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HYBRID MISMATCH.COM: NEUTRALIZING THE TAX EFFECTS OF HYBRID MISMATCH ARRANGEMENTS

by

Maria S. Domingo*

I. INTRODUCTION

One reality is as certain as taxes: when people—even accountants—think of taxes, dating is not the first topic to come to mind. Oddly enough, though, what follows closely resembles today's online dating phenomenon (at least as closely as tax ever could).

What began as personals or personal ads, first printed in local newspapers, have evolved into global online dating services, which are now commonly used by individuals who are looking to find their "perfect match." These services provide subscription dating products around the world through websites and mobile applications that help individuals in their quest to find and develop a meaningful connection.[1] Online dating includes search and matching features that enable users to search profiles, receive algorithmic matches and may use location-based technology—the mix of these features is "constantly subject to iteration and evolution" in response to "competitors' offerings, user requirements, social trends and the technological landscape."[2] In the digital world, online dating, akin to a present

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day matchmaker, has yielded favorable outcomes for many of its users and produced lucrative business results.[3]

Much like individuals looking to find their "perfect match," multinational enterprises (MNEs) have found connections in the tax laws of various jurisdictions to develop the perfect *mis*match in their cross-border transactions, which until recently has produced favorable outcomes for MNEs and lucrative tax savings. Consistent with the premise that "opposites attract," hybrid mismatch arrangements use the differences in the tax treatment of financial instruments, entities or transfers to create favorable asymmetrical tax effects between countries that are part of the same transaction. The mismatch can result in a deduction with no corresponding income inclusion or even a double deduction that erodes the MNEs' tax bases in the applicable jurisdictions and substantially reduces their aggregate tax burden. In a globalized world, governments need to consider how different tax regimes interact with each other in cross-border activities and the overall tax effect of these transactions. As part of the Tax Cuts and Jobs Act, the United States has codified key provisions (in line with the OECD's Base Erosion and Profit Shifting Plan) meant to shut down the effects of hybrid mismatch arrangements. However, different tax jurisdictions have divergent interests and reason follows that each country's goal is to protect its tax revenue. Absent global minimum standards, how long before taxpayers evolve with another iteration of tax strategies that work around anti-hybrid recommendations in perhaps more amenable locales or jurisdictions?

The remainder of this article proceeds as follows: Part II provides background regarding the U.S. worldwide tax system (prior to Pub. L. 115-97) compared to the territorial tax system. Parts III and IV provide an overview of hybrid mismatch arrangements and discuss tax policy issues. Part V navigates

through the key provisions of the Tax Cuts and Jobs Act that directly impact hybrid mismatch arrangements and discusses proposals for reform. Lastly, Part VI concludes.

II. TAX REGIMES

Background – U.S. Tax System

U.S. international transactions are generally divided into two broad categories for tax purposes: outbound transactions and inbound transactions. Outbound transactions involve U.S. citizens and residents (including domestic corporations created or organized in the U.S.) doing business and/or investing abroad; as inbound transactions involve foreign taxpayers (nonresident aliens and foreign corporations) doing business and/or investing in the U.S.

Outbound Transactions:

From a U.S. tax perspective, "outbound" pertains to U.S. persons, i.e., individuals or entities with foreign source income and/or that engage in activities outside of the U.S. Prior to the Tax Cuts and Jobs Act of 2017 ("TCJA"),[4] the U.S. imposed a "worldwide" tax system (or residence-based system) in which domestic corporations were subject to U.S. tax on a worldwide basis. In general, domestic corporations were subject to U.S. income tax on all income irrespective of whether the corporation derived income from a U.S. source[5] or a foreign source. The U.S. imposed entity-level taxation on a C corporation's taxable income at statutory federal income tax rates of up to 35%. To ameliorate the potential for double taxation that may result from U.S. taxes imposed on a domestic corporation's foreign source income, the domestic corporation could claim a foreign tax credit for income taxes already paid to foreign countries, subject to certain limitations.[6]

A domestic parent corporation was subject to U.S. tax when its foreign corporate subsidiaries (which conduct foreign operations) repatriated their earnings as dividend distributions to the U.S. parent corporation. As a result, the U.S. tax on such income was generally deferred until the foreign subsidiary repatriated the income—that is, U.S. multinationals could defer U.S. tax indefinitely on their foreign subsidiaries' active income until the foreign subsidiary repatriated the income as a dividend to the U.S. parent corporation.[7] Under Subpart F[8] prior to its amendment under TCJA and the passive foreign investment company[9] provisions of the Internal Revenue Code (anti-deferral tax provisions), the domestic parent corporation was subject to immediate U.S. tax only on certain items that its foreign subsidiaries earned as passive income (e.g., interest, dividends, annuities, rents and royalties) or highly mobile income regardless of whether the foreign subsidiaries distributed the income as a dividend to their U.S. parent corporation. The Subpart F provisions, in essence, treated certain passive income of a controlled foreign corporation as a deemed dividend to its U.S. parent subject to immediate U.S. taxation (i.e., no deferral until repatriation).

Simply put, a U.S. multinational company was subject to U.S. tax on its worldwide income reduced by foreign tax credits and active foreign profits (e.g., foreign subsidiary's earnings) only upon repatriation to a U.S. parent. As a result, multinational enterprises ("MNEs") implemented tax strategies to shift profits from the U.S.[10] to no-tax or low-tax jurisdictions.

Inbound Transactions:

From a U.S. tax perspective, "inbound" pertains to non-U.S. persons, i.e., individuals and entities with U.S. income and/or that engage in U.S. activities—including, for example, a

foreign corporation with U.S. source income and/or U.S. activities. Prior to the TCJA, foreign corporations were subject to U.S. tax only on income with sufficient nexus to the U.S., i.e., income "effectively connected" with the conduct of a trade or business in the U.S. In other words, the U.S. taxes a foreign corporation's income generated within U.S. borders. "Effectively connected income" generally requires that the taxpayer have a physical presence or use assets in the U.S., and such income is taxed the same as income of a U.S. corporation (e.g., same tax rates). However, tax treaties between the U.S. and the applicable foreign country may cap the amount of U.S. tax on a foreign subsidiary's income.[11] Moreover, foreign corporations are still generally subject to a U.S. withholding tax of 30% on interest, dividends, rents, royalties and certain types of income from U.S. sources, which a treaty may also decrease or eliminate.

Territorial Tax

Many other countries have adopted the "territorial" tax system (or source-based tax system), in which a country taxes an MNE's income sourced only within its borders, i.e., income earned within the country's tax jurisdiction. Foreign source income (i.e., income generated outside of the country's borders) is not subject to tax by the corporation's country of residence under this system. Therefore, the territorial tax system generally exempts from taxation the distributions of controlled foreign subsidiaries. As such, it is important for countries that have implemented a territorial tax regime to determine accurately the source of a multinational's revenues and expenses. Pursuant to the participation exemption,[12] the U.S. has recently made strides toward a territorial tax system via a 100% dividends-received deduction on certain foreign source income distributed to U.S. corporate shareholders.

III. HYBRID MISMATCH ARRANGEMENTS

In recent years, governments have become increasingly alarmed by MNEs' use of aggressive tax planning in their cross-border transactions.[13] The practical reality is that a multinational corporate group functions more akin to a single undivided organization rather than separate individual organizations—that is, the parent corporation may strategically coordinate its direct or indirect control of subsidiaries and/or affiliates to reduce overall taxes of the group and thereby increase profitability as a whole.[14] Revenue authorities and tax policy makers have expressed concerns about the difficulty of taxing MNEs engaged in cross-border activities (e.g., lack of transparency, increased level of complexity and sophistication in structuring cross-border transactions) and a rise in BEPS.[15] The different tax regimes of multiple jurisdictions have resulted in asymmetrical tax effects between countries that are part of the same transaction. This asymmetry, in turn, enables taxpayers to engage in base erosion and profit shifting.[16] Therefore, it is imperative in a globalized world for governments to consider how different tax regimes interact with each other in cross-border activities and the overall tax effect of these transactions.[17]

In an effort to neutralize aggressive tax planning, the Organization of Economic Cooperation and Development ("OECD")[18] and G20[19] countries have adopted a 15 Action Item plan to address BEPS. In 2015, the OECD issued final reports on the 15 Action Items, which aim to ensure that profits are taxed in the jurisdiction where the MNEs performed the economic activities that produced such profits and where value was created.[20] Interestingly, the OECD's recommendations require that one country (to determine its own tax treatment) take into consideration the taxpayer's position and tax treatment in another country. This view is generally alien to legislators in most jurisdictions whose primary concern is to protect their own

country's tax base. In particular, Action 2 provides recommendations for domestic law and tax treaty provisions to neutralize the effects of hybrid mismatch arrangements. In a surprise move, the U.S. has more recently enacted legislation that adopts a number of the OECD's recommendations. But are these recommendations enough to curtail these arrangements?

What are hybrid mismatch arrangements?

Hybrid mismatch arrangements are cross-border transactions that exploit the differences in the tax treatment of financial instruments, entities or transfers between two or more tax regimes. These arrangements both comply with the tax laws of the applicable jurisdictions and yet, use the very same laws to erode the tax bases in these countries. Oftentimes to the benefit of the taxpayer (and detriment of revenue authorities), these arrangements may result in "double non-taxation" or tax deferral. Hybrid mismatch arrangements can substantially reduce the aggregate tax burden of MNEs that are engaged in these transactions.[21] The structured arrangements generally use hybrid financial instruments, hybrid transfers, and/or hybrid entities to achieve (1) a deduction with no corresponding income inclusion ("D/NI"), (2) a double deduction ("DD"), (3) an indirect D/NI or (4) foreign tax credits.

Specifically, D/NI arrangements create a deduction in the payer jurisdiction (e.g., interest expense, which erodes the MNE's tax base in that country) without a corresponding inclusion in the payee's ordinary income by a second country that is involved in the same transaction. Simply put, a multinational group deducts a payment under the tax system of the payer jurisdiction without a requisite inclusion in the payee's ordinary income. In DD arrangements, the MNE claims an income tax deduction for the same contractual obligation in two different jurisdictions—that is, multiple deductions are claimed

for a single expense. Foreign tax credit generator arrangements enable MNEs to generate foreign tax credits that would otherwise be unavailable (e.g., generate multiple foreign tax credits for one amount of foreign tax paid). Indirect D/NI arrangements involve payments that are deductible in the payer jurisdiction, which the payee then offsets against a deduction under a hybrid mismatch arrangement. Accordingly, hybrid mismatch arrangements reduce the taxpayer's collective tax base resulting in significant overall tax savings.[22]

Cross-border conflicts in the characterization of a payment between multiple jurisdictions can result in tax mismatches of sorts. The OECD's recommendations are "linking rules" intended to align one tax jurisdiction's treatment of a hybrid financial instrument or hybrid entity with the tax consequences in the counterparty jurisdiction to the transaction. The rationale behind the recommendations is to "ensure matching of income and deductions across international boundaries."[23] The OECD divides the recommendations into a primary response and secondary/defensive rule where the defensive rule is administered only if the other jurisdiction lacks a hybrid mismatch rule or the jurisdiction does not apply the rule to the arrangement.[24] The rules focus on the payments and whether the characterization of the payment results in a deduction for the payer and income recognition for the payee. In general, the primary rule provides that the payer jurisdiction deny the taxpayer's deduction for a payment if the payment is excluded from payee's (recipient) taxable income in the counterparty jurisdiction or the counterparty jurisdiction also permits a deduction for the same payment. If the payer's jurisdiction does not apply the primary rule, then the counterparty jurisdiction may apply the defensive rule, which requires the payee to include the amount as income or deny the duplicate deduction.[25] In order for these rules to apply, a hybrid

element must bring about the mismatch in tax outcomes in the first place.

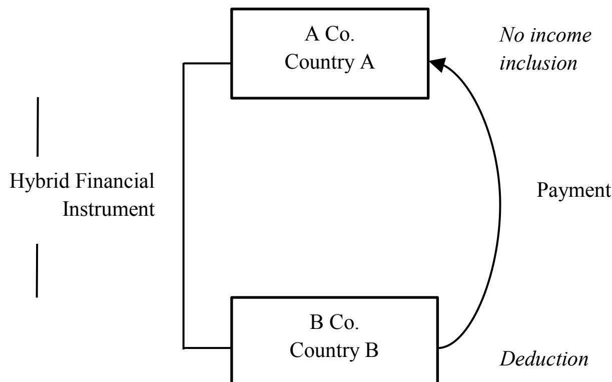
The OECD's approach is to provide recommendations upon which each country can legislate domestically in a consistent and coherent manner with other jurisdictions. The following discusses simplified examples[26] of hybrid mismatch arrangements to illustrate their overall tax effect along with the OECD's recommendations for domestic law to counteract these transactions.

Hybrid Financial Instruments:

Hybrid financial instruments are instruments that two or more countries involved in the same transaction treat differently for tax purposes because of a conflict in the tax jurisdictions' characterizations of the instrument. For example, the instrument is considered debt in one jurisdiction and equity in another jurisdiction. In other words, the jurisdictions differ in their tax treatment of the same payment, which the taxpayer makes under the instrument. In the following example, an MNE uses a hybrid financial instrument to achieve a favorable D/NI result.

Example 1:[27] A Co., a resident of Country A, owns 100% of B Co., a resident of Country B. Country A's domestic law exempts dividends paid by a foreign company if its shareholder held greater than 10% of the company's shares in the 12-month period before the foreign company pays the dividend. Country A has no law in place that denies the dividend exemption in the payee jurisdiction (Country A) for payments that are deducted in the payer's jurisdiction (Country B). In other words, Country A has no law in place that denies A Co. the dividend exemption in Country A for payments that B Co. deducts in Country B. B Co. borrows money from A Co. via a hybrid financial instrument. The terms of the loan require

a market interest rate payable every six months in arrears. B Co.'s interest and principal payments under the loan are subordinated to B Co.'s creditors and B Co. can defer the payments if it does not meet certain solvency requirements. It is important to consider the characterization of the instrument and tax treatment of the payments thereto under the domestic law of each party's jurisdiction.



Country A and Country B Perspectives: Country B treats the instrument as *debt* and permits the payer, B Co., to deduct the interest payments. Meanwhile Country A treats the instrument as *equity* and exempts the payment as a dividend under its domestic laws. Accordingly, A Co. is not subject to tax on receipt of the payment. Therefore, the transaction results in a D/NI outcome.

OECD's Recommendations: The OECD's recommendations are intended to align the treatment of an MNE's cross-border payments via a hybrid financial instrument such that if the payer's jurisdiction treats the payment as an expense then the payee's jurisdiction recognizes the payment as ordinary income.[28] As the primary recommendation, Country B

should deny B Co. the deduction to the extent the transaction causes a D/NI outcome, i.e., B Co.'s interest payment is denied to the extent A Co. excludes the amount from its income under Country A's laws. As the defensive rule, if Country B does not apply the primary response, then Country A should require A Co. to include the payment in ordinary income.

Example 1.1:[29] Interestingly, the OECD's final report includes an example using the territorial system. The facts are the same as Example 1 above except that Country A follows a territorial tax regime and, therefore, taxes only domestically sourced income. Furthermore, B Co. has no permanent establishment in Country A. A Co. treats the interest income from B Co. (a non-resident) as foreign source income, which is exempt from tax in Country A.

Country A and Country B Perspectives*:* Under the domestic laws of Country A, A Co. excludes the interest from its income and, thus, is not subject to tax on the interest income. B Co. may deduct the interest payment under the domestic laws of Country B. Therefore, the transaction results in a D/NI outcome.

OECD's Recommendation*:* Although the transaction results in a D/NI outcome, the mismatch is *not* derived from the terms of the financial instrument itself but rather the territorial tax regime of Country A—that is, A Co. is exempt from tax on any foreign source income. The parties could not change the terms of the instrument in any way that would make the interest payments taxable in Country A. Thus, the hybrid financial instrument rule applies only if the mismatch results from the terms of the financial instrument itself.

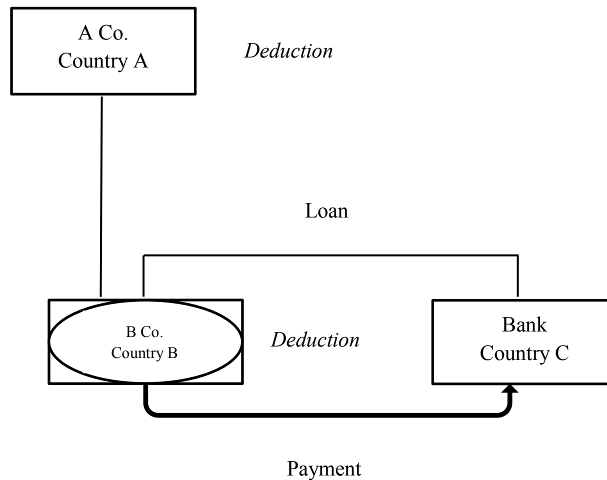
In contrast, in Example 1, Country A (payee jurisdiction) exempts only dividend income. Country A's tax exemption of

the dividends in Example 1 is attributable to both the source of the payments and the terms of the financial instrument. Therefore, the transaction results in a hybrid mismatch.

Hybrid Entities:

Hybrid entities are entities that one country considers non-transparent or opaque for tax purposes while another country treats the same entity as a transparent flow-through or disregarded entity. For example, one country may treat an entity as a C corporation (that is taxed as a separate legal entity) and another country treats the same entity as a partnership (whose partners are generally taxed on their share of the partnership's income subject to certain exceptions). In the following example, an MNE uses a hybrid entity to achieve a favorable DD result.

Example 2:[30] A Co., an entity resident of Country A, owns 100% of B Co., a foreign subsidiary in Country B. B Co. is a hybrid entity—that is, B Co. is treated as a disregarded entity under the laws of Country A and a separate legal entity under the laws of Country B for tax purposes. B Co. borrows money from a local bank and pays interest on the loan.



Country A and Country B Perspectives: Country B views B Co. as a separate legal entity, and, therefore, gives rise to an interest deduction in Country B. Meanwhile, A Country disregards B Co. and treats A Co. as the borrower of the loan permitting A Co. to deduct the interest payment in Country A as well. As a result, the taxpayer achieves a double deduction (i.e., Country A deduction and Country B deduction) for the same interest payment.

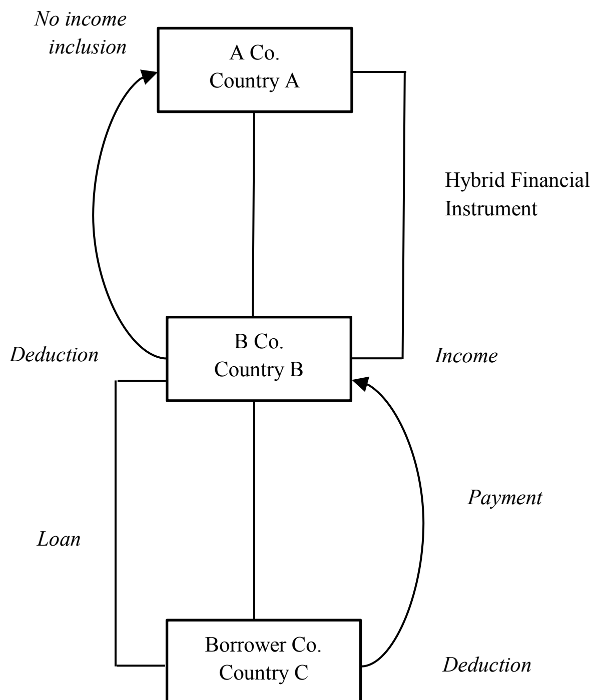
OECD's Recommendations: The OECD recommends a "linking rule" that aligns the tax results in the payer jurisdiction (Country B) with the parent jurisdiction (Country A).[31] The OECD's primary recommendation is for the parent jurisdiction (Country A) to deny the duplicate deduction to the extent the payment gives rise to a DD outcome. As the defensive rule, if the parent jurisdiction (Country A) does not apply the primary response, then the OECD recommends the payer jurisdiction

(Country B) deny the deduction to the extent the payment gives rise to a DD outcome. The defensive rule applies only if the parties to the mismatch are in the same control group or structured arrangement in which the taxpayer is party to that structured arrangement. Moreover, no mismatch arises to the extent the deduction offsets dual inclusion income. [32]

Imported Mismatch Arrangements:

After a taxpayer engages in a hybrid mismatch arrangement between two countries, the taxpayer may shift or import the tax benefit of that offshore hybrid mismatch into a third country via a financial instrument (e.g., an ordinary loan).[33] Imported mismatch arrangements rely on the void of effective hybrid mismatch rules in offshore jurisdictions to achieve the mismatch in tax results, which the taxpayer can then import into the payer jurisdiction. In the following example, an MNE uses an imported mismatch arrangement to achieve a favorable D/NI result.

Example 3:[34] A Co., an entity resident of Country A, owns 100% of B Co., an entity resident of Country B. A Co.'s business is to lend money to medium-sized enterprises. In a back-to-back financing arrangement, A Co. lends money to B Co. via a hybrid financial instrument, and B Co. then lends the same money to C Co., an entity resident of Country C. C Co. is sufficiently involved in the arrangement's design to understand its mechanics and anticipated tax results. Country A treats the hybrid financial instrument as *equity* and exempts the interest payment from B Co. as a dividend under its domestic laws. Country B treats the hybrid financial instrument as debt (to A Co.) and has not implemented hybrid mismatch rules under its domestic laws. C Co.'s financial instrument in Country C is an ordinary loan (from B Co.).



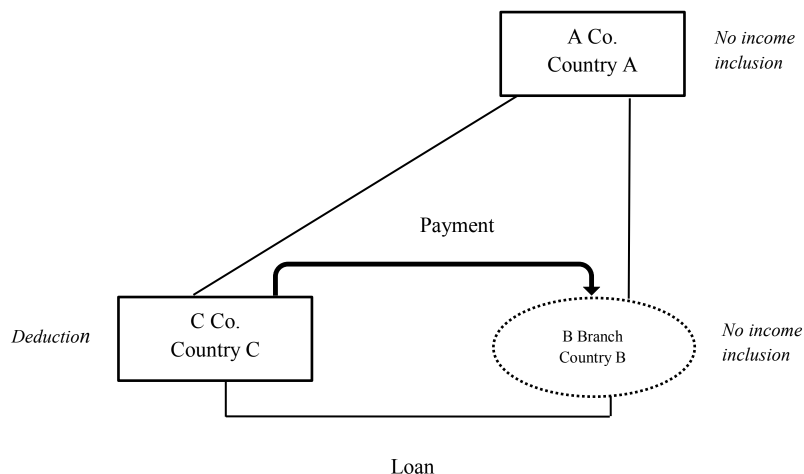
Country A, Country B, and Country C Perspectives: Country A exempts the interest payment from B Co. to A Co. from tax under Country A's domestic law, while B Co. deducts its interest payment to A Co. on its Country B tax return under Country B's laws. C Co. deducts its interest payment to B Co. on its Country C tax return under Country C's laws, while B Co. includes the receipt of the interest on its Country B tax return. As a result of this structure, the taxpayer achieves a favorable indirect D/NI outcome between Country A and Country C. In Country B, B Co.'s interest payment to A Co. should offset the interest income from C Co.

OECD's Recommendations: The OECD recommends a "linking rule" as its primary recommendation, which requires the payer jurisdiction to deny the deduction for the payment to the extent the payment generates an indirect D/NI tax result. In other words, the payer jurisdiction (Country C) should deny a deduction for payment to the extent the payee (B Co.) treats such payment as an offset against a hybrid deduction (B Co.'s interest payment to A Co.) in the payee jurisdiction (Country B).[35] Thus, if the primary response is implemented, then C Co.'s deduction is disallowed, B Co.'s receipt of interest income from C Co. is offset against B Co.'s interest payment to A Co., and A Co. recognizes no income on the interest received from B Co. There is no defensive rule for the imported mismatch arrangement.

Branch Mismatch Structures:

A mismatch can occur when one entity makes a deductible payment to a branch and the taxpayer's residence jurisdiction treats the payment as income received by its foreign branch, and, therefore, exempt from income tax under domestic law. Likewise, the branch's jurisdiction disregards the branch, and, thus, does not subject the income to tax. In other words, neither the residence jurisdiction nor the branch jurisdiction includes the payment in ordinary income. In the following example, an MNE uses a disregarded branch structure to achieve a favorable D/NI result.

Example 4:[36] A Co., an entity resident of Country A, has a branch in Country B (B Branch). A Co. lends money to C Co., a related company of A Co. and an entity resident of Country C, through B Branch. C Co. pays interest to B Branch on the loan.



Country A, Country B, and Country C Perspectives: C Co. deducts the interest payment under Country C's domestic laws. A Co. excludes the interest payment because the payment is attributable to a foreign branch (B Branch) under Country A's domestic laws. Moreover, Country B does not tax the interest income because A Co. does not have sufficient presence in Country B under that jurisdiction's domestic laws. Therefore, the structure gives rise to an intra-group mismatch that achieves a D/NI outcome.

OECD's Recommendations: The OECD recommends for a disregarded branch structure that the payer jurisdiction (Country C) deny C Co.'s deduction for a payment that gives rise to a D/NI outcome to the extent that the mismatch is a result of a payment to a disregarded branch (B Branch). Therefore, C Co. cannot deduct its interest payment to B Branch.[37]

IV. TAX POLICY

Hybrid mismatch arrangements raise several policy concerns that can impact tax revenue, competition, fairness, economic efficiency and transparency.[38] Although taxpayers incur initial costs for advice and implementation of hybrid mismatch arrangements, these arrangements can lead to significant tax savings—that is, MNEs have the potential to reduce the overall tax burden for the parties involved. Consequently, the tax authorities are unable to collect as much tax revenue and collectively lose revenue in the process. The tax advantages that these structures create may also provide MNEs with a competitive advantage in comparison to small or mid-sized companies, which cannot easily expend the cost for tax advice nor implement mismatch arrangements.[39] MNEs may have access to tax planning experts or strategies (which reduce their tax liabilities) but are cost prohibitive to smaller businesses, which some argue is inherently unfair.[40]

Hybrid mismatch arrangements can affect economic efficiency, i.e., investors may find cross-border investment more attractive in locales conducive to hybrid mismatches than an equal domestic investment.[41] Furthermore, hybrid mismatch arrangements may add to financial instability by increases in tax-favored leveraging or borrowing and a rise in risk-taking because investments that were uneconomic before tax may become practicable after tax. These tax-driven arrangements may also affect transparency if the public does not fully grasp the underlying cause of a taxpayer's low effective tax rate.[42]

The tax policy behind the BEPS project centers on the single tax principle, which provides that all income should be taxed only once.[43] Specifically, the tax rate that applies depends on whether the income is passive or active, i.e., passive income should be taxed at the residence country tax rate and active

income at the average source country tax rate. Thus, the single tax principle requires the removal of not only double taxation, but double **non**-taxation as well (e.g., D/NI, DD transactions).[44] Commentators have remarked that OECD's Action 2 solutions are "soft recommendations" rather than global minimum standards.[45] Consequently, the length of time for countries to converge and adopt these recommendations is unclear and may result in non-coordination and inconsistency. Although a number of countries have displayed their intent to legislatively integrate the OECD's recommendations, other countries may not act as deftly (or if at all) in this regard.[46] The divergent interests of different tax jurisdictions and unilateral action by some countries to protect tax revenue have made it difficult to establish a cohesive set of rules.[47]

To further complicate matters, each country must have a working knowledge of the tax treatment of the hybrid arrangements in other jurisdictions to apply the recommendations.[48] Without cooperation and transparency from the taxpayers themselves to apply these rules under the applicable domestic law of affected countries, government agencies may find it difficult to recognize and determine the tax effects of a hybrid mismatch arrangement (much less enforce the rules under local law). Moreover, taxpayers may find it appealing to restructure or replace existing hybrid mismatch arrangements with other planning opportunities that achieve the same D/NI or DD outcome but are beyond the reach of Action 2's linking rules, e.g., income exempt from tax under a pure territorial regime. Because each country can determine its own domestic laws, countries may continue to vary in their treatment of financial instruments (e.g., debt versus equity) or hybrid entities (e.g., transparent or separate taxable entity).[49] Yet, even worse, countries may engage in a "race to the bottom" that compromises the neutralizing effects of Action 2's recommendations in some tax jurisdictions.[50]

Despite these challenges, the OECD has reported some progress in this area. In particular, the OECD states:

> Although not a minimum standard, Action 2 has been rapidly adopted by a number of members of the OECD/G20 Inclusive Framework. EU Member States adopted hybrid and branch mismatch rules in Council Directive (EU) 2017 ("ATAD 2") and hybrid mismatch rules were also included as part of the US tax reform legislation, which passed into law at the end of last year.[51]

V. U.S. TAX IMPLICATIONS – THE EFFECTS OF THE TAX CUTS AND JOBS ACT

The Tax Cuts and Jobs Act has been touted as the most significant U.S. tax reform since the Tax Reform Act of 1986. As part of the recent tax overhaul, TCJA codified sweeping changes that impact international tax—specifically, tax provisions meant to deter and combat base erosion and profit shifting. TCJA's international tax provisions directly address the factors under prior law (i.e., high corporate tax rate, worldwide tax regime, deferral of overseas profits) that provided incentives for MNEs to engage in tax arbitrage. The TCJA reduced the corporate tax rate and added or modified provisions to limit interest expense deductions, tax unrepatriated earnings, move towards a territorial tax system, and impose a base erosion and anti-abuse tax ("BEAT"). The following discusses key provisions of TCJA that directly impact and may have been implemented to defeat (or at least deter) the effect of hybrid mismatch structures.

Corporate Tax Rate

Prior to TCJA, corporations were subject to a graduated tax rate structure and the top corporate tax rate was generally 35 percent on taxable income in excess of $10 million. Effective for taxable years beginning after December 31, 2017, TCJA provides a flat corporate tax rate of 21 percent.[52] Although the 21% U.S. corporate tax rate is significantly lower than the prior tax of 35%, this rate still exceeds the corporate tax rates of competing jurisdictions such as Ireland's 12.5% tax rate and the United Kingdom's 19% tax rate.[53] Arguably, other countries may respond to the U.S. in kind by competitively reducing their tax rates below the current U.S. corporate tax rate of 21%.[54]

Deemed Repatriation of Accumulated Post-1986 Deferred Foreign Income

The Joint Committee on Taxation estimated for 2015 that U.S. companies accumulated approximately $2.6 trillion of undistributed and previously untaxed foreign earnings offshore.[55] Under prior law, U.S. multinational companies could defer taxation on unrepatriated foreign earnings and profits generally declared as "permanently reinvested" abroad for financial statement purposes. TCJA imposes a one-time tax on these foreign earnings through the mechanism of deemed repatriation, which subjects previously untaxed foreign earnings to immediate taxation under the Subpart F rules.[56] As the U.S. moves towards a quasi-territorial tax system, the deemed repatriation tax is in essence a transition tax on previously unrepatriated foreign earnings. To ensure that all distributions from foreign subsidiaries are treated in the same manner under the quasi-territorial tax system (participation exemption system),[57] unrepatriated earnings must be taxed as if the earnings are repatriated subject to a reduced tax rate. The provision is effective for the last tax year of a foreign corporation that begins

before January 1, 2018, and with respect to U.S. shareholders, for the tax years in which or with which such foreign corporations' tax years end.

In general, the repatriation tax applies not only to controlled foreign corporations, but also foreign corporations in which a U.S. person owns a 10-percent voting interest.[58] A U.S. shareholder is required to include its pro rata share of certain foreign subsidiaries' post-1986 accumulated deferred foreign earnings and profits.[59] Pursuant to I.R.C. Section 965, the foreign corporation's Subpart F income is increased by the greater of accumulated post-1986 deferred foreign earnings determined as of November 9, 2017 or December 31, 2017[60] and the U.S. shareholder must include this amount in its gross income.[61] The inclusion, however, is reduced by the U.S. shareholder's pro rata share of deficits from certain foreign subsidiaries.[62] Moreover, the U.S. shareholder may deduct a portion of the income inclusion in a manner such that the deduction results in a reduced tax rate on the inclusion of previously untaxed foreign earnings.[63] The amount of the deduction depends on whether the deferred earnings are held in cash or other assets—that is, the U.S. shareholder may deduct from the inclusion the amount necessary to obtain a 15.5 percent effective tax rate on deferred foreign earnings held in cash (or cash equivalents) and an 8 percent effective tax rate on all other earnings (i.e., illiquid assets).[64] Furthermore, the U.S. shareholder may offset the tax with foreign tax credits subject to limitations, i.e., foreign tax credits are limited to the taxable portion of the inclusion.[65] The domestic corporation generally may elect to pay the tax liability over an eight-year period.[66]

Lastly, if a U.S. shareholder expatriates[67] within 10 years of TCJA's enactment on December 22, 2017 (i.e., 12/22/27), then the formerly domestic corporation is subject to recapture of the deduction.[68] Indeed, the expatriated entity[69] is denied any

deduction on the inclusion and the entire inclusion is taxed at 35 percent.

Interest Expense Limitation

Earnings stripping occurs when a corporation pays interest to a related party and the related party is not (or is only minimally) subject to U.S. tax on the corresponding interest income. Effective for tax years beginning after December 31, 2017, TCJA modified the earnings stripping provision under I.R.C. Section 163(j) by limiting the business interest deduction to the sum of the following for the taxable year:[70] (1) business interest income,[71] (2) 30 percent of the taxpayer's adjusted taxable income ("ATI") but not below zero, and (3) the taxpayer's floor plan financing interest.[72] ATI is defined as taxable income calculated without the following: (1) any item of income, gain, deduction or loss that is not properly allocable to a trade or business; (2) any business interest expense or business interest income; (3) any net operating loss deduction; (4) deductions for qualified business income under I.R.C. § 199A; and (5) for taxable years beginning before January 1, 2022, any deduction allowable for depreciation, amortization or depletion.[73] In other words, ATI is approximately equal to earnings before interest, taxes, depreciation and amortization for tax years after December 31, 2017 and before January 1, 2022. For tax years after December 31, 2021, ATI then approximately equals earnings before interest and taxes. Furthermore, the taxpayer may carryforward any disallowed business interest deductions indefinitely subject to certain restrictions.[74]

Example 5: For the taxable year ended December 31, 2018, A Corporation has business interest income of $1,000, ATI of $20,000 and no floor plan financing interest. A Corporation pays $10,000 of business interest expense. A Corporation's deduction for business interest is limited to

$7,000 [$1,000 + (30% x $20,000)] and the remaining $3,000 of disallowed interest is carried forward indefinitely.

Pursuant to an exception for small businesses, taxpayers with average annual gross receipts for the three-taxable-year period ending with the prior taxable year that do not exceed $25 million are exempt from the interest expense limitation.[75] Moreover, I.R.C. Section 163(j) does not apply to regulated public utilities, certain real estate industries (by taxpayer's election), electric cooperatives, the trade or business of performing services as an employee and farming businesses (by taxpayer's election).[76]

Participation Exemption System (a Quasi-territorial Tax System)

As discussed in Part II, countries that follow a territorial tax system impose tax only on income that is sourced within the specific country's borders. TCJA includes provisions that move the U.S. from a worldwide tax system toward a quasi-territorial tax regime under I.R.C. Section 245A. Effective for distributions made after December 31, 2017, a U.S. *corporation* that owns at least 10% stock of foreign corporations[77] may deduct 100 percent of the foreign-source portion of the dividends that it receives from these foreign corporations.[78] Notably, this provision does not apply to non-corporate U.S. shareholders (e.g., individuals). Furthermore, this dividend deduction applies only to income of foreign corporations and not to income of branches. I.R.C. Section 245A effectively exempts certain foreign source income through this 100-percent dividends-received deduction ("DRD") even if there is no withholding tax on the dividend at source and the foreign subsidiary paid the dividend from earnings that were not subject to foreign tax in its country of incorporation. The foreign-source portion of the dividend is the amount that bears the same

ratio to the dividend as the undistributed foreign earnings[79] bears to the foreign corporation's[80] total undistributed earnings and profits.[81] Furthermore, the Internal Revenue Code disallows a foreign tax credit or deduction for paid or accrued taxes attributable to the portion of a distribution that qualifies for the DRD.[82]

To qualify for the DRD, the U.S. corporation must satisfy a holding period requirement, i.e., the domestic corporation must hold the stock of the specified 10%-owned foreign corporation for more than 365 days during the 731-day period beginning on the date that is 365 days before the date on which the share becomes ex-dividend with respect to the dividend.[83] In essence, the U.S. has eliminated U.S. tax on repatriated foreign earnings in an effort to disincentivize U.S. multinationals from keeping their earnings offshore.

Hybrid Dividends:

I.R.C. Section 245A squarely addresses hybrid mismatch arrangements, which take advantage of the different tax treatments under U.S. and foreign laws of certain payments (e.g., hybrid financial instrument, hybrid entities) that produce D/NI or DD outcomes.[84] The purpose of the provision is to deter the benefits of such tax arbitrage and it follows generally (but does not codify all) the OECD's Action 2 recommendations for hybrid financial instruments.[85] In accordance with the single tax principle, a U.S. shareholder is disallowed from claiming the 100-percent DRD for any dividend from a controlled foreign corporation ("CFC") that is a hybrid dividend.[86]

As illustrated in the examples in Part III, a hybrid dividend results when a CFC distributes a dividend to a U.S. shareholder and both the foreign corporation and the U.S. shareholder can deduct the dividend under each entity's

respective tax jurisdictions—that is, the foreign corporation (payor) may claim a deduction (or other tax benefit) for the dividend in its country and the U.S. shareholder (payee) may also deduct the dividend in the U.S. under the general rule of I.R.C. Section 245A.[87] The U.S. shareholder, however, is denied the DRD, and thus, the double deduction that taxpayers may otherwise claim is prevented.[88] Moreover, if a controlled foreign corporation distributes a hybrid dividend to another recipient-controlled foreign corporation, then the latter treats the hybrid dividend as Subpart F income. Accordingly, its U.S. shareholder must include the shareholder's pro rata share in gross income.[89] Lastly, the U.S. shareholder cannot claim foreign tax credits or deductions for any taxes paid or accrued with respect to the hybrid dividend.[90] Under these circumstances, the provision effectively blocks the U.S. shareholder (payee) from the benefits of a tax-free repatriation of foreign income.

Base Erosion Anti-avoidance Tax
Cross-border Payments between Affiliated Companies:

In an effort to target base erosion and profit shifting, I.R.C. Section 59A (as added by TCJA) provides the base erosion anti-avoidance tax ("BEAT"). These provisions are meant to deter base erosion via deductible cross-border payments between affiliated companies (i.e., foreign parents or controlled foreign corporations).[91] Simply put, BEAT's purpose is to deter earnings stripping transactions, which multinational entities have used to shift profits to lower tax jurisdictions through intercompany transfers. BEAT appears to take particular aim at U.S. subsidiaries of foreign parents that shift profits outside of the U.S. through outbound payments.

In essence, BEAT is an alternative minimum tax, which an MNE must pay if it reduces its regular U.S. tax liability below

the applicable percentage of its modified taxable income for this purpose. BEAT applies to U.S.-owned and foreign-owned multinational corporations and casts its net on payments to foreign parents and foreign subsidiaries.[92] Consistent with the single tax principle, if the income is not subject to tax at residence, then BEAT imposes tax at the source of the income.[93]

Effective for base erosion payments paid or accrued in taxable years beginning after December 31, 2017, a taxpayer must pay a "base erosion minimum tax"[94] if (1) the taxpayer is a corporation (other than a regulated investment company, a real estate investment trust, or an S corporation) with average annual gross receipts of at least $500 million for the three-year taxable year period ending with the preceding tax year and (2) the corporation's base erosion percentage for the tax year is 3 percent[95] or greater.[96] The base erosion percentage is determined by dividing the taxpayer's aggregate base erosion tax benefits (generally, any deduction from certain base erosion payments to a foreign related party)[97] by the taxpayer's aggregate deductions allowed [tax-deductible expenses], taking into account base erosion tax benefits subject to certain exceptions.[98] A base erosion payment is (1) any deductible amount that a taxpayer paid or accrued to a foreign related party[99] (e.g., interest payment to foreign parent, royalty payment to foreign subsidiary), (2) paid or accrued to a foreign related party to acquire property that is subject to depreciation or amortization, (3) certain reinsurance payments to a foreign related party, or (4) certain payments with respect to a surrogate foreign corporation or related foreign persons that results in a reduction of the taxpayer's gross receipts.[100] Therefore, BEAT may significantly impact companies that depend on cross-border transactions (e.g., professional service, banks, insurance companies).

The tax is equal to the excess of the applicable rate (5% for taxable year beginning in 2018, 10% for tax year beginning in 2019 through 2025, and 12.5% for tax year beginning after December 31, 2025)[101] of the taxpayer's modified taxable income over its regular tax liability reduced by certain tax credits (but not below zero).[102] For this purpose, the modified taxable income is generally equal to taxable income without any base erosion tax benefit or base erosion percentage from a net operating loss deduction.[103] In other words, the taxpayer adds back to its taxable income any base erosion tax benefit and base erosion percentage from a net operating loss deduction. The taxpayer must compare taxes calculated under BEAT to its regular tax liability and, consequently, pay the higher levy. Notably, BEAT applies only to payments made to related parties, and thus, taxpayers may avoid BEAT altogether by transacting with customers or unrelated distributors.[104]

Hybrid Transactions or Hybrid Entities:

As discussed in Part III, a hybrid transaction is any transaction, series of transactions, agreement, or instrument where the payer's tax jurisdiction treats the payment(s) as deductible interest or royalties (e.g., U.S. federal income tax) while the payee recipient's jurisdiction does not. The difference in treatment between the jurisdictions results in a D/NI (deduction with no corresponding income inclusion) or DD (double deduction) mismatch to the taxpayer's benefit. A hybrid entity is considered fiscally transparent (e.g., partnership) for U.S. federal income tax purposes while another tax jurisdiction considers the same entity as non-transparent or opaque (e.g., C corporation) for tax purposes. In contrast, a reverse hybrid entity is considered non-transparent or opaque for U.S. tax purposes while another tax jurisdiction considers the same entity fiscally transparent.

Consistent with the OECD's BEPS Action 2 initiative and the single tax principle, I.R.C. Section 267A denies a deduction for payments to a related party pursuant to a hybrid transaction or hybrid entity if (1) there is no corresponding inclusion to the related party under its tax jurisdiction (D/NI) or (2) the related party is also allowed a deduction under its tax jurisdiction (DD). I.R.C. Section 267A is effective for tax years beginning after December 31, 2017.

Proposals for Reform

Practitioners and commentators have raised their concerns about the recent legislation, and in particular, technical and policy issues of the provisions involving hybrid arrangements. Overall, the consensus appears to be that the U.S. is moving in the right direction toward international tax reform, but there is still much work left to be done. The following discusses key issues and proposals for reform (through legislation or regulation) debated by commentators.

Deemed Repatriation Tax:

Deemed repatriation rules under I.R.C. Section 965 impose an immediate tax on previously untaxed foreign earnings at rates of 15.5% on cash and cash equivalents (i.e., liquid assets) held abroad and 8% on all other unrepatriated earnings (i.e., illiquid assets). Commentators have expressed a number of concerns about the technical aspects of this provision. First, cash equivalent as defined for this purpose appears overly broad. The definition of cash includes financial instruments, e.g., options contracts, futures contracts and bona-fide hedging transactions, that if held overseas are subject to a tax rate of 15.5% under these rules.[105] Commentators have argued that this treatment could be over-inclusive because some of these financial instruments may be illiquid or may have a non-tax

avoidance business purpose.[106] The Secretary is authorized to issue regulations or other guidance that may be necessary or appropriate to carry out the provisions of I.R.C. Section 965.[107] Accordingly, Treasury should provide regulatory guidance that clarifies the term cash and cash equivalents for this purpose.

Second, downward attribution rules (meant to limit corporate inversions) apply under I.R.C. Section 965 for purposes of determining the U.S. ownership of a foreign corporation. In other words, stock owned by a foreign corporation is attributed to a U.S. person for purposes of establishing a controlled foreign corporation. As a result, the amount of taxpayers defined as a U.S. shareholder in a CFC may increase and cause a higher inclusion of income subject to the deemed repatriation tax.[108] To prevent this over inclusion, Congress should consider limiting the downward attribution rules only to corporations.[109]

Third, the deemed repatriation tax is calculated using the higher measured base of two testing dates, i.e., November 2, 2017 and December 31, 2017. Commentators have raised a potential loophole related to the testing dates for taxpayers with fiscal year ends (rather than calendar year ends). Taxpayers with fiscal year ends (e.g., 6/30, 9/30) could potentially avoid additional cash accumulations (subject to the deemed repatriation tax) by distributing any increase as dividends.[110] To address this potential loophole, Treasury should provide guidance that considers the facts and circumstances of a taxpayer's cash movements and investments.[111]

Lastly, if history repeats itself, MNEs during the 2004 tax holiday used repatriated earnings to distribute dividends to or buyback stock from their shareholders rather than create new jobs nor invest in capital spending or expansion.[112] Although MNEs repatriated offshore earnings because of the transition

tax, a significant amount of the repatriated earnings was invested in stock buybacks.[113]

Interest Expense Limitation:

The interest expense limitation is directed at MNEs that use interest expense deductions to strip earnings out of higher-tax jurisdictions. Commentators have raised concerns over various methods taxpayers could use to avoid the limitation. For example, financial institutions with positive net interest can lease assets and deduct the rental payments on those leases.[114] Taxpayers could also opt to incur debt outside of the U.S. or to issue preferred equity.[115] The House and Senate bills included a provision specifically directed at profit shifting by restricting the U.S. entity's share of debt based on its income or assets; however, the provision was removed from the final legislation. To prevent taxpayers from circumventing the interest expense limitation, Congress should consider using a worldwide interest allocation that allows a U.S. company to deduct only its allocable share of interest expense based on its share of worldwide income.[116]

BEAT :

The primary purpose of BEAT is to deter earnings stripping transactions, which MNEs have used to shift profits to lower tax jurisdictions through intercompany payments between affiliated companies. Although BEAT appears to strengthen U.S. taxation of inbound transactions, commentators have argued over a number of issues that may impact the intended effect of the tax. First, commentators have asserted that the $500 million revenue threshold that triggers BEAT is too high, i.e., the amount is 10 times the threshold under I.R.C. Section 385 directed at earnings stripping. Because of the high threshold, many MNEs below this threshold that engage in profit shifting

transactions (otherwise subject to BEAT) are able to avoid the tax.[117] Moreover, BEAT does not apply unless the base erosion payments are above the specified threshold, which is generally 3%.

Both thresholds create a "cliff effect" and may encourage MNEs to plan their structures or transactions in a manner such that they fall right below the required thresholds to escape BEAT entirely—that is, $499 million in average annual gross receipts and/or a base erosion percentage of 2.99%.[118] Nonetheless, even when BEAT does apply, the nominal tax rate of 10% appears hardly sufficient to deter profit shifting.[119] To address these issues, Congress should consider the following: significantly reduce BEAT's $500 million revenue threshold and add an asset test similar to the thresholds under I.R.C Section 385's earnings stripping regulations; remove the base erosion percentage threshold of 3% altogether; and increase the BEAT rate of 10% to a tax rate that would more likely deter profit shifting. Perhaps Congress should simply restrict BEAT to outbound payments made to no or low tax jurisdictions.[120]

Second, base erosion payments, as defined, generally exclude payments for cost of goods sold (except for inverted corporations after November 9, 2017). As a result, taxpayers could exploit planning opportunities that avoid BEAT altogether such as capitalizing royalty payments into cost of goods sold, embedding foreign intellectual property into a product's cost of goods sold, or restructuring the supply chain.[121] For example, a U.S. subsidiary pays a foreign parent for tangible property and includes the goods in its inventory for sale. The U.S. subsidiary also pays a royalty to the foreign parent for the trademark or distribution rights of these goods. Because the royalty payments are capitalized as part of cost of goods sold, the U.S. subsidiary is able to elude BEAT on these royalty payments.[122] To prevent this loophole, commentators have suggested that base erosion

payments include payments for goods, but the taxpayer should be permitted to claim a cost component deduction (which would address the royalty payments concern).[123] However, there is no clear answer to this issue because a tax on cross-border sales of inventory could prove problematic with the World Trade Organization and, consequently, result in trade and treaty issues.[124]

Third, certain services with no mark-up (i.e., services using the service cost method) are excluded from base erosion payments. Commentators and practitioners disagree over the treatment of the cost component of services *with* a markup—that is, some argue that any service with a markup is included for BEAT purposes in total while others argue that only the markup is included.[125] Proposed Treasury Regulations clarify whether taxpayers may exclude any portion of the services with a markup from BEAT—that is, taxpayers may use the service cost method exception if there is a markup, but the portion of any payment that exceeds the total cost of services (the markup component) is ineligible for this exception and consequently a base erosion payment.[126]

Fourth, BEAT does not provide a credit for foreign taxes and, therefore, may function more as a tax on foreign source income rather than serve its intended purpose to limit profit shifting. For example, a multinational with substantial foreign source income from high tax jurisdictions makes the minimum base erosion payments subject to BEAT. Because there is no foreign tax credit for BEAT, it acts as a tax on foreign source income in this scenario instead of serving its intended purpose, which is to restrict the effects of profit shifting.[127] Accordingly, Congress should consider allowing a foreign tax credit for BEAT.[128]

Fifth, commentators expressed various other concerns including whether taxpayers must aggregate individual payments for BEAT purposes (e.g., if interest payments are assessed at a gross or net basis); BEAT is over-inclusive in certain circumstances (e.g., applies to ordinary transactions, nonabusive commercial transactions, and securities lending); BEAT may penalize routine lending transactions between groups; and BEAT may impact intragroup interest payments made by regulated financial intermediaries (e.g., banks, securities dealers).[129] To address these concerns, Congress should reconsider using a worldwide allocation of interest that allows a U.S. company to deduct only its allocable share of interest expense based on its share of worldwide income or assets.[130]

Finally, because the anti-hybrid provisions limit interest and royalty payments between related parties, MNEs may find ways to deduct other types of payments to create D/NI or DD outcomes.[131] In addition, a number of issues remain unresolved in this area, e.g., the treatment of conduit arrangements and multiple country arrangements, which may impact the effectiveness of the anti-hybrid provisions.[132] Treasury should provide guidance that addresses these remaining concerns.

VI. CONCLUSION

MNEs have used hybrid mismatch arrangements to produce favorable tax outcomes (D/NI or DD) that erode its tax bases in applicable jurisdictions through double non-taxation or tax deferral resulting in significant tax savings. In 2015, the OECD issued its final reports on the 15 Action Items included in its Base Erosion Profit Shifting Plan—specifically, Action 2 provides recommendations under domestic law to neutralize the

effects of hybrid mismatch arrangements. In an effort to defeat these transactions, the U.S. has codified key provisions in recent legislation that generally follow the OECD's recommendations and directly address in TCJA's anti-hybrid provisions the impact of hybrid mismatch arrangements. However, multilateral efforts are needed to deter hybrid mismatch arrangements and coherently dismantle the benefits of base erosion and profit shifting. Moreover, there is a risk that TCJA's recent provisions may be changed in the future, and as in any match, only time will tell if these provisions produce the results intended or if these transactions continue off the BEATen path as the "perfect mismatch."

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[1] Match Group, Inc., Annual Report (Form 10-K), at 3 (Dec. 31, 2017). Match Group, Inc. operates a portfolio of online dating brands including Match, Tinder, PlentyOfFish, Meetic, OkCupid, OurTime, and Pairs. *Id.*

[2] *Id.* at 4-5.

[3] *Id.* at 31 & 57.

[4] Tax Cuts and Jobs Act of 2017, Pub. L. 115-97, 131 Stat. 2054 (2017).

[5] Source refers to the country in which a taxpayer's income and expenses are allocated. I.R.C. §§ 861, 865.

[6] I.R.C. §§ 901, 904.

[7] *See* I.R.C. §§ 951–65.

[8] *See* I.R.C. §§ 954–64. The Subpart F provisions require U.S. shareholders of "controlled foreign corporations" ("CFC") to recognize their pro rata share of and pay U.S. tax on certain CFC income. In general, a CFC is a foreign corporation owned by U.S. shareholders who own more than 50% of the vote or value of the CFC's outstanding shares. I.R.C. § 951(b).

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[9] *See* I.R.C. §§ 1291–98, which impose current tax on U.S. shareholders of foreign investment companies.
[10] Prior to the TCJA, the U.S. corporate tax rate could reach up to 35%.
[11] For example, a foreign corporation may be subject to U.S. tax only on income from business operations that the foreign corporation conducted through a "permanent establishment" in the U.S.
[12] *See* Part V, *infra* (U.S. Tax Implications – The Effects of the Tax Cuts and Jobs Act).
[13] OECD, *Hybrid Mismatch Arrangements: Tax Policy and Compliance Issues* (May 3, 2012), http://www.oecd.org/ctp/exchange-of-tax-information/hybridmismatcharrangementstaxpolicyandcomplianceissues.htm [hereinafter OECD, *Hybrid Mismatch*].
[14] Reuven S. Avi-Yonah & Haiyan Xu, *Evaluating BEPS: A Reconsideration of the Benefits Principle and Proposal for UN Oversight*, 6 HARV. BUS. L. REV. 185 (2016), at 209, http://www.hblr.org/wp-content/uploads/2017/01/1.-Evaluating-BEPS.pdf.
[15] Joint Committee on Taxation, *Background, Summary, and Implications of the OECD/G20 Base Erosion and Profit Shifting Project*, JCX-139-15, Nov. 30, 2015 [hereinafter JCX-139-15].
[16] *Id.* at 9.
[17] OECD, *Hybrid Mismatch*, *supra* note 13, at 5.
[18] The OECD is a forum where governments across the globe work together to contend with economic, social and environmental challenges of globalization. *See* OECD, *Hybrid Mismatch, supra* note 13. The OECD has also provided a setting where governments can work to coordinate domestic and international policies. For example, the OECD has worked to develop normative tax principles that resolve conflicts over multi-jurisdictional claims to tax cross-border income. *See* JCX-139-15, *supra* note 15. The OECD includes the following member countries: Australia, Austria, Belgium, Canada, Chile,

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the Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Israel, Italy, Japan, Korea, Luxembourg, Mexico, the Netherlands, New Zealand, Norway, Poland, Portugal, the Slovak Republic, Slovenia, Spain, Sweden, Switzerland, Turkey, the United Kingdom and the United States. (JCX-139-15, *supra* note 15, at 4-5)

[19]The G20 is a forum for international economic cooperation, which includes the following member countries and the European Union: Argentina, Australia, Brazil, Canada, China, France, the European Union, Germany, India, Indonesia, Italy, Japan, the Republic of Korea, Mexico, Russia, Saudi Arabia, South Africa, Turkey, the United Kingdom, and the United States. (JCX-139-15, *supra* note 15, at 7)

[20] OECD, *Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2 – 2015 Final Report* (Oct. 5, 2015), http://www.oecd.org/ctp/neutralising-the-effects-of-hybrid-mismatch-arrangements-action-2-2015-final-report-9789264241138-en.htm [hereinafter OECD, *Final Report*].

[21] See OECD, *Hybrid Mismatch*, *supra* note 13.

[22] *Id.* at 7.

[23] Itai Grinberg, *The New International Tax Diplomacy*, 104 GEO. L.J. 1137 (2016), at 1174.

[24] OECD, *Final* Report, *supra* note 20; *see also* OECD, *Public Discussion Draft BEPS Action 2: Neutralise the Effects of Hybrid Mismatch Arrangements (Recommendations for Domestic Laws)* (2014), https://www.oecd.org/ctp/aggressive/hybrid-mismatch-arrangements-discussion-draft-domestic-laws-recommendations-march-2014.pdf.

[25] OECD, *Final* Report, *supra* note 20.

[26] For a detailed discussion of complex hybrid mismatch arrangements, see OECD, *Final* Report, *supra* note 20.

[27] OECD, *Final* Report, *supra* note 20, at 175, Ex. 1.1.

[28] OECD, *Final* Report, *supra* note 20, at 18.

[29] *Id.* at 195, Ex. 1.7.

[30] *Id*. at 326, Ex. 6.4.
[31] *Id*. at 17, 67, 69.
[32] Dual inclusion income is defined as "income brought into account for tax purposes
under the laws of both jurisdictions." *Id*. at 69. An item of income will be dual inclusion income "if the same item is included in income under the laws of the jurisdictions where the DD outcome arises." *Id*. at 71.
[33] *Id*. at 83.
[34] *Id*. at 443, Ex. 10.5.
[35] *Id*. at 83, 85.
[36] OECD, *Neutralising the Effects of Branch Mismatch Arrangements, Action 2* (July 27, 2017), http://www.oecd.org/tax/beps/neutralising-the-effects-of-branch-mismatch-arrangements-action-2-9789264278790-en.htm.
[37] *Id.* at 27, 28.
[38] OECD, *Hybrid Mismatch*, *supra* note 13, at 11.
[39] *Id.*
[40] *Id*. at 12.
[41] *Id.*
[42] *Id.* at 11–12.
[43] Grinberg, *supra* note 23, at 17.
[44] Avi-Yonah & Xu, *Evaluating BEPS*, *supra* note 14, at 23.
[45] *Id.* at 31.
[46] Mindy Herzfeld, *The Case Against BEPS – Lessons for Coordination*, 21 FLA. TAX REV. 1 (2017), at 7, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2985752. *But see* Part V, *infra* (U.S. Tax Implications – The Effects of the Tax Cuts and Jobs Act).
[47] Herzfeld, *supra* note 46, at 23, 32.
[48] Brett Wells, *Get with the BEAT*, TAX NOTES (Feb. 15, 2016), at 798-99.
[49] Avi-Yonah & Xu, *Evaluating BEPS*, *supra* note 14, at 31.
[50] *Id*.

[51] OECD, *OECD/G20 Inclusive Framework on BEPS: Progress Report July 2017-June 2018* (2018), at 26, http://www.oecd.org/tax/beps/inclusive-framework-on-beps-progress-report-july-2017-june-2018.pdf.
[52] I.R.C. § 11(b). *See* I.R.C. § 15(a) and Notice 2018-38, 2018-18 I.R.B. 38, which provides guidance for corporations whose fiscal tax year started before January 1, 2018 but ended after December 31, 2017.
[53] *See* KPMG CORPORATE TAX RATES TABLE, *at* https://home.kpmg.com/xx/en/home/services/tax/tax-tools-and-resources/tax-rates-online/corporate-tax-rates-table.html (last visited January 2, 2019).
[54] David Kamin *et al.*, *The Games They Will Play: Tax Games, Roadblocks, and Glitches Under the 2017 Tax Legislation*, 103 MINN. L. REV. (forthcoming), at 61–62, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3089423## .
[55] Joint Committee on Taxation, *Letter to U.S. House of Representatives*, Aug. 31, 2016, https://waysandmeans.house.gov/wp-content/uploads/2016/09/20160831-Barthold-Letter-to-BradyNeal.pdf.
[56] *See* Part II, *supra* (Tax Regimes).
[57] *See* Part V, *supra* (Participation Exemption System (a Quasi-territorial Tax System)).
[58] I.R.C. § 965(e)(1), which defines a “specified foreign corporation.”
[59] As defined in I.R.C. § 965(d)(2).
[60] I.R.C. § 965(a). *See* Joint Committee on Taxation, *General Explanation of Public Law 115-97*, JCS-1-18, Dec. 20, 2018 [hereinafter JCS-1-18], at 355-368.
[61] I.R.C. §§ 951(a), 965(f)(1). The E&P measurement dates are defined as November 2, 2017, and December 31, 2017, collectively, and each an E&P measurement date. Prop. Treas. Reg. § 1.965-1(f)(23). The final cash measurement date of a

specified foreign corporation is the close of the last taxable year of the specified foreign corporation that begins before January 1, 2018, and ends on or after November 2, 2017. Prop. Treas. Reg. § 1.965-1(f)(24). According to the preamble of the proposed regulations, "[t]he choice of a November 2, 2017, measurement date reflects an intent to impose a transition tax on a snapshot of earnings as of a date that coincides with the introduction of the Act in Congress, and reflects a general policy of disregarding taxpayer actions occurring after November 2, 2017, that reduce the taxpayer's liability imposed by reason of section 965..."

[62] I.R.C. § 965(b)(2).

[63] I.R.C. § 965(c).

[64] I.R.C. § 965(c). *See* Prop. Treas. Reg. § 1.965-1, REG-104226-18 (Aug. 1, 2018) for guidance on how to apply particular mechanical rules; Notice 2018-7, 2018-4 I.R.B. 317; Notice 2018-13, 2018-6 I.R.B. 341 and Notice 2018-26, 2018-16 I.R.B. 480; *see also* IRS Publication 5292: How to Calculate Code Sec. 965 Amounts and Elections Available to Taxpayers (Apr. 6, 2018), https://www.irs.gov/pub/irs-pdf/p5292.pdf.

[65] I.R.C. § 965(g).

[66] I.R.C. § 965(h)(1).

[67] *See* I.R.C. § 7874(a)(2).

[68] I.R.C. § 965(l)(1).

[69] I.R.C. § 965(l)(2).

[70] I.R.C. § 163(j)(1). *See* JCS-1-18, *supra* note 60, at 173-179; Prop. Treas. Reg. § 1.163(j)-1 *et seq.*, REG-106089-18 (Nov. 26, 2018) for specific guidance on how to determine the amount of deductible business interest expense.

[71] As defined in I.R.C. § 163(j)(6).

[72] I.R.C. § 163(j)(9)(A). Floor plan financing indebtedness is defined as "indebtedness used to finance the acquisition of motor vehicles for sale or lease" to retail customers and secured by the inventory so acquired. I.R.C. § 163(j)(9)(B).

[73] I.R.C. § 163(j)(8).

[74] I.R.C. § 163(j)(2).
[75] I.R.C. § 163(j)(3).
[76] I.R.C. § 163(j)(7).
[77] A "specified 10-percent owned foreign corporation" is defined as any foreign corporation (other than a passive foreign investment company that is not also a controlled foreign corporation) to which any domestic corporation is a U.S. shareholder. I.R.C. § 245A(b).
[78] I.R.C. § 245A(a). *See* JCS-1-18, *supra* note 60, at 348-351. Notably, portfolio U.S. investors are still subject to tax on foreign source dividends. Furthermore, if a U.S. parent corporation makes a dividend distribution to its taxable U.S. shareholders, the distribution is subject to tax at the capital gains rate.
[79] Undistributed foreign earnings include only the portion of undistributed earnings that is neither attributable to effectively connected income [I.R.C. § 245(a)(5)(A)] nor dividends from an 80-percent owned domestic corporation [I.R.C. § 245(a)(5)(B)]. I.R.C. § 245A(c)(3).
[80] I.R.C. § 245A(c)(1).
[81] I.R.C. § 245A(c)(2).
[82] I.R.C. § 245A(d).
[83] I.R.C. § 246(c)(5); H.R REP. NO. 115-466, at 600 (2017) (Conf. Rep.).
[84] I.R.C. § 245A(e)(1).
[85] OECD, *Final Report*, *supra* note 20.
[86] I.R.C. § 245A(e)(1).
[87] I.R.C. § 245A(e)(4).
[88] I.R.C. § 245A(e)(1).
[89] I.R.C. § 245A(e)(2).
[90] I.R.C. § 245A(e)(3).
[91] I.R.C. § 59A.
[92] Kamin *et al.*, *supra* note 54, at 56.
[93] R. Avi-Yonah, *The International Provisions of the TCJA: A Preliminary Summary and Assessment* (Univ. of Mich. Pub. L.

Research Paper No. 605, 2017), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3193278.
[94] I.R.C. § 59A(a). *See* JCS-1-18, *supra* note 60, at 399-409.
[95] 2% or higher for banks and registered securities dealers.
[96] I.R.C. § 59A(e)(1).
[97] I.R.C. § 59A(c)(2)(A). *See* Prop. Treas. Reg. § 1.59A-1 *et seq*., REG-104529-18 (Dec. 13, 2018) for guidance on how to determine the tax on base erosion payments of taxpayers with substantial gross receipts.
[98] I.R.C. § 59A(c)(4)(B).
[99] As defined in I.R.C. § 59A(g).
[100] I.R.C. § 59A(d); Prop. Treas. Reg. § 1.59A-3. In general, base erosion payments do not include payments for cost of goods sold such as manufacturer's raw materials (subject to exceptions), certain services nor certain qualified derivative payments. I.R.C. § 59A(h).
[101] I.R.C. § 59A(b)(2). Note, certain banks and securities dealers are subject to higher rates. I.R.C. § 59A(b)(3).
[102] I.R.C. § 59A(b)(1).
[103] I.R.C. § 59A(c)(1).
[104] Avi-Yonah, *The International Provisions of the TCJA*, *supra* note 93.
[105] Notice 2018-7, 2018-4 I.R.B. 317.
[106] JANE G. GRAVELLE & DONALD J. MARPLES, CONGRESSIONAL RESEARCH SERV., R45186, ISSUES IN INTERNATIONAL CORPORATE TAXATION: THE 2017 REVISION (P.L. 115-97) (2018), at 39.
[107] I.R.C. § 965(o).
[108] Andrew Velarde, *AICPA Lobbying for Downward Attribution Transition Tax Relief*, TAX NOTES INT'L, Mar. 19, 2018.
[109] GRAVELLE & MARPLES, *supra* note 106, at 40.
[110] Stephen E. Shay, *Treasury Can Close a Potential Loophole in the Treatment of Deferred Foreign Income in the Tax Cuts and Jobs Act – Will It Act?* (Dec. 26, 2017),

https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3093379; Lynnley Browning, *Tax Law Quirk Could Help Apple and Microsoft Lower Their Bills*, BLOOMBERG, Apr. 3, 2018, https://www.bloomberg.com/news/articles/2018-04-03/irs-seen-blessing-tax-law-quirk-that-could-help-apple-microsoft.

[111] GRAVELLE & MARPLES, *supra* note 106, at 40.

[112] Avi-Yonah & Mazzoni, *BEPS, ATAP and the New Tax Dialogue: A Transatlantic Competition?* (Univ. of Mich. Pub. L. Research Paper No. 612, 2018), at 4–5, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3204242.

[113] Avi-Yonah, *The International Provisions of the TCJA: Six Results after Six Months* (Univ. of Mich. Pub. L. Research Paper No. 621, 2018), at 3, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3242008.

[114] GRAVELLE & MARPLES, *supra* note 106, at 38.

[115] For a discussion of how a partnership can be used to "game" around the interest limitation with preferred equity, *see* Kamin *et al.*, *supra* note 54, at 63–65.

[116] GRAVELLE & MARPLES, *supra* note 106, at 39.

[117] Kamin *et al.*, *supra* note 54, at 57.

[118] Rebecca M. Kysar, *Judging the New International Tax Regime: Testimony Before the U.S. Senate Committee on Finance* (Apr. 24, 2018), at https://www.finance.senate.gov/imo/media/doc/24APR2018KysarSTMNT.pdf.

[119] Kamin *et al.*, *supra* note 54, at 57–58.

[120] GRAVELLE & MARPLES, *supra* note 106, at 38.

[121] Kamin *et al.*, *supra* note 54, at 56.

[122] *Id.*

[123] GRAVELLE & MARPLES, *supra* note 106, at 38.

[124] Kamin *et al.*, *supra* note 54, at 61.

[125] *See* Andrew Velarde, *Failing BEAT's Services Cost Method Exception Could Cost Big*, TAX NOTES INT'L (Jan. 29, 2018), at 419–21; Martin Sullivan, *Economic Analysis: Can Marked-Up Services Skip the BEAT*, TAX NOTES (Feb. 5, 2018), at 705–09;

Manal Corwin *et al.*, *A Response to an Off-Beat Analysis*, TAX NOTES (Feb. 12, 2018), at 933–36; Alexander Lewis, *Officials Differ on Importance of BEAT Legislative History*, TAX NOTES TODAY (Feb. 16, 2018); Martin Sullivan, *Marked-up Services and the BEAT, Part II*, TAX NOTES (Feb. 26, 2018).
[126] Prop. Treas. Reg. § 1.59A-3(b)(3)(i).
[127] GRAVELLE & MARPLES, *supra* note 106, at 36, 38.
[128] *Id.* at 38.
[129] Yalman Onaran, *How Trump's Tax Overhaul Could Hit Big Foreign Banks*, BLOOMBERG (Dec. 29, 2017), https://www.bloomberg.com/news/articles/2017-12-29/trump-s-tax-overhaul-may-punish-foreign-banks-with-u-s-units.
[130] GRAVELLE & MARPLES, *supra* note 106, at 38.
[131] Joseph A. Goldman *et al.*, *The U.S. Tax Cuts and Jobs Act: Fundamental Changes to Business Taxation*, JONES DAY WHITE PAPER (Jan. 2018), at 13, https://www.jonesday.com/files/Publication/f54dfba7-db13-432b-8de2-b10cde64f163/Presentation/PublicationAttachment/3112e6aa-1d80-42fc-8bd7-bea4a7ea6c76/Tax%20Cuts%20and%20Jobs%20Act2.pdf.
[132] *Id.*