this rule to extend its applicability to other transactions for which similar timing differences can arise. For example, suppose that a CFC licensed property to a related CFC for ten years and received pre-payments of royalties during the disqualified period from the related CFC. Since these prepayments were received by the licensor CFC during the disqualified period, they would not have affected amounts included under section 965 nor given rise to GILTI tested income. However, the licensee CFC that made the payments would not have claimed the total of the corresponding deductions during the disqualified period, since the timing of deductions are generally tied to economic performance over the period of use. The licensee CFC would claim deductions over the ten years of the contract, and since these deductions would be claimed during taxable years when section 951A is in effect, these deductions would reduce GILTI tested income or increase GILTI tested loss. Thus, this type of transaction could lower overall income inclusions for the U.S. shareholder of these CFCs in a manner that does not accurately reflect the earnings of the CFCs over time.

The Treasury Department and the IRS propose that all deductions attributable to payments to a related CFC during the disqualified period should be allocated and apportioned to residual CFC gross income. These deductions will not thereby reduce tested, subpart F or effectively connected income. This rule provides similar treatment to transactions involving prepayments as the rule in the GILTI final regulations provides to asset transfers between related CFCs during the disqualified period.

Relative to a no-action baseline, the proposed regulations harmonize the treatment of similar transactions. Since this rule applies to deductions resulting from transactions that occurred during the disqualified period and not to any new transactions, the Treasury Department and the IRS do not expect changes in taxpayer behavior under the proposed regulations, relative to the no-action baseline.

The Treasury Department and the IRS estimate that the number of taxpayers potentially affected by these proposed regulations will be an upper bound of approximately 25,000 to 35,000 taxpayers. This estimate is based on filers of income tax returns with a Form 5471 attached because only filers that are U.S. shareholders of CFCs or that have at least a 10 percent ownership in a foreign corporation would be subject to section 951A. This estimate is an upper bound because it is based on all filers subject to section 951A, even though only a portion of such taxpayers may have engaged in the pre-payment transactions during the disqualified period described in the proposed regulations. Therefore, the Treasury Department and the IRS estimate that the number of taxpayers potentially affected by these proposed regulations will be substantially less than 25,000 to 35,000 taxpayers.

II. Paperwork Reduction Act

Pursuant to §1.6038-2(f)(14), certain U.S. shareholders of a CFC must provide information relating to the CFC and the rules of section 245A(e) on Form 5471, “Information Return of U.S. Persons With Respect to Certain Foreign Corporations,” (OMB control number 1545-0123), as the form or other guidance may prescribe. The proposed regulations do not impose any additional information collection requirements relating to section 245A(e). However, the proposed regulations provide guidance regarding certain computations required under section 245A(e), and such could affect the information required to be reported on Form 5471. For purposes of the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)) (“PRA”), the reporting burden associated with §1.6038-2(f)(14) is reflected in the PRA submission for Form 5471. See the chart at the end of this part II of this Special Analyses section for the status of the PRA submission for Form 5471. As described in the Special Analyses section the preamble to the section 245A(e) final regulations, and as set forth in the chart below, the IRS estimates the number of affected filers to be 2,000.

Pursuant to §1.6038-5, certain U.S. shareholders of a CFC must provide information relating to the CFC and the U.S. shareholder’s GILTI inclusion under section 951A on new Form 8992, “U.S. Shareholder Calculation of Global Intangible Low-Taxed Income (GILTI),” (OMB control number 1545-0123), as the form or other guidance may prescribe. The proposed regulations do not impose any additional information collection requirements relating to section 951A. However, the proposed regulations provide guidance regarding computations required under section 951A for taxpayers who engaged in certain transactions during the disqualified period, and such guidance could affect the information required to be reported by these taxpayers on Form 8992. For purposes of the PRA, the reporting burden associated with the collection of information under §1.6038-5 is reflected in the PRA submission for Form 8992. See the chart at the end of this part II of this Special Analyses section for the status of the PRA submission for Form 8992. As discussed in the Special Analyses section of the preamble to the proposed regulations under section 951A (REG-104390-18, 83 FR 51072), and as set forth in the chart below, the IRS estimates the number of filers subject to §1.6038-5 to be 25,000 to 35,000. Since the proposed regulations only apply to taxpayers who engaged in certain transactions during the disqualified period, the IRS estimates that the number of filers affected by the proposed regulations and subject to the collection of information in §1.6038-5 will be significantly less than 25,000 to 35,000.

There is no existing collection of information relating to conduit financing arrangements, and the proposed regulations do not impose any new information collection requirements relating to conduit financing arrangements. Therefore, a PRA analysis is not required with respect to the proposed regulations relating to conduit financing arrangements.

As a result, the IRS estimates the number of filers affected by these proposed regulations to be the following.

Tax Forms Impacted		
Collection of information	**Number of respondents (estimated, rounded to nearest 1,000)**	**Forms in which information may be collected**
§1.6038-2(f)(14)	2,000	Form 5471 (Schedule I)
§1.6038-5	25,000 – 35,000	Form 8992

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

The current status of the PRA submissions related to the tax forms associated with the information collections in §§1.6038-2(f)(14) and 1.6038-5 is provided in the accompanying table. The reporting burdens associated with the information collections in §§1.6038-2(f)(14) and 1.6038-5 are included in the aggregated burden estimates for OMB control number 1545-0123, which represents a total estimated burden time for all forms and schedules for corporations of 3.157 billion hours and total estimated monetized costs of $58.148 billion ($2017). The overall burden estimates provided in 1545-0123 are aggregate amounts that relate to the entire package of forms associated with the OMB control number, and are therefore not accurate for future calculations needed to assess the burden specific to certain regulations, such as the information collections under §1.6038-2(f)(14) or §1.6038-5. No burden estimates specific to the proposed regulations are currently available. The Treasury Department and the IRS have not identified any burden estimates, including those for new information collections, related to the requirements under the proposed regulations. The Treasury Department and the IRS estimate PRA burdens on a taxpayer-type basis rather than a provision-specific basis. Changes in those estimates will capture both changes made by the Act and those that arise out of discretionary authority exercised in the proposed regulations.

The Treasury Department and the IRS request comments on all aspects of information collection burdens related to the proposed regulations, including estimates for how much time it would take to comply with the paperwork burdens related to the forms described and ways for the IRS to minimize the paperwork burden. Proposed revisions (if any) to these forms that reflect the information collections related to the proposed regulations will be made available for public comment at https://apps.irs.gov/app/picklist/list/draftTaxForms.html and will not be finalized until after these forms have been approved by OMB under the PRA.

Form	**Type of Filer**	**OMB Number(s)**	**Status**
Form 5471	Business (NEW	1545-0123	Published in the Federal Register on 9/30/19 (84 FR 51718). Public Comment

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<tr><td>Individual (NEW Model)</td><td>1545-0074</td><td>Published in the Federal Register on 9/30/19 (84 FR 51712). Public Comment period closed on 11/29/19. Approved by OMB through 1/31/2021.</td></tr>
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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).

These proposed regulations, if finalized, would amend certain computations required under section 245A(e) or section 951A. As discussed in the Special Analyses accompanying the preambles to the section 245A(e) final regulations and the proposed regulations under section 951A (REG-104390-18, 83 FR 51072), as well as in this part III of the Special Analyses, the Treasury Department and the IRS project that a substantial number of domestic small business entities will not be subject to sections 245A(e) and 951A, and therefore, the existing requirements in §§1.6038-2(f)(14) and 1.6038-5 will not have a significant economic impact on a substantial number of small entities.

The small entities that are subject to section 245A(e) and §1.6038-2(f)(14) are controlling U.S. shareholders of a CFC that engage in a hybrid arrangement, and the small entities that are subject to section 951A and §1.6038-5 are U.S. shareholders of a CFC. A CFC is a foreign corporation in which more than 50 percent of its stock is owned by U.S. shareholders, measured either by value or voting power. A U.S. shareholder is any U.S. person that owns 10 percent or more of a foreign corporation's stock, measured either by value or voting power, and a controlling U.S. shareholder of a CFC is a U.S. person that owns more than 50 percent of the CFC's stock.

The Treasury Department and the IRS estimate that there are only a small number of taxpayers having gross receipts below either $25 million (or $41.5 million for financial entities) who would potentially be affected by these regulations.[8] Our estimate of those entities who could potentially be affected is based on our review of those taxpayers who filed a domestic corporate income tax return in 2016 with gross receipts below either $25 million (or $41.5 million for financial institutions) who also reported dividends on a Form 5471. The Treasury Department and the IRS estimate that the number of small entities potentially affected by these regulations will be between 1 and 6 percent of all affected entities regardless of size.

The Treasury Department and the IRS cannot readily identify from these data amounts that are received pursuant to hybrid arrangements because those amounts are not separately reported on tax forms. Thus, dividends received as reported on Form 5471 are an upper bound on the amount of hybrid arrangements by these taxpayers.

[8] This estimate is limited to those taxpayers who report gross receipts above $0.

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

Notwithstanding this certification, the Treasury Department and IRS invite comments about the impact this proposal may have on small entities.

Pursuant to section 7805(f) of the Code, this notice of proposed rulemaking has been submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Requests for Public Hearing

Before the proposed regulations are adopted as final regulations, consideration will be given to any comments that are submitted timely to the IRS as prescribed in this preamble under the "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, then notice of the date, time, and place for the public hearing will be published in the **Federal Register**.

Drafting Information

The principal authors of these regulations are Shane M. McCarrick and Richard F. Owens of the Office of Associate Chief Counsel (International). However, other personnel from the Treasury Department and the IRS participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1--INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

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

Par. 2. Section 1.245A(e)-1 is amended by:

1. Adding paragraphs (d)(4)(i)(B) and (d)(4)(ii).
2. Adding a sentence at the end of the introductory text of paragraph (g).
3. Adding paragraphs (g)(1)(v) and (h)(2).

The additions read as follows:

<u>§1.245A(e)-1 Special rules for hybrid dividends</u>.

* * * * *

(d) * * *

(4) * * *

(i) * * *

(B) Second, the account is decreased (but not below zero) pursuant to the rules of paragraphs (d)(4)(i)(B)(1) through (3) of this section, in the order set forth in this paragraph (d)(4)(i)(B).

(1) Adjusted subpart F inclusions--(i) In general. Subject to the limitation in paragraph (d)(4)(i)(B)(1)(ii) of this section, the account is reduced by an adjusted subpart F inclusion with respect to the share for the taxable year, as determined pursuant to the rules of paragraph (d)(4)(ii) of this section.

(ii) Limitation. The reduction pursuant to paragraph (d)(4)(i)(B)(1)(i) of this section cannot exceed the hybrid deductions of the CFC allocated to the share for the taxable year multiplied by a fraction, the numerator of which is the subpart F income of the CFC for the taxable year and the denominator of which is the taxable income (as determined under §1.952-2(b)) of the CFC for the taxable year. However, if the denominator of the fraction would be zero or less, then the fraction is considered to be zero.

(iii) Special rule allocating reductions across accounts in certain cases. This paragraph (d)(4)(i)(B)(1)(iii) applies after each of the specified owner's hybrid deduction accounts with respect to its shares of stock of the CFC are adjusted pursuant to paragraph (d)(4)(i)(B)(1)(i) of this section but before the accounts are adjusted pursuant to paragraph (d)(4)(i)(B)(2) of this section, to the extent that one or more of the hybrid deduction accounts would have been reduced by an amount pursuant to paragraph (d)(4)(i)(B)(1)(i) of this section but for the limitation in paragraph (d)(4)(i)(B)(1)(ii) of this section (the aggregate of the amounts that would have been reduced but for the limitation, the excess amount, and the accounts that would have been reduced by the excess amount, the excess amount accounts). When this paragraph (d)(4)(i)(B)(1)(iii) applies, the specified owner's hybrid deduction accounts other than the excess amount accounts (if any) are ratably reduced by the lesser of the excess amount and the difference of the following two amounts: the hybrid deductions of the CFC allocated to the specified owner's shares of stock of the CFC for the taxable year multiplied by the fraction described in paragraph (d)(4)(i)(B)(1)(ii) of this section; and the reductions pursuant to paragraph (d)(4)(i)(B)(1)(i) of this section with respect to the specified owner's shares of stock of the CFC.

(2) Adjusted GILTI inclusions--(i) In general. Subject to the limitation in paragraph (d)(4)(i)(B)(2)(ii) of this section, the account is reduced by an adjusted GILTI inclusion with respect to the share for the taxable year, as determined pursuant to the rules of paragraph (d)(4)(ii) of this section.

(ii) Limitation. The reduction pursuant to paragraph (d)(4)(i)(B)(2)(i) of this section cannot exceed the hybrid deductions of the CFC allocated to the share for the taxable year multiplied by a fraction, the numerator of which is the tested income of the CFC for the taxable year and the denominator of which is the taxable income (as determined under §1.952-2(b)) of the CFC for the taxable year. However, if the denominator of the fraction would be zero or less, then the fraction is considered to be zero.

(iii) Special rule allocating reductions across accounts in certain cases. This paragraph (d)(4)(i)(B)(2)(iii) applies after each of the specified owner's hybrid deduction accounts with respect to its shares of stock of the CFC are adjusted pursuant to paragraph (d)(4)(i)(B)(2)(i) of this section but before the accounts are adjusted pursuant to paragraph (d)(4)(i)(B)(3) of this section, to the extent that one or more of the hybrid deduction accounts would have been reduced by an amount pursuant to paragraph (d)(4)(i)(B)(2)(i) of this section but for the limitation in paragraph (d)(4)(i)(B)(2)(ii) of this section (the aggregate of the amounts that would have been reduced but for the limitation, the excess amount, and the accounts that would have been reduced by the excess amount, the excess amount accounts). When this paragraph (d)(4)(i)(B)(2)(iii) applies, the specified owner's hybrid deduction accounts other than the excess amount accounts (if any) are ratably reduced by the lesser of the excess amount and the difference of the following two amounts: the hybrid deductions of the CFC allocated to the specified owner's shares of stock of the CFC for the taxable year multiplied by the fraction described in paragraph (d)(4)(i)(B)(2)(ii) of this section; and the reductions pursuant to paragraph (d)(4)(i)(B)(2)(i) of this section with respect to the specified owner's shares of stock of the CFC.

(3) Certain section 956 inclusions. The account is reduced by an amount included in the gross income of a domestic corporation under sections 951(a)(1)(B) and 956 with respect to the share for the taxable year of the domestic corporation in which or with which the CFC's taxable year ends, to the extent so included by reason of the application of section 245A(e) and this section to the hypothetical distribution described in §1.956-1(a)(2).

* * * * *

(ii) Rules regarding adjusted subpart F and GILTI inclusions. (A) The term adjusted subpart F inclusion means, with respect to a share of stock of a CFC for a taxable year of the CFC, a domestic corporation's pro rata share of the CFC's subpart F income included in gross income under section 951(a)(1)(A) for the taxable year of the domestic corporation in which or with which the CFC's taxable year ends, to the extent attributable to the share (as determined under the principles of section 951(a)(2) and §1.951-1(b) and (e)), adjusted by--

(1) Adding to the amount the associated foreign income taxes with respect to the amount; and

(2) Subtracting from such sum the quotient of the associated foreign income taxes divided by the percentage described in section 11(b).

(B) The term adjusted GILTI inclusion means, with respect to a share of stock of a CFC for a taxable year of the CFC, a domestic corporation's GILTI inclusion amount (within the meaning of §1.951A-1(c)(1)) for the U.S. shareholder inclusion year (within the meaning of §1.951A-1(f)(7)), to the extent attributable to the share (as determined under paragraph (d)(4)(ii)(C) of this section), adjusted by--

(1) Adding to the amount the associated foreign income taxes with respect to the amount;

(2) Multiplying such sum by the difference of 100 percent and the percentage described in section 250(a)(1)(B); and

(3) Subtracting from such product the quotient of 80 percent of the associated foreign income taxes divided by the percentage described in section 11(b).

(C) A domestic corporation's GILTI inclusion amount for a U.S. shareholder inclusion year is attributable to a share of stock of the CFC based on a fraction--

(1) The numerator of which is the domestic corporation's pro rata share of the tested income of the CFC for the U.S. shareholder inclusion year, to the extent attributable to the share (as determined under the principles of §1.951A-1(d)(2)); and

(2) The denominator of which is the aggregate of the domestic corporation's pro rata share of the tested income of each tested income CFC (as defined in §1.951A-2(b)(1)) for the U.S. shareholder inclusion year.

(D) The term associated foreign income taxes means--

(1) With respect to a domestic corporation's pro rata share of the subpart F income of the CFC included in gross income under section 951(a)(1)(A) and attributable to a share of stock of a CFC for a taxable year of the CFC, current year tax (as described in §1.960-1(b)(4)) allocated and apportioned under §1.960-1(d)(3)(ii) to the subpart F income groups (as described in §1.960-1(b)(30)) of the CFC for the taxable year, to the extent allocated to the share under paragraph (d)(4)(ii)(E) of this section; and

(2) With respect to a domestic corporation's GILTI inclusion amount under section 951A attributable to a share of stock of a CFC for a taxable year of the CFC, current year tax (as described in §1.960-1(b)(4)) allocated and apportioned under §1.960-1(d)(3)(ii) to the tested income groups (as described in §1.960-1(b)(33)) of the CFC for the taxable year, to the extent allocated to the share under paragraph (d)(4)(ii)(F) of this section, multiplied by the domestic corporation's inclusion percentage (as described in §1.960-2(c)(2)).

(E) Current year tax allocated and apportioned to a subpart F income group of a CFC for a taxable year is allocated to a share of stock of the CFC by multiplying the foreign income tax by a fraction--

(1) The numerator of which is the domestic corporation's pro rata share of the subpart F income of the CFC for the taxable year, to the extent attributable to the share (as determined under the principles of section 951(a)(2) and §1.951-1(b) and (e)); and

(2) The denominator of which is the subpart F income of the CFC for the taxable year.

(F) Current year tax allocated and apportioned to a tested income group of a CFC for a taxable year is allocated to a share of stock of the CFC by multiplying the foreign income tax by a fraction--

(1) The numerator of which is the domestic corporation's pro rata share of tested income of the CFC for the taxable year, to the extent attributable to the share (as determined under the principles §1.951A-1(d)(2)); and

(2) The denominator of which is the tested income of the CFC for the taxable year.

* * * * *

(g) * * * No amounts are included in the gross income of US1 under sections 951(a)(1)(A), 951A(a), or 951(a)(1)(B) and 956.

(1) * * *

(v) Alternative facts – account reduced by adjusted GILTI inclusion. The facts are the same as in paragraph (g)(1)(i) of this section, except that for taxable year 1 FX has $130x of gross tested income and $10.5x of current year tax (as described in §1.960-1(b)(4)) that is allocated and apportioned under §1.960-1(d)(3)(ii) to the tested income groups of FX. In addition, FX has $119.5x of tested income ($130x of gross tested income, less the $10.5x of current year tax deductions properly allocable to the gross tested income). Further, of US1's pro rata share of the tested income ($119.5x), $80x is attributable to Share A and $39.5x is attributable to Share B (as determined under the principles of §1.951A-1(d)(2)). Moreover, US1's net deemed tangible income return (as defined in §1.951A-1(c)(3)) for taxable year 1 is $71.7x, and US1 does not own any stock of a CFC other than its stock of FX. Thus, US1's GILTI inclusion amount (within the meaning of §1.951A-1(c)(1)) for taxable year 1, the U.S. shareholder inclusion year, is $47.8x (net CFC tested income of $119.5x, less net deemed tangible income return of $71.7x) and US1's inclusion percentage (as described in §1.960-2(c)(2)) is 40 ($47.8x/$119.5x). At the end of year 1, US1's hybrid deduction account with respect to Share A is: first, increased by $80x (the amount of hybrid deductions allocated to Share A); and second, decreased by $10x (the sum of the adjusted GILTI inclusion with respect to Share A, and the adjusted GILTI inclusion with respect to Share B that is allocated to the hybrid deduction account with respect to Share A) to $70x. See paragraphs (d)(4)(i)(A) and (B) of this section. In year 2, the entire $30x of each dividend received by US1 from FX during year 2 is a hybrid dividend, because the sum of US1's hybrid deduction accounts with respect to each of its shares of FX stock at the end of year 2 ($70x) is at least equal to the amount of the dividends ($60x). See paragraph (b)(2) of this section. At the end of year 1, US1's hybrid deduction account with respect to Share A is decreased by $60x (the amount of the hybrid deductions in the account that give rise to a hybrid dividend or tiered hybrid dividend during year 1) to $10x. See paragraph (d)(4)(i)(C) of this section. Paragraphs (g)(1)(v)(A) through (C) of this section describe the computations pursuant to paragraph (d)(4)(i)(B)(2) of this section.

(A) To determine the adjusted GILTI inclusion with respect to Share A for taxable year 1, it must be determined to what extent US1's $47.8x GILTI inclusion amount is attributable to Share A. See paragraph (d)(4)(ii)(B) of this section. Here, $32x of the inclusion is attributable to Share A, calculated as $47.8x multiplied by a fraction, the numerator of which is $80x (US1's pro rata share of the tested income of FX attributable to Share A) and denominator of which is $119.5x (US1's pro rata share of the tested income of FX, its only CFC). See paragraph (d)(4)(ii)(C) of this section. Next, the associated foreign income taxes with respect to the $32x GILTI inclusion amount attributable to Share A must be determined. See paragraphs (d)(4)(ii)(B) and (D) of this section. Such associated foreign income taxes are $2.8x, calculated as $10.5x (the current year tax allocated and apportioned to the tested income groups of FX) multiplied by a fraction, the numerator of which is $80x (US1's pro rata share of the tested income of FX attributable to Share A) and the denominator of which is $119.5x (the tested income of FX), multiplied by 40% (US1's inclusion percentage). See paragraphs (d)(4)(ii)(D) and (F) of this section. Thus, pursuant to paragraph (d)(4)(ii)(B) of this section, the adjusted GILTI inclusion with respect to Share A is $6.7x, computed by--

(1) Adding $2.8x (the associated foreign income taxes with respect to the $32x GILTI inclusion attributable to Share A) to $32x, which is $34.8x;

(2) Multiplying $34.8x (the sum of the amounts in paragraph (g)(1)(v)(A)(1) of this section) by 50% (the difference of 100 percent and the percentage described in section 250(a)(1)(B)), which is $17.4x; and

(3) Subtracting $10.7x (calculated as $2.24x (80% of the $2.8x of associated foreign income taxes) divided by .21 (the percentage described in section 11(b)) from $17.4x (the product of the amounts in paragraph (g)(1)(v)(A)(2) of this section), which is $6.7x.

(B) Pursuant to computations similar to those discussed in paragraph (g)(1)(v)(A) of this section, the adjusted GILTI inclusion with respect to Share B is $3.3x. However, the hybrid deduction account with respect to Share B is not reduced by such $3.3x, because of the limitation in paragraph (d)(4)(i)(B)(2)(ii) of this section, which, with respect to Share B, limits the reduction pursuant to paragraph (d)(4)(i)(B)(2)(i) of this section to $0 (calculated as $0, the hybrid deductions allocated to the share for the taxable year, multiplied by 1, the fraction described in paragraph (d)(4)(i)(B)(2)(ii) of this section (computed as the $119.5x of tested income divided by the $119.5x of taxable income)). See paragraphs (d)(4)(i)(B)(2)(i) and (ii) of this section.

(C) US1's hybrid deduction account with respect to Share A is reduced by the entire $6.7x adjusted GILTI inclusion with respect to the share, as such $6.7x does not exceed the limit in paragraph (d)(4)(i)(B)(2)(ii) of this section ($80x, calculated as $80x, the hybrid deductions allocated to the share for the taxable year, multiplied by 1, the fraction described in paragraph (d)(4)(i)(B)(2)(ii) of this section). See paragraphs (d)(4)(i)(B)(2)(i) and (ii) of this section. In addition, the hybrid deduction account is reduced by another $3.3x, the amount of the adjusted GILTI inclusion with respect to Share B that is allocated to the hybrid deduction account with respect to Share A. See paragraph (d)(4)(i)(B)(2)(iii) of this section. As a result, pursuant to paragraph (d)(4)(i)(B)(2) of this section, US1's hybrid deduction account with respect to Share A is reduced by $10x ($6.7x plus $3.3x).

* * * * *

(h) * * *

(2) Special rules. Paragraphs (d)(4)(i)(B) and (d)(4)(ii) of this section (decrease of hybrid deduction accounts; rules regarding adjusted subpart F and GILTI inclusions) apply to taxable years ending on or after [date of publication of the final regulations in the **Federal Register]**. However, a taxpayer may apply those paragraphs to taxable years ending before that date, so long as the taxpayer consistently applies paragraphs (d)(4)(i)(B) and (d)(4)(ii) to those taxable years.

Par. 3. Section 1.881-3 is amended by:

1. Adding a sentence at the end of paragraph (a)(1).

2. Revising paragraph (a)(2)(i)(C).

3. In paragraph (a)(2)(ii)(B)(1) introductory text, removing "one of the following" and adding "one or more of the following" in its place.

4. In paragraph (a)(2)(ii)(B)(1)(ii), removing the word "or" at the end of the paragraph.

5. In paragraph (a)(2)(ii)(B)(1)(iii), removing the period at the end and adding a semicolon in its place.

6. Adding paragraphs (a)(2)(ii)(B)(1)(iv) and (v) and (d)(1)(iii).

7. Adding a sentence at the end of paragraph (e) introductory text.

8. In paragraph (e), designating Examples 1 through 26 as paragraphs (e)(1) through (26), respectively.

9. In newly designated paragraph (e)(3), removing "Example 2" and "§301.7701-3" and adding "paragraph (e)(2) of this section (the facts in Example 2)" and "§301.7701-3 of this chapter" in their places, respectively.

10. Redesignating newly designated paragraphs (e)(4) through (26) as paragraphs (e)(6) through (28), respectively.

11. Adding new paragraphs (e)(4) and (5);

12. In newly redesignated paragraph (e)(9)(ii), removing "(a)(4)(i)" and adding "(a)(4)(i) of this section" in its place.

13. In newly redesignated paragraph (e)(23)(i), removing "Example 20" and adding "paragraph (e)(22) of this section (the facts in Example 22)" in its place.

14. In newly redesignated paragraph (e)(23)(ii), removing "Example 19" and "paragraph (i) of this Example 21" and adding "paragraph (e)(21) of this section (Example 21)" and "paragraph (e)(23)(i) of this section (this Example 23)" in their places, respectively.

15. In newly redesignated paragraph (e)(25)(i), removing "Example 22" and adding "paragraph (e)(24) of this section (the facts in Example 24)" in its place.

16. In newly redesignated paragraph (e)(26)(i), removing "Example 22" and adding in its place "paragraph (e)(24) of this section (the facts in Example 24)".

17. Adding paragraph (e)(29).

18. In paragraph (f):

i. Revising the paragraph heading.

ii. Removing "Paragraph (a)(2)(i)(C) and Example 3 of paragraph (e) of this section" and adding "Paragraphs (a)(2)(i)(C) and (e)(3) of this section" in its place.

iii. Adding a sentence at the end of the paragraph.

The additions and revision read as follows:

§1.881-3 Conduit financing arrangements.

(a) * * *

(1) * * * See §1.1471-3(f)(5) for the application of a conduit transaction for purposes of sections 1471 and 1472. See also §§1.267A-1 and 1.267A-4 (disallowing a deduction for certain interest or royalty payments to the extent the income attributable to the payment is offset by a deduction with respect to equity).

(2) * * *

(i) * * *

(C) Treatment of disregarded entities. For purposes of this section, the term person includes a business entity that is disregarded as an entity separate from its single member owner under §§301.7701-1 through 301.7701-3 of this chapter and therefore such entity may be treated as a party to a financing transaction with its owner.

(ii) * * *

(B) * * *

(1) * * *

(iv) The issuer is allowed a deduction or another tax benefit (such as an exemption, exclusion, credit, or a notional deduction determined with respect to the stock or similar interest) for amounts paid, accrued, or distributed (deemed or otherwise) with respect to the stock or similar interest, either under the laws of the issuer's country of residence or a country in which the issuer has a taxable presence, such as a permanent establishment, to which a payment on a financing transaction is attributable; or

(v) A person related to the issuer is, under the tax laws of the issuer's country of residence, allowed a refund (including through a credit), or similar tax benefit for taxes paid by the issuer to its country of residence on amounts paid, accrued, or distributed (deemed or otherwise) with respect to the stock or similar interest, without regard to any related person's tax liability under the laws of the issuer's country of residence.

* * * * *

(d) * * *

(1) * * *

(iii) Limitation for certain types of stock. If a financing transaction linking one of the parties to the financing arrangement is stock (or a similar interest in a partnership, trust, or other person) described in paragraph (a)(2)(ii)(B)(1)(iv) of this section, and the issuer is allowed a notional interest deduction with respect to its stock or similar interest (under the laws of its country of residence or another country in which it has a place of business or permanent establishment), the portion of the payment made by the financed entity that is recharacterized under paragraph (d)(1)(i) of this section attributable to such financing transaction will not exceed the financing transaction's principal amount as determined under paragraph (d)(1)(ii) of this section multiplied by the rate used to compute the issuer's notional interest deduction for the taxable year in which the payment is made.

* * * * *

(e) Examples. * * * For purposes of these examples, unless otherwise indicated, it is assumed that no stock is of the types described in paragraph (a)(2)(ii)(B)(1)(iv) or (v) of this section.

* * * * *

(4) Example 4. Hybrid instrument as financing arrangement. The facts are the same as in paragraph (e)(2) of this section (the facts in Example 2), except that FP assigns the DS note to FS in exchange for stock issued by FS. The stock issued by FS is in form convertible debt with a 49-year term that is treated as debt under the tax laws of Country T. The FS stock is not subject to any of the redemption, acquisition, or payment rights or requirements specified in paragraphs (a)(2)(ii)(B)(1)(i) through (iii) of this section. Because the FS stock gives rise to a deduction under the tax laws of Country T, the FS stock is a financing transaction under paragraph (a)(2)(ii)(B)(1)(iv) of this section. Therefore, the DS note held by FS and the FS stock held by FP are financing transactions within the meaning of paragraphs (a)(2)(ii)(A)(1) and (2) of this section, respectively, and together constitute a financing arrangement within the meaning of paragraph (a)(2)(i) of this section. See also §1.267A-4 for rules applicable to disqualified imported mismatch amounts.

(5) Example 5. Refundable tax credit treated as financing transaction. FS lends $1,000,000 to DS in exchange for a note issued by DS. Additionally, Country T has a regime whereby FP, as the sole shareholder of FS, is allowed a refund with respect to distributions of earnings by FS that is equal to 90% of the Country T taxes paid by FS associated with any such distributed earnings. FP is not itself subject to Country T tax on distributions from FS. The loan from FS to DS is a financing transaction within the meaning of paragraph (a)(2)(ii)(A)(1) of this section. FP's stock in FS constitutes a financing transaction within the meaning of paragraph (a)(2)(ii)(B)(1)(v) of this section because FP, a person related to FS, is allowed a refund of FS's Country T taxes even though FP is not subject to Country T tax on such payments. Together, the FS stock held by FP and the DS note held by FS constitute a financing arrangement within the meaning of paragraph (a)(2)(i) of this section.

* * * * *

(29) Example 29. Amount of payment subject to recharacterization. (i) FP lends $10,000,000 to FS in exchange for a ten-year note with a stated interest rate of 6%. FP also contributes $5,000,000 to FS in exchange for FS stock. Pursuant to Country T tax law, FS is entitled to a notional interest deduction with respect to the stock equal to the prevailing Country T government bond rate multiplied by the taxpayer's net equity for the previous taxable year. FS, pursuant to a tax avoidance plan, lends $20,000,000 to DS in exchange for a note that pays 8% interest annually. DS makes its first $1,600,000 payment on this note in year X, when the prevailing Country T bond rate is 1%.

(ii) Both the note and the stock issued by FS to FP are financing transactions. The note is an advance of money under paragraph (a)(2)(i)(A) of this section. The stock is described in paragraph (a)(2)(ii)(A)(2) of this section, by reason of paragraph (a)(2)(ii)(B)(1)(iv) of this section, because Country T law entitles FS to a notional interest deduction with respect to its stock. The note issued by DS is also financing transaction by reason of paragraph (a)(2)(ii)(A)(1) of this section. Accordingly, FP is advancing money and DS receives money, effected through FS an intermediary entity, and the receipt and advance are effected through financing transactions (that is, the FS note, FS stock, and the DS note linking all three entities). As such, the arrangement may be treated as a financing arrangement. See paragraph (a)(2)(i)(A) of this section. FP is the financing entity, FS is the intermediate entity, and DS is the financed entity. The aggregate principal amount of financing transactions linking DS to the financing arrangement ($20,000,000) is greater than the aggregate principal amount of the financing transactions linking FP to the financing arrangement ($15,000,000). Therefore, under paragraph (d)(1)(i) of this section, the amount of DS's payment recharacterized as a payment directly between DS and FP would be $1,200,000 ($1,600,000 x $15,000,000 / $20,000,000) prior to the application of paragraph (d)(1)(iii) of this section. However, of the $1,200,000 subject to re-characterization, $400,000 ($1,200,000 x $5,000,000 / $15,000,000) is attributable to NID stock and thus subject to the limitation in paragraph (d)(1)(iii) of this section. Thus, only $50,000 ($5,000,000 x 1%) of the $400,000 may be recharacterized as a transaction between DS and FP. The remaining $800,000 is not subject to the limitation in paragraph (d)(1)(iii) of this section because it is not attributable to stock that entitles the issuer to a notional interest deduction. Accordingly, only $850,000 of DS's payment is recharacterized as going directly from DS to FP. See also §1.267A-4 for rules applicable to disqualified imported mismatch amounts.

(f) Applicability date. * * * Paragraphs (a)(2)(ii)(B)(1)(iv) and (v) and (d)(1)(iii) of this section apply to payments made on or after [date of publication of the final regulations in the **Federal Register]**.

Par. 4. Section 1.951A-0, as proposed to be amended at 84 FR 29114 (June 21, 2019), is further amended by adding entries for §1.951A-2(c)(6), (c)(6)(i) and (ii), (c)(6)(ii)(A) through (C), (c)(6)(iii), (c)(6)(iv), (c)(6)(iv)(A), (c)(6)(iv)(A)(1) and (2), (c)(6)(iv)(B), (c)(6)(iv)(B)(1) and (2), (c)(7), (c)(7)(i) and (ii), (c)(7)(ii)(A), (c)(7)(ii)(A)(1) and (2), (c)(7)(ii)(B), (c)(7)(iii) through (v), (c)(7)(v)(A) through (D), (c)(7)(v)(D)(1) and (2), (c)(7)(v)(D)(2)(i) and (ii), (c)(7)(v)(E), (c)(7)(v)(E)(1) and (2), (c)(7)(vi), (c)(7)(vi)(A), (c)(7)(vi)(A)(1) and (2), and (c)(7)(vi)(B) and §1.951A-7(d) to read as follows:

§1.951A-0 Outline of section 951A regulations.
* * * * *
§1.951A-2 Tested income and tested loss.
* * * * *
(c) * * *
(6) Allocation of deductions attributable to certain disqualified payments.
(i) In general.
(ii) Definitions related to disqualified payment.
(A) Disqualified payment.
(B) Disqualified period.
(C) Related recipient CFC.
(iii) Treatment of partnerships.
(iv) Examples.
(A) Example 1: Deduction related directly to disqualified payment to related recipient CFC.
(1) Facts.
(2) Analysis.
(B) Example 2: Deduction related indirectly to disqualified payment to partnership in which related recipient CFC is a partner.
(1) Facts.

(2) Analysis.
(7) Election for application of high tax exception of section 954(b)(4).
(i) In general.
(ii) Definitions.
(A) Tentative gross tested income item.
(1) In general.
(2) Income attributable to a QBU.
(B) Tentative net tested income item.
(iii) Effective rate at which taxes are imposed.
(iv) Taxes paid or accrued with respect to a tentative net tested income item.
(v) Rules regarding the election.
(A) Manner of making election.
(B) Scope of election.
(C) Duration of election.
(D) Revocation of election.
(1) In general.
(2) Limitations by reason of revocation.
(i) In general.
(ii) Exception for change of control.
(E) Rules applicable to controlling domestic shareholder groups.
(1) In general.
(2) Definition of controlling domestic shareholder group.
(vi) Example.
(A) Example: Effect of disregarded payments between QBUs.
(1) Facts.
(2) Analysis.
(B) [Reserved]

* * * * *

§1.951A-7 Applicability dates.

* * * * *
(d) Deduction for certain disqualified payments.

Par. 5. Section 1.951A-2, as proposed to be amended at 84 FR 29114 (June 21, 2019), is further amended by redesignating paragraph (c)(6) as paragraph (c)(7) and adding a new paragraph (c)(6) and a reserved paragraph (c)(7)(vi)(B) to read as follows:

§1.951A-2 Tested income and tested loss.

* * * * *

(c) * * *

(6) Allocation of deductions attributable to certain disqualified payments--(i) In general. A deduction related directly or indirectly to a disqualified payment is allocated or apportioned solely to residual CFC gross income, and any deduction related to a disqualified payment is not properly allocable to property produced or acquired for resale under section 263, section 263A, or section 471.

(ii) Definitions related to disqualified payment. The following definitions apply for purposes of this paragraph (c)(6).

(A) Disqualified payment. The term disqualified payment means a payment made by a person to a related recipient CFC during the disqualified period with respect to the related recipient CFC, to the extent the payment would constitute income described in section 951A(c)(2)(A)(i) and paragraph (c)(1) of this section without regard to whether section 951A applies.

(B) Disqualified period. The term disqualified period has the meaning provided in §1.951A-3(h)(2)(ii)(C)(1), substituting "related recipient CFC" for "transferor CFC."

(C) Related recipient CFC. The term related recipient CFC means, with respect to a payment by a person, a recipient of the payment that is a controlled foreign corporation that bears a relationship to the payor described in section 267(b) or 707(b) immediately before or after the payment.

(iii) Treatment of partnerships. For purposes of determining whether a payment is made by a person to a related recipient CFC for purposes of paragraph (c)(6)(ii)(A) of this section, a payment by or to a partnership is treated as made proportionately by or to its partners, as applicable.

(iv) Examples. The following examples illustrate the application of this paragraph (c)(6).

(A) Example 1: Deduction related directly to disqualified payment to related recipient CFC--(1) Facts. USP, a domestic corporation, owns all of the stock in CFC1 and CFC2, each a controlled foreign corporation. Both USP and CFC2 use the calendar year as their taxable year. CFC1 uses a taxable year ending November 30. On October 15, 2018, before the start of its first CFC inclusion year, CFC1 receives and accrues a payment from CFC2 of $100x of prepaid royalties with respect to a license. The $100x payment is excluded from subpart F income pursuant to section 954(c)(6) and would constitute income described in section 951A(c)(2)(A)(i) and paragraph (c)(1) of this section without regard to whether section 951A applies.

(2) Analysis. CFC1 is a related recipient CFC (within the meaning of paragraph (c)(6)(ii)(C) of this section) with respect to the royalty prepayment by CFC2 because it is related to CFC2 within the meaning of section 267(b). The royalty prepayment is received by CFC1 during its disqualified period (within the meaning of paragraph (c)(6)(ii)(B) of this section) because it is received during the period beginning January 1, 2018, and ending November 30, 2018. Because it would constitute income described in section 951A(c)(2)(A)(i) and paragraph (c)(1) of this section without regard to whether section 951A applies, the payment is a disqualified payment. Accordingly, CFC2's deductions related to such payment accrued during taxable years ending on or after **[INSERT DATE OF FILING WITH THE FEDERAL REGISTER]** are allocated or apportioned solely to residual CFC gross income under paragraph (c)(6)(i) of this section.

(B) Example 2: Deduction related indirectly to disqualified payment to partnership in which related recipient CFC is a partner--(1) Facts. The facts are the same as in paragraph (c)(6)(iv)(A)(1) of this section (the facts in Example 1), except that CFC1 and USP own 99% and 1%, respectively of FPS, a foreign partnership, which has a taxable year ending November 30. USP receives a prepayment of $110x from CFC2 for the performance of future services. USP subcontracts the performance of these future services to FPS for which FPS receives and accrues a $100x prepayment from USP. The services will be performed in the same country under the laws of which CFC1 and FPS are created or organized, and the $100x prepayment is not foreign base company services income under section 954(e) and §1.954-4(a). The $100x prepayment would constitute income described in section 951A(c)(2)(A)(i) and paragraph (c)(1) of this section without regard to whether section 951A applies.

(2) Analysis. CFC1 is a related recipient CFC (within the meaning of paragraph (c)(6)(ii)(C) of this section) with respect to the services prepayment by USP because, under paragraph (c)(6)(iii) of this section, it is treated as receiving $99x (99% of $100x) of the services prepayment from USP, and it is related to USP within the meaning of section 267(b). The services prepayment is received by CFC1 during its disqualified period (within the meaning of paragraph (c)(6)(ii)(B) of this section) because it is

received during the period beginning January 1, 2018, and ending November 30, 2018. Because it would constitute income described in section 951A(c)(2)(A)(i) and paragraph (c)(1) of this section without regard to whether section 951A applies, the prepayment is a disqualified payment. CFC2's deductions related to its prepayment to USP are indirectly related to the disqualified payment by USP. Accordingly, CFC2's deductions related to such payment accrued during taxable years ending on or after **[INSERT DATE OF FILING WITH THE FEDERAL REGISTER]** are allocated or apportioned solely to residual CFC gross income under paragraph (c)(6)(i) of this section.

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Par. 6. Section 1.951A-7, as proposed to be amended at 84 FR 29114 (June 21, 2019), is further amended by adding paragraph (d) to read as follows:

§1.951A-7 Applicability dates.

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(d) Deduction for certain disqualified payments. Section §1.951A-2(c)(6) applies to taxable years of foreign corporations ending on or after **[INSERT DATE OF FILING WITH THE FEDERAL REGISTER]**, and to taxable years of United States shareholders in which or with which such taxable years end.

Sunita Lough,

Deputy Commissioner for Services and Enforcement.

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