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Section 267A Is a Headache — Does Pillar Two Make It Worse?

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It isn't clear how §267A applies in a Pillar Two world, and Treasury and the IRS may want to think twice about incorporating Pillar Two into §267A, say Baker McKenzie practitioners.

The Pillar Two rules combine the income and loss of all related entities that are located in the same jurisdiction for purposes of determining whether any Pillar Two top-up tax is owed for that jurisdiction. One effect of this Pillar Two "jurisdictional blending" rule is that a foreign entity's deductions could be viewed as offsetting the income items of every other related entity that is also located in the foreign entity's jurisdiction. Now that Pillar Two is live in multiple countries, U.S. taxpayers are (rightly) concerned that this forced jurisdictional blending could greatly expand the frequency with which the dual consolidated loss ("DCL") rules in §1503(d) and the anti-hybrid rules in §267A apply.

Numerous commentators (including us) have addressed the potential DCL implications of the Pillar Two rules. However, few, if any, have discussed §267A – with good reason. The §267A regulations are hard enough to understand and apply without the Pillar Two overlay, and the addition of Pillar Two risks stretching those regulations to their conceptual breaking point. Yet, in Notice 2023-80, Treasury and the IRS expressly stated that they were studying the interaction of the Pillar Two rules with §267A. Against this backdrop, we forge ahead into §267A and consider whether or not there is in fact any material interaction with Pillar Two of which taxpayers should be aware.

I. Jurisdictional Blending Under Pillar Two

By now, we expect that most readers are familiar with the three Pillar Two collection mechanisms — the Income Inclusion Rule ("IIR"), the Undertaxed Profits Rule ("UTPR"), and the Qualified Domestic Minimum Top-up Tax ("QDMTT"). The starting point for the IIR and UTPR is to determine whether a jurisdiction falls below the 15% minimum tax rate. The IIR and UTPR make this determination by comparing 15% to the quotient of the sum of the "Adjusted Covered Taxes" of each "Constituent Entity" in a jurisdiction over the "Net GloBE Income" of that jurisdiction (*See* Global Anti-Base Erosion ("GloBE") Rules, Arts. 5.1.1 & 5.2.1). The delta between 15% and the jurisdictional effective tax rate computed in the manner described above is the "Top up Tax Percentage." Oversimplifying, that Top up Tax Percentage can then be multiplied by "Net GloBE Income" for the jurisdiction, less the "Substance-based Income Exclusion" for that jurisdiction, to arrive at the top-up tax that is due for that jurisdiction (*See* GloBE Rules, Arts. 2.5, 5.2.2 – 5.2.3). If the jurisdiction has implemented a QDMTT, the top-up tax is reduced by the aggregate QDMTT amount for all Constituent Entities in the jurisdiction (*See* GloBE Rules, Art. 5.2.3). Unlike an IIR or UTPR, a jurisdiction has the flexibility to design its QDMTT to apply on a

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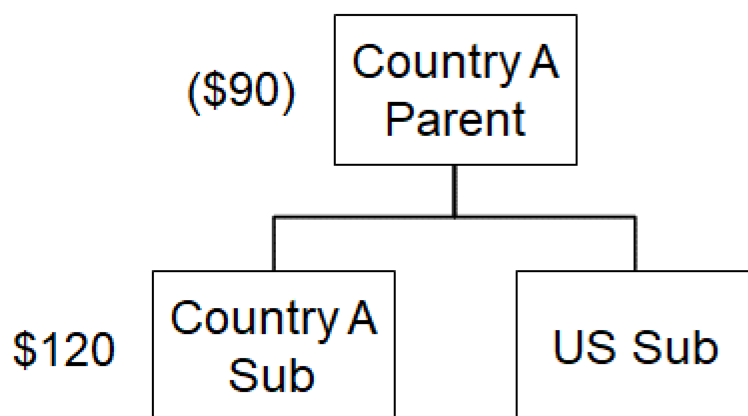
Constituent - Entity by Constituent - Entity basis, and only to those Constituent Entities that have an effective tax rate that is less than 15% (*See* Administrative Guidance on the GloBE Rules (July 2023) ¶ 11 at 58). However, we anticipate jurisdictions will more commonly design their QDMTTs so that the liability is determined in the aggregate for all Constituent Entities in the jurisdiction, much like an IIR. Therefore, for purposes of this article, we assume that any QDMTT is determined on an aggregate basis.

While there are a number of defined terms in the paragraph above, for purposes of this article, we focus on the terms, "Net GloBE Income" and "Constituent Entity." Generally speaking, a Constituent Entity is a legal person, a partnership, a trust, or a PE that is part of a consolidated financial reporting group (*See* GloBE Rules, Arts. 1.3, 10.1.1). Net GloBE Income equals the sum of the "GloBE Income" of all Constituent Entities in a jurisdiction less the sum of the "GloBE Loss" of all Constituent Entities in a jurisdiction (*See* GloBE Rules, Art. 5.1.2). Generally speaking, GloBE Income and GloBE Loss for a Constituent Entity are the financial statement income or loss of that entity as determined in accordance with the accounting standard of the ultimate parent of the group to which the Constituent Entity belongs (*See* GloBE Rules, Art. 3.1.2).

The following simple example illustrates how the computation of Net GloBE Income applies in the U.S. federal income tax context:



In this example, a parent company in jurisdiction A has a $90 financial statement loss, and a subsidiary in jurisdiction A has $120 of financial statement income, both as determined using the parent's accounting standard. The Net GloBE Income for jurisdiction A is therefore $30 because Net GloBE Income is the sum of jurisdiction A Constituent Entities' financial statement income and loss.

In addition to the Pillar Two rules, the OECD/G20 Inclusive Framework also issued a document setting forth certain safe harbors that could be available to multinational groups in the early years of Pillar Two. The safe harbors key off the country-by-country reporting rules that BEPS Action 13 introduced (*See* Safe Harbours and Penalty Relief: Global Anti-Base Erosion Rules (Pillar Two), OECD/G20 Inclusive Framework on BEPS, OECD, Paris (2022)). Like the Pillar Two rules, the country-by-country reporting rules aggregate book profit and loss in a given jurisdiction to arrive at a jurisdictional net profit/loss (*See* Instructions to IRS Form 8975 and Schedule A; Treas. Reg. §1.6038-4(d)(2); *see also* the Action 13 Report, Annex III to Chapter V). Thus, in the example above, the country-by-country result could also be $30 — i.e., $120 of book income less $90 of book loss.

II. §267A and the Jurisdictional Blending Rule

Pillar Two and its jurisdictional blending rule could create unique issues under the hybrid deduction disallowance rules in §267A. In particular, if Treasury and the IRS were to treat Pillar Two as "the tax law" that triggers these provisions , *see* §267A(b), (c), then Pillar Two and this blending rule could create complexities sunder the imported mismatch rules in Treas. Reg. §1.267A-4.

Our hope is that Treasury and the IRS will confirm that Pillar Two is not "the tax law" that could give rise to hybrid deductions under §267A. We note that the statute does not define what "the tax law" of a jurisdiction is. Nevertheless, the §267A regulations state that the term "tax law of a country includes statutes, regulations, administrative or judicial rulings, and income tax treaties of the country." (*See* Treas. Reg. §1.267A-5(a)(21)). Therefore, under the current §267A regulations, which predate Pillar Two, it is plausible that Pillar Two is indeed part of "the tax law" to the extent it is incorporated into the "statutes," "regulations," and/or "administrative . . . rulings" of a given country. Treasury and the IRS are nevertheless empowered to carve Pillar Two out of the definition of tax law, and we hope they will do so for the reasons discussed below.

There are two operative sections of the §267A regulations — Treas. Reg. §1.267A-2, which addresses hybrid arrangements generally, and Treas. Reg. §1.267A-4, which addresses imported mismatches. Treas. Reg. §1.267A-2 generally focuses on situations in which there is a U.S./CFC deduction and the corresponding income is not included in the direct foreign recipient's income due to hybridity. The imported mismatch rules in Treas. Reg. §1.267A-4, on the other hand, focus on situations in which the foreign recipient includes a payment from a U.S. person/branch or a CFC in the foreign recipient's income, but the income from this payment is effectively not subject to foreign tax due to hybridity elsewhere in the structure.

Given the jurisdictional blending rule's mandate to net GloBE Income and GloBE Loss of all entities within a jurisdiction, we expect the interaction of the imported mismatch rules in Treas. Reg. §1.267A-4 and Pillar Two to give rise to the most issues. For this reason, we focus this article on the interaction of these rules and Pillar Two.

A. Overview of the Imported Mismatch Rules

At a high level, the imported mismatch rules in Treas. Reg. §1.267A-4 apply when:

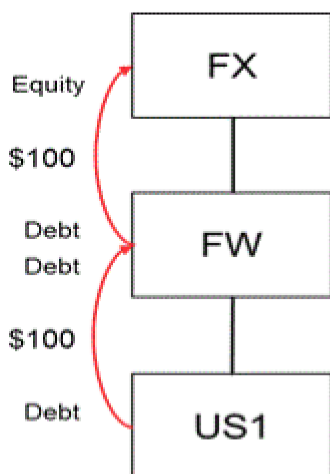
1. a U.S. person/branch or a CFC makes a payment of interest or royalties to a related foreign recipient that is not within the U.S. tax net (*see* Treas. Reg. §1.267A-3(b), (4)(a)(2)(v));
2. the foreign recipient includes the taxable interest/royalty income;
3. there is a "hybrid deduction" of a related foreign person/branch (termed a "foreign tax resident" or "foreign taxable branch") (that is different from the recipient) (as discussed in II.B); and
4. this hybrid deduction directly or indirectly "offsets" the U.S. interest/royalty income at the foreign recipient (as discussed in II.C) (*See* Treas. Reg. §1.267A-4(a)).

The imported mismatch rules aim to stop hybrid flows between foreign persons/branches that are outside the U.S. tax net when those hybrid flows are directly or indirectly used to shelter foreign tax that would otherwise be owed on U.S. interest/royalty payments. These rules are difficult to apply because one might think there is no U.S. deduction to deny when the prohibited hybrid transaction does not involve a U.S. party. However, the imported mismatch rules effectively treat certain foreign-to-foreign

hybrid payments as being "imported" into the United States, resulting in a disallowance of the U.S. deduction.

Although the imported mismatch rules apply to payments of interest and royalties, as noted above, we focus on interest payments in this article because interest payments/accruals more typically give rise to concerns under §267A generally and the imported mismatch rules specifically.

We illustrate the application of the imported mismatch rules with the following example from the §267A regulations (*See* Treas. Reg. §1.267A-6(c)(8), Ex. 8). FX and FW are foreign corporations resident in jurisdictions X and W, respectively. US1 is a domestic corporation. Assume that FX holds all the interests in FW, and FW holds all the interests in US1. FX holds an instrument from FW that is treated as equity in jurisdiction X and debt in jurisdiction W. FW holds an instrument from US1 that is treated as debt in both jurisdiction W and the United States. US1 pays $100 to FW, and FW pays $100 to FX. US1 and FW recognize deductions for their payments, FW includes the payment it receives in income, and FX does not include the payment from FW in income because jurisdiction X treats the amount as an excludable dividend.



The payment from FW to FX is a mismatch payment and, as we explain below, FW's deduction is a "hybrid deduction." The payment from US1 to FW "imports" the mismatch payment into the United States – i.e., it is an "imported mismatch payment." The example concludes that §267A disallows a deduction for US1's entire payment.

The Pillar Two rules give rise to two questions under the imported mismatch rules. First, can the Pillar Two rules create hybrid deductions (within the meaning of Treas. Reg. §1.267A-4(b)) that trigger the imported mismatch rules? Second, if the Pillar Two rules can create hybrid deductions, then does the Pillar Two jurisdictional blending rule make it much more likely that the Pillar Two hybrid deductions indirectly offset (within the meaning of Treas. Reg. §1.267A-4(c)) income associated with the expense that a U.S. person/branch or CFC incurs, such that the U.S. person/branch or CFC is no longer allowed a deduction for the relevant interest payments?

B. Hybrid Deductions and Pillar Two
Under the imported mismatch rules, a "hybrid deduction" is a deduction that is allowed to a foreign tax resident or a foreign taxable branch "under its tax law" for either:

1. Interest expense to the extent that a deduction would be disallowed "if [the foreign tax resident's or foreign taxable branch's] tax law contained rules substantially similar to those under" the §267A regulations, or
2. With respect to equity to the extent the investor in the foreign tax resident, or the home office of the foreign branch, would have included the amount of the deduction in income had the amount been interest. *See* Treas. Reg. §1.267A-4(b)(1).

In the example above, FW's deduction is a hybrid deduction because the deduction would have been disallowed had FW's jurisdiction incorporated rules substantially similar to those under the §267A regulations.

Based on this definition of hybrid deduction, an imported mismatch arrangement can arise from five types of hybrid deduction arrangements:

- Payments pursuant to hybrid transactions (e.g., payments that are treated as interest to the payor and dividends to the recipient) as described in Treas. Reg. §1.267A-2(a);
- Disregarded payments (e.g., interest payments that are not regarded in the recipient's jurisdiction and exceed the payor's "dual inclusion income") as described in Treas. Reg. §1.267A-2(b);
- Deemed branch payments (i.e., amounts deemed paid by a branch that are not taken into account by the home office) as described in Treas. Reg. §1.267A-2(c);
- Payments to reverse hybrid entities as described in Treas. Reg. §1.267A-2(d); and
- A deduction on equity that would have given rise to interest income of the investor/owner had the amount been interest (e.g., a notional interest deduction) as described in Treas. Reg. §1.267A-4(b)(1)(ii).

While an analysis of all these hybrid deduction arrangements in the context of Pillar Two is beyond the scope of this article, there are several points that are worth raising.

First, a hybrid deduction under the imported mismatch rules can only arise if a foreign entity has an interest deduction under its tax law. *See* Treas. Reg. §1.267A-4(b)(1). Accordingly, for the imported mismatch rules to apply to Pillar Two deductions, Treasury and the IRS would have to take the position that Pillar Two is "the tax law" of a jurisdiction (*See* §267A(b)(1); Treas. Reg. §1.267A-2, -3(a)). If Pillar Two is "the tax law" for purposes of §267A, then this position could potentially be a headache for or a gift to a taxpayer.

Treating Pillar Two as "the tax law" for purposes of §267A would be a headache for many taxpayers because this position would mean that the imported mismatch rules could potentially apply if a foreign person/branch has a Pillar Two interest expense. Accordingly, an affected taxpayer would then have to apply the imported mismatch rules to test its structure for hybridity, taking into account the broad offset rules described in II.C.

Nevertheless, treating Pillar Two as "the tax law" for purposes of §267A could potentially be a gift to some taxpayers. Doing so could potentially mean that a Pillar Two income inclusion (for a payment that

is otherwise a hybrid arrangement under "regular" foreign tax law) may be enough to turn off the imported mismatch rules as well as the hybrid transaction rules in Treas. Reg. §1.267A-2(a) in many circumstances.

The argument is as follows. Treas. Reg. §1.267A-2(a), which is incorporated into the imported mismatch rules, disallows a deduction for an interest payment paid pursuant to a "hybrid transaction" except "to the extent that, under the tax law" of the recipient, the recipient takes the payment into account in its income at the full marginal rate (*See* Treas. Reg. §1.267A-3(a)(1)(i)). The regulations also provide that an interest payment is made pursuant to a "hybrid transaction" if the interest payment is "not so treated for purposes of the tax law of [the recipient]" (Treas. Reg. §1.267A-2(a)(2)(i)).

Based on these two rules, does it not follow that, if Pillar Two is "the tax law," then a Pillar Two interest income inclusion can call off the hybrid transaction rules in Treas. Reg. §1.267A-2(a) because, pursuant to Treas. Reg. §1.267A-3(a)(1)(i), the interest recipient includes the corresponding interest income in its Pillar Two income at the full Pillar Two rate (even if the interest income may not be included in the recipient's regular foreign taxable income)? Similarly, couldn't the fact that a payment of interest is treated as interest income to the recipient under Pillar Two mean that the payment is no longer a "hybrid transaction" under Treas. Reg. §1.267A-2(a) (even if the payment would be paid pursuant to a "hybrid transaction" for regular foreign income tax purposes)? Given these issues, Treasury and the IRS may want to think twice about taking the position that Pillar Two expenses can give rise to hybrid deductions under §267A.

Second, the jurisdictional blending provisions could create uncertainty as to when "disregarded payments" arise for purposes of §267A. For instance, a CFC in jurisdiction A could make a payment of interest to a non-CFC related entity in jurisdiction A, and the income of the non-CFC related entity could net against the expense of the CFC for Pillar Two purposes. Under the §267A regulations, a disregarded payment can arise in a situation where a foreign consolidation regime allows for an offsetting deduction with respect to the payment and there is not sufficient "dual inclusion income" (*See* Treas. Reg. §1.267A-2(b)(2)(ii)). While Pillar Two does not provide for a deduction with respect to a specific payment, the fact that the CFC's expense could offset the non-CFC's income dollar for dollar raises concern.

Third, if a jurisdiction has incorporated the EU's Anti-Tax Avoidance Directive or other anti-hybrid rules into its tax law (broadly defined, as noted above), then the imported mismatch rules generally only apply to hybrid deduction arrangements that arise from either (1) interest-free loans or (2) notional interest deductions (*See* Treas. Reg. §1.267A-4(b)(2)(i)). This limitation may significantly constrain the application of the imported mismatch rules to Pillar Two deductions that accrue to EU entities or entities in other jurisdictions that have adopted anti-hybrid rules.

In short, §267A could create pitfalls for both the government and taxpayers if it applies in the context of Pillar Two. Moreover, §267A may have limited application to Pillar Two deductions in many jurisdictions in light of the carve out for anti-hybrid rules. These considerations weigh strongly in favor of expressly excluding Pillar Two from §267A's scope. The risk to the U.S. fisc is minimal, and benefit of avoiding unnecessarily complicating the administration of the U.S. tax regime is great.

C. The Set-Off Rules and Jurisdictional Blending Under Pillar Two

If there is a hybrid deduction within a group's foreign structure (but not at the foreign recipient of the relevant payment), then the taxpayer needs to determine whether this hybrid deduction offsets interest

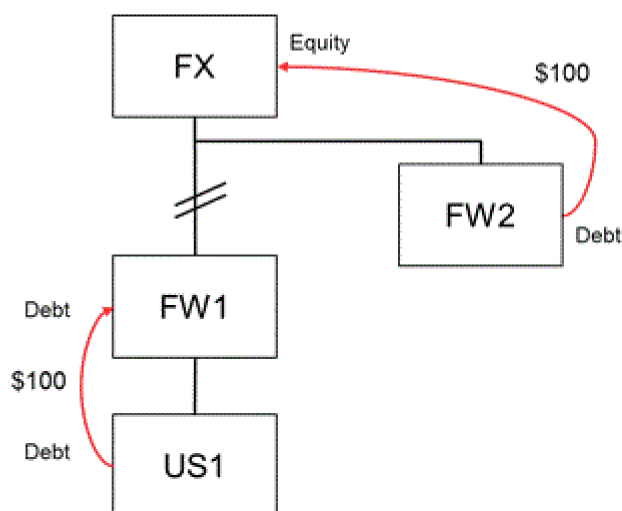
income attributable to a U.S. person/branch or a CFC pursuant to the rules in Treas. Reg. §1.267A-4(c). The imported mismatch example above illustrates a relatively simple situation in which a foreign subsidiary offsets its U.S. interest income with a hybrid deduction through the use of a hybrid debt instrument that its foreign parent holds. However, the imported mismatch rules contain very broad set-off rules that can create offsets in very surprising situations, in particular in consolidation regimes.

Treas. Reg. §1.267A-4(c)(1) articulates the general rule for when a hybrid deduction offsets income: "[A] hybrid deduction directly or indirectly offsets the income attributable to an imported mismatch payment to the extent that, under paragraph (c)(3) of this section, the payment directly or indirectly funds the hybrid deduction." In addition, Treas. Reg. §1.267A-4(c)(3)(vi) provides that consolidated entities are treated as a single taxpayer.

Specifically, the regulation provides:

"If a deduction or loss that is not incurred by a foreign tax resident or foreign taxable branch is directly or indirectly made available to offset income of the foreign tax resident or foreign taxable branch under its tax law, then, for purposes of this paragraph (c), the foreign tax resident or foreign taxable branch to which the deduction or loss is made available and the foreign tax resident or foreign taxable branch that incurs the deduction or loss are treated as a single foreign tax resident or foreign taxable branch. For example, if a deduction or loss of one foreign tax resident is made available to offset income of another foreign tax resident under a tax consolidation, fiscal unity, group relief, loss sharing, or any similar regime, then the foreign tax residents are treated as a single foreign tax resident for purposes of this paragraph (c)."

Assume that we modify the imported mismatch example above so that debt runs from US1 to one jurisdiction W entity ("FW1"). Elsewhere in the structure, another jurisdiction W entity ("FW2") is a party to a hybrid arrangement with FX. FW1 recognizes income for Pillar Two purposes. FW2 recognizes expense for Pillar Two purposes. Have we run afoul of the funding rule in Treas. Reg. §1.267A-4(c) if jurisdiction W implements a QDMTT regime?



The answer might be yes under the Pillar Two jurisdictional blending rule because the set-off rule may treat FW1 and FW2 as a single foreign tax resident if their income is consolidated for purposes of the

QDMTT. In effect, this second example collapses into the first example, because FW1 and FW2 are treated as a single entity, FW. The better answer, however, is that Pillar Two is not like a consolidation, fiscal unity, or similar regime because it applies regardless of whether Constituent Entities elect into the regime, and regardless of whether the jurisdiction in which the Constituent Entities are located has adopted Pillar Two.

Similar to the country-by-country reporting rules, Pillar Two employs a mechanism that looks at financial results on a jurisdictional basis. If jurisdictions X and W were not adopt Pillar Two, and FX were to have a subsidiary located in jurisdiction Y that were to adopt Pillar Two, that subsidiary could have a tax liability in respect of jurisdiction W under the UTPR. That subsidiary's UTPR tax liability would be determined in part by consolidating the financial statement income and loss of FW1 and FW2. That consolidation would not occur under the tax law of jurisdiction W; it would occur under the tax law of jurisdiction Y, to determine the tax the jurisdiction Y subsidiary pays under the UTPR. Simply put, Pillar Two mandates consolidation for a jurisdiction whether or not that jurisdiction agrees to Pillar Two.

Moreover, the jurisdictional blending rule can create even more uncertainty when taxpayers have to analyze payments through subsidiaries in multiple jurisdictions. For example, if FX had another subsidiary incorporated in jurisdiction X that had a hybrid deduction, then the "consolidation" rule and the indirect funding rules in Treas. Reg. §1.267A-4(c)(3) could bring that jurisdiction X subsidiary into the imported mismatch web.

If Pillar Two is a consolidation or similar regime, then we need to ask whether the imported mismatch rules will require separate analyses for Pillar Two and regular income tax purposes. The answer ought to be yes, because the jurisdictional blending rule in Pillar Two would otherwise effectively cause all entities within a jurisdiction to become consolidated for purposes of applying the imported mismatch rules to that foreign country's regular foreign income tax. As noted in the regulation quoted above, if a deduction of one foreign tax resident is made available to offset income of another foreign tax resident under a consolidation or similar regime, then the foreign residents are treated as a single resident for purposes of the set-off rule. Thus, by virtue of Pillar Two consolidating the residents' income and loss for Pillar Two purposes, Treas. Reg. §1.267A-4(c) could cause the residents to be treated as a single resident for regular foreign income tax notwithstanding the fact that the regular foreign income tax may not mandate or even allow consolidation. That cannot be correct, and is yet another reason to expressly exclude Pillar Two from §267A.

III. Conclusion

Section 267A is enough of a headache for U.S. taxpayers. To the extent §267A could apply in the context of Pillar Two, it shouldn't. The cost of compliance and administration will vastly outweigh any potential fiscal benefit. Let's not make the §267A headache any worse than it already is.

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