

¶760 Related Party Payments Involving Hybrid Entities or Hybrid Transactions

NEW LAW EXPLAINED

Deduction for disqualified related party payments involving hybrid transactions or hybrid entities denied.—A deduction is disallowed for a disqualified related party amount paid or accrued pursuant to a hybrid transaction. A deduction is also disallowed for a disqualified related party amount paid or accrued by, or to, a hybrid entity (Reg. §267A(a), as added by the Tax Cuts and Jobs Act of 2017).

Any interest or royalty paid or accrued to a related party is a "disqualified related party amount" to the extent that under the tax law of the country where the related party is a resident for tax purposes or is subject to tax:

- the amount is not included in the income of the related party, or
- the related party is allowed a deduction for the amount (Code Sec. 267A(b)(1), as added the 2017 Tax Cust Act).

A disqualified related party amount does not include any payment that is included in the gross income of a U.S. shareholder under subpart F and Code Sec. 951(a).

A "related party" means a related person as defined under Code Sec. 954(d)(3), except that the person is related to the payor rather than a controlled foreign corporation (CFC) (Code Sec. 267A(b)(2), as added by the 2017 Tax Cuts Act). Thus, a related person includes any individual, corporation, partnership, trust, or estate, that directly or indirectly, controls or is controlled by the payor (or is controlled by the same person that controls the payor). Control is ownership of more than 50 percent (by vote or value) of the corporation's stock or more than a 50 percent (by value) of the beneficial interests in a partnership, trust or estate.

EXAMPLE

Foreign Corporation owns two U.S. subsidiaries, a C corporation and an LLC. The LLC is treated as a partnership for U.S. tax purposes and a corporation for foreign tax purposes. Interest is paid by the C corporation to the LLC. The interest payment flows through LLC to the Foreign Corporation as a dividend and is excluded from tax under foreign country tax. The payment of the interest may not be deducted by the C corporation because the payment is a disqualified related party amount. Interest is paid to the Foreign Corporation, which controls the payor C corporation and so is a related party. The amount is not included in the income of the Foreign Corporation under the tax laws of the Foreign Corporation.

Hybrid transaction. A hybrid transaction means any transaction, series of transactions, agreement, or instrument, if one or more payments are treated as interest or royalties for federal income tax purposes, but are not treated as such for purposes of the tax law of the foreign country where the recipient of the payment is resident for tax purposes or is subject to tax (Code Sec. 267A(c), as added by the 2017 Tax Cuts Act).

Hybrid entity. A hybrid entity means any entity that is either:

- 1) treated as fiscally transparent for federal income tax purposes, but not under the tax law of the foreign country where the entity is resident for tax purposes or is subject to tax, or
- 2) treated as fiscally transparent under the tax law of the foreign country where the entity is resident for tax purposes or is subject to tax, but not for federal income tax purposes (Code Sec. 267A(d), as added by the 2017 Tax Cuts Act).

Regulations. The Secretary is authorized under Code Sec. 267A to issue regulations or other guidance as necessary and appropriate to carry out this provision, including regulations or other guidance providing rules for:

- 1) denying deductions for conduit arrangements involving a hybrid transaction or hybrid entity;
- 2) the application of this provision to foreign branches;
- 3) applying this provision to certain structured transactions;
- 4) denying all or a portion of a deduction claimed for an interest or a royalty payment that, as a result of the hybrid transaction or entity, is included in the recipient's income under a preferential tax regime of the country of residence of the recipient and has the effect of reducing the country's generally applicable statutory tax rate by at least 25 percent;
- 5) denying all of a deduction claimed for an interest or a royalty payment if the amount is subject to a participation exemption system or other system providing for the exclusion or deduction of a substantial portion of the amount;
- 6) rules for determining the tax residence of a foreign entity if the foreign entity is otherwise considered a resident of more than one country or of no country;
- 7) exceptions to the general rule set forth in the provision; and
- 8) requirements for record keeping and information in addition to any requirements imposed by Code Sec. 6038A (Code Sec. 276A(e), as added by the 2017 Tax Cuts Act).

Effective date. The amendment made by this section applies to tax years beginning after December 31, 2017 (Act Sec. 14222(c) of the Tax Cuts and Jobs Act).