Section 954.—Foreign Base Company Income

26 CFR 1.954–9T: Hybrid branches (temporary).

T.D. 8767

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Parts 1 and 301

Guidance Under Subpart F Relating to Partnerships and Branches

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Temporary and final regulations.

SUMMARY: This document contains regulations relating to the treatment under subpart F of certain payments involving branches of a controlled foreign corporation (CFC) that are treated as separate entities for foreign tax purposes or partnerships in which CFCs are partners. These regulations are necessary to provide guidance on transactions relating to such entities. These regulations will affect United States shareholders of controlled foreign corporations. The text of these temporary regulations also serves as the text of the proposed regulations published in REG–104537–97, page 21 of this Bulletin.

DATES: *Effective date:* These regulations are effective March 23, 1998.

Applicability date: For dates of applicability see §§1.904–5T(o), 1.954–1T(c)-(1)(i)(E), 1.954–2T(a)(5)(iii) and (a)(6)(ii), 1.954–9T(d) and 301.7701–3T(f) of these regulations.

FOR FURTHER INFORMATION CONTACT: Valerie Mark, (202) 622-3840 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

I. *In general*

In these temporary regulations and in proposed regulations published in REG–104537–97, the Treasury and IRS set forth a framework for dealing with issues posed by the use of certain entities that are regarded as fiscally transparent for purposes of U.S. tax law, with regard to the application of subpart F of the Internal Revenue Code.

Subpart F was enacted by Congress to limit the deferral of U.S. taxation of certain income earned outside the United States by foreign corporations controlled by U.S. persons. Limited deferral was retained after the enactment of subpart F to protect the competitiveness of controlled foreign corporations (CFCs) doing business overseas. See S. Rep. No. 1881, 87th Cong., 2d Sess. 78–80 (1962). This limited deferral furthers the objective of allowing a CFC engaged in an active business, and located in a foreign country for appropriate economic reasons, to compete in a similar tax environment with non-U.S. owned corporations located in the same country.

Conversely, one of the purposes of subpart F is to prevent CFCs from converting active income that is not easily moveable and is earned in a jurisdiction in which a business is located for non-tax reasons, into passive, easily moveable income that is shifted to a lower tax jurisdiction primarily for tax avoidance. Moreover, when subpart F was first enacted it was realized that related person transactions can be easily manipulated to reduce both United States and foreign taxes. Consequently, in enacting subpart F, Congress provided that transactions of CFCs that involve related persons generally give rise to subpart F income with certain enumerated exceptions.

Hybrid branches, which, by definition, are not regarded as fiscally transparent under foreign law, are particularly well suited to the type of tax avoidance described above. In light of the recent proliferation of hybrid branches, Treasury and the IRS believe that it is appropriate to consider the issues related to transactions involving hybrid branches, or other hybrid entities, under subpart F.

The use of partnerships that are fiscally transparent for U.S. tax purposes raises additional issues in the context of subpart F that are similar to those raised in connection with hybrid branches. Such partnerships may or may not be fiscally transparent under foreign law. (Other fiscally-transparent entities, such as grantor trusts, will be the subject of guidance issued in conjunction with the finalization of regulations under section 672(f).)

The entity classification regulations of §§301.7701–1 through 301.7701–3 (the check-the-box regulations) make entity classification generally elective, in part so that taxpayers can choose a tax status that is consistent with their business objectives. This administrative provision was not intended to change substantive law. Particularly in the international area, the ability to more easily achieve fiscal transparency can lead to inappropriate results under certain substantive international provisions of the Code. Thus, the Treasury and the IRS believe that it is necessary to provide additional guidance regarding the use of hybrid entities in the international context. See preamble to TD 8697, 61 Fed. Reg. 66585 (December 18, 1996).

II. *Hybrid Branches*

As announced in Notice 98–11 (1998–6 I.R.B. 13), the Treasury and the IRS understand that certain taxpayers are using arrangements involving hybrid branches to circumvent the purposes of subpart F (sections 951 through 964 of the Code). These arrangements generally involve the use of deductible payments to reduce the taxable income of a CFC under foreign law, thereby reducing that CFC's foreign tax and, also under foreign law, the corresponding creation in another entity of low-taxed, passive income of the type to which subpart F was intended to apply. Because of the structure of these arrangements, however, taxpayers take the position that this income is not taxed under subpart F. Treasury and the IRS have concluded that use of these hybrid branch arrangements is contrary to the policies and rules of subpart F.

U.S. international tax policy seeks to balance the objective of neutrality of taxation between domestic and foreign business enterprises (seeking neither to encourage nor to discourage one over the other), while keeping U.S. business competitive. Subpart F strongly reflects and enforces that balance, while the arrangements described above involving hybrid branches upset that balance.

Explanation of Provisions

Under these temporary regulations, hybrid branch payments, as defined in the regulations, between a CFC and its hybrid branch, or between hybrid branches of the CFC may give rise to subpart F income. When certain conditions are present, the non-subpart F income of the CFC, in the amount of the hybrid branch payment, is recharacterized as subpart F income of the CFC. Those conditions include that: the hybrid branch payment reduces the foreign tax of the payor; the hybrid branch payment would have been foreign personal holding company income if made between separate CFCs; and there is a disparity between the effective rate of tax on the payment in the hands of the payee and the hypothetical rate of tax that would have applied if the income had been taxed in the hands of the payor. Treasury and the IRS are considering applying similar principles with respect to the foreign base company services income rules of section 954(e). Comments are requested on this issue. Any regulations promulgated on this issue will be prospective.

Policies underlying subpart F would also be avoided in certain non-hybrid branch transactions that do not reduce the tax of the payor. Treasury and the IRS invite comments on the extent to which rules should be provided to address such transactions. Any regulations promulgated on this issue will be prospective. Comments are also requested regarding the application of these rules to dividend and other equity distributions.

The temporary regulations make clear that the CFC and the hybrid branch, or the hybrid branches, are treated as separate corporations only to recharacterize non-subpart F income as subpart F income in the amount of the hybrid branch payment, and to apply the tax disparity rule of §1.954–9T(a)(5)(iv). For all other purposes (e.g., for purposes of the earnings and profits limitation of section 952), a CFC and its hybrid branch, or hybrid branches, are not treated as separate corporations.

The temporary regulations provide that the amount recharacterized as subpart F income is the gross amount of the hybrid branch payment limited by the amount of the CFC's earnings and profits attributable to non-subpart F income. This amount is the excess of current earnings and profits over subpart F income, determined after the application of the rules of sections 954(b) and 952(c) and before the application of these temporary regulations. To the extent that the full amount required to be recharacterized under this provision cannot be recharacterized because it exceeds earnings and profits attributable to non-subpart F income, there is no requirement to carry such amounts back or forward to another year.

For purposes of determining the amount of taxes deemed paid under section 960, the amount of non-subpart F income recharacterized as subpart F income is treated as attributable to income in separate foreign tax credit baskets in proportion to the ratio of non-subpart F income in each basket to the total amount of non-subpart F income of the CFC for the taxable year.

The temporary regulations provide that, under certain circumstances, the recharacterization rules will also apply to a CFC's proportionate share of any hybrid branch payment made between a partnership in which the CFC is a partner and a hybrid branch of the partnership, or between hybrid branches of such a partnership. When the partnership is treated as fiscally transparent by the CFC's taxing jurisdiction, the recharacterization rules are applied by treating the hybrid branch payment as if it had been made directly between the CFC and the hybrid branch, or as though the hybrid branches of the partnership had been hybrid branches of the CFC, as applicable. If the partnership is treated as a separate entity by the CFC's taxing jurisdiction, the recharacterization rules are applied to the partnership as if it were a CFC. Comments are requested on whether the rule for such non-fiscally transparent partnerships should be relaxed in the case of small ownership interests.

The temporary regulations provide that income will not be recharacterized unless there is a disparity between the effective rate at which the hybrid branch payment is taxed to the payee and a hypothetical tax rate that measures the tax savings to the payor from the deductible payment. This provision is similar to the rule in §1.954–3(b), and adopts the same percentage tests as contained in that provision. The regulations also provide a special high tax exception applicable to the hybrid branch payment that is similar to the one contained in section 954(b)(4). Comments are invited on whether the rules of §1.954–9T could cause inappropriate multiple recharacterizations where the hybrid branch payments are made through a series of related hybrid entities.

The temporary regulations provide that if these provisions affect an entity that has elected under §301.7701–3(c) to be treated as an entity disregarded as separate from its owner, such an entity may elect to be classified as a corporation, provided it fulfills certain requirements, notwithstanding the sixty-month limitation in that section.

III. *Related Provisions*

These temporary regulations provide rules, contained in §1.954–1T(c)(1)(i)(B), to prevent expenses, including related person interest expense which would normally be allocable under section 954(b)(5) to subpart F income of a CFC, from being allocated to a payment from which the expense arises. The allocation limit applies: (i) to the extent such payment is included in the subpart F income of the CFC; (ii) if the expense arises from any payment by the CFC to a hybrid partnership in which the CFC is a partner; and (iii) if the payment reduces foreign tax and there is a significant disparity in tax rates between the payor and payee jurisdictions.

These temporary regulations also address the application of the related person exceptions to the foreign personal holding company income rules in the context of partnership distributive shares and transactions involving hybrid branches. Under section 954(c)(3), foreign personal holding company income does not include certain interest, dividends, rents and royalties received from related corporations. These exceptions apply, in the case of interest and dividends, when the related corporate payor is organized in the country in which the CFC is organized and uses a substantial part of its assets in a trade or business in that country and, in the case of rents and royalties, when the rent or royalty payment is made for the use or privilege of using property within the CFC's country of incorporation.

The rules regarding the application of the related person exceptions with respect to a CFC partner's distributive share of

partnership income are part of the broader set of rules addressing distributive share issues in the context of subpart F contained in the proposed regulations published in REG–104537–97. Certain rules relating to the related person exception with respect to a CFC partner's distributive share of partnership income, and certain rules relating to the related person exception with respect to hybrid branches, however, are included in these temporary regulations because they address a fact pattern similar to the one to which the hybrid branch payment rules apply. No inference is intended as to the treatment under existing law of such arrangements in relation to the related party exceptions.

Under these rules, if the partnership receives an item of income that reduces the income tax of the payor, the related person exceptions of section 954(c)(3) apply to exclude the income from the foreign personal holding company income of the CFC partner only where: the exception would have applied if the CFC earned the income directly (testing relatedness and country of incorporation at the CFC partner level); and either the partnership is organized and operates in the CFC's country of incorporation, the partnership is treated as fiscally transparent in the CFC's countries of incorporation and operation, or there is no significant disparity between the effective rate of tax imposed on the income and the rate of tax that would be imposed on the income if earned directly by the CFC partner.

The rules applying the related person exceptions with respect to hybrid branches address transactions illustrated in the first example of Notice 98–11 (1998–6 I.R.B. 13). These rules apply to payments by a CFC to a hybrid branch of a related CFC. Under these rules, the related person exceptions will apply to exclude the payments from the foreign personal holding company income of the recipient CFC only if the payment would have qualified for the exception if the hybrid branch had been a separate CFC incorporated in the jurisdiction in which the payment is subject to tax (other than a withholding tax).

IV. *Effective Date.*

These regulations are effective March 23, 1998. For dates of applicability see §§1.904–5T(o), 1.954–1T(c)(1)(i)(E), 1.954–2T(a)(5)(iii) and (6)(iii), 1.954–9T(d) and 301.7701–3T(f) of these regulations.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedures Act (5 U.S.C. chapter 5) does not apply to these regulations and, because the regulation does not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Internal Revenue Code, these temporary regulations will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

Drafting Information

The principal author of these regulations is Valerie Mark, of the Office of the Associate Chief Counsel (International). Other personnel from the IRS and Treasury Department also participated in the development of these regulations.

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Adoption of Amendments to the Regulations

Accordingly, 26 CFR parts 1 and 301 are amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for 26 CFR part 1 continues to read in part as follows:

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

Par. 2. In §1.904–5, paragraph (o) is amended by adding a sentence at the end to read as follows:

§1.904–5 Look-through rules as applied to controlled foreign corporations and other entities.

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(o) * * * Paragraph (k)(1) of this section does not apply on or after March 23, 1998. For rules applicable on or after March 23, 1998, see §1.904–5T(k)(1).

Par. 3. §1.904–5T is added to read as follows:

§1.904–5T Look-through rules as applied to controlled foreign corporations and other entities (temporary).

(a) through (j) [Reserved]. For further guidance, see §1.904–5(a) through (j).

(k) *Ordering rules*—(1) *In general.* Income received or accrued by a related person to which the look-through rules apply is characterized before amounts included from, or paid or distributed by, that person and received or accrued by a related person. For purposes of determining the character of income received or accrued by a person from a related person if the payor or another related person also receives or accrues income from the recipient and the look-through rules apply to the income in all cases, the rules of paragraph (k)(2) of this section apply. Notwithstanding any other provision of this section, the principles of §1.954–1T(c)(1)(i) will apply to any expense subject to that subparagraph.

(k)(2) through (n) [Reserved]. For further guidance, see §1.904–5(k)(2) through (n).

(o) *Effective date.* Section 1.904–5T(k)(1) applies on or after March 23, 1998. For rules prior to March 23, 1998, see §1.904–5(k)(1).

Par. 4. Section 1.954–0(b) is amended by revising the paragraph heading and the entry for §1.954–0(b) in the list to read as follows:

§1.954–0 Introduction.

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(b) *Outline of §§1.954–0, 1.954–1 and 1.954–2.*

§1.954–0 Introduction.

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(b) Outline of §§1.954–0, 1.954–1, and 1.954–2.

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Par. 5. Section 1.954–1 is amended by adding a new paragraph (c)(1)(iv) to read as follows:

§1.954–1 Foreign base company income.

* * * * *

(c) * * *

(1) * * *

(iv) *Effective date.* Paragraph (c)(1)(i) of this section does not apply to all amounts paid or accrued on or after March 23, 1998, except for amounts paid or accrued pursuant to arrangements entered into before March 23, 1998, and not substantially modified (including, for example, by expansion of the arrangement (whether by exercise of an option or otherwise) such as by an increase in the amount of or term of any borrowing, leasing or licensing constituting the arrangement, changes in direct or indirect control of any entity that is a party to the arrangement, or any similar measure which materially increases the tax benefit of the arrangement) on or after March 23, 1998. For rules applicable on or after March 23, 1998, see §1.954–1T(c)(1)(i).

Par. 6. Section 1.954–1T is added to read as follows:

§1.954–1T Foreign base company income (temporary).

(a) through (c)(1)(i) [Reserved]. For further guidance, see §1.954–1(a) through (c)(1).

(c)(1)(i) *Deductions against gross foreign base company income*—(A) *In general.* [Reserved]. For further guidance, see §1.954–1(c)(1)(i).

(B) *Special rule for deductible payments to certain non-fiscally transparent entities.* Notwithstanding any other provision of this section, except as provided in paragraph (c)(1)(i)(C) of this section, an expense (including a distributive share of any expense) that would otherwise be allocable under section 954(b)(5) against the subpart F income of a controlled foreign corporation shall not be allocated against subpart F income of the controlled foreign corporation resulting from the payment giving rise to the expense if—

(*1*) Such expense arises from a payment between the controlled foreign corporation and a partnership in which the controlled foreign corporation is a partner and the partnership is not regarded as fiscally transparent, as defined in §1.954–9T(a)(7), by any country in which the controlled foreign corporation does business or has substantial assets; and

(*2*) The payment from which the expense arises would have met the foreign tax reduction test of §1.954–9T(a)(3) and the tax disparity test of §1.954–9T(a)(5)(iv) if those provisions had been applicable to the payment.

(C) *Limitations.* Paragraph (c)(1)(i)(B) shall not apply to the extent that the controlled foreign corporation partner has no income against which to allocate the expense, other than its distributive share of a payment described in paragraph (c)(1)(i)(B) of this section. Similarly, to the extent an expense described in paragraph (c)(1)(i)(B) of this section exceeds the controlled foreign corporation partner's distributive share of the payment from which the expense arises, such excess amount of the expense may reduce subpart F income (other than such payment) to which it is properly allocable or apportionable under section 954(b)(5).

(D) *Example.* The following example illustrates the application of paragraph (c)(1)(i)(B) and (C) of this section:

Example. CFC, a controlled foreign corporation in Country A, is a 70 percent partner in partnership P, located in Country B. Country A's tax laws do not classify P as a fiscally transparent entity. The rate of tax in country B is 15 percent of the tax rate in country A. P loans $100 to CFC at a market rate of interest. In year 1, CFC pays P $10 of interest on the loan. The interest payment would have caused the recharacterization rules of §1.954–9T to apply if the payment were made between the entities described in §1.954–9T(a)(2). CFC's distributive share of P's interest income is $7, which is foreign personal holding company income to CFC under section 954(c). Under paragraph (c)(1)(i)(B) of this section, $7 of the $10 interest expense may not be allocated against any of CFC's subpart F income. However, to the extent the remaining $3 of interest expense is properly allocable to subpart F income of CFC other than its distributive share of P's interest income, this expense may offset such other subpart F income.

(E) *Effective date.* Paragraph (c)(1)(i)(B), (C) and (D) of this section shall apply to all amounts paid or accrued on or after March 23, 1998, except for amounts paid or accrued pursuant to arrangements entered into before March 23, 1998, and not substantially modified (including, for example, by expansion of the arrangement (whether by exercise of an option or otherwise) such as by an increase in the amount of or term of any borrowing, leasing or licensing constituting the arrangement, changes in direct or indirect control of any entity that is a party to the arrangement, or any similar measure which materially increases the tax benefit of the arrangement) on or after March 23, 1998. For rules applicable to amounts paid or accrued pursuant to arrangements entered into before March 23, 1998, see §1.954–1.

(c)(1)(ii) through (f) [Reserved]. For further guidance, see §1.954–1(c)(1)(ii) through (f).

Par. 7. Section 1.954–2T is added to read as follows:

§1.954–2T Foreign personal holding company income (temporary).

(a)(1) through (4) [Reserved]. For further guidance, see §1.954–2(a) through (4).

(5) *Special rules applicable to distributive share of partnership income*—(i) *Application of related person exceptions where payment reduces foreign tax of payor.* If a partnership receives an item of income that reduced the foreign income tax of the payor (determined under the principles of §1.954–9T(a)(3)), to determine the extent to which a controlled foreign corporation's distributive share of such item of income is foreign personal holding company income, the exceptions contained in section 954(c)(3) shall apply only if—

(A)(*1*) Any such exception would have applied to exclude the income from foreign personal holding company income if the controlled foreign corporation had earned the income directly (determined by testing, with reference to such controlled foreign corporation, whether an entity is a related person, within the meaning of section 954(d)(3), or is organized under the laws of, or uses property in, the foreign country in which the controlled foreign corporation is created or organized); and

(*2*) The distributive share of such income is not in respect of a payment made by the controlled foreign corporation to the partnership; and

(B)(*1*) The partnership is created or organized, and uses a substantial part of its assets in a trade or business in the country under the laws of which the controlled foreign corporation is created or organized (determined under the principles of §1.954–2(b)(4));

(*2*) The partnership is regarded as fiscally transparent, as defined in §1.954–9T(a)(7), by all countries under the laws of which the controlled foreign corporation is created or organized or has substantial assets; or

(*3*) The income is taxed in the year when earned at an effective rate of tax

(determined under the principles of §1.954–1(d)(2)) that is not less than 90 percent of, and not more than five percentage points less than, the effective rate of tax that would have applied to such income under the laws of the country in which the controlled foreign corporation is created or organized if such income were earned directly by the controlled foreign corporation partner from local sources.

(ii) *Certain other exceptions applicable to foreign personal holding company income.* [Reserved].

(iii) *Effective date.* Paragraph (a)(5)(i) of this section shall apply to all amounts paid or accrued on or after March 23, 1998, except for amounts paid or accrued pursuant to arrangements entered into before March 23, 1998, and not substantially modified (including, for example, by expansion of the arrangement (whether by exercise of an option or otherwise) such as by an increase in the amount of or term of any borrowing, leasing or licensing constituting the arrangement, changes in direct or indirect control of any entity that is a party to the arrangement, or any similar measure which materially increases the tax benefit of the arrangement) on or after March 23, 1998.

(6) *Special rules applicable to exceptions from foreign personal holding company income treatment in circumstances involving hybrid branches*—(i) *In general.* In the case of a payment between a controlled foreign corporation (or its hybrid branch, as defined in §1.954–9T(a)-(6)) and the hybrid branch of a related controlled foreign corporation, the exceptions contained in section 954(c)(3) shall apply only if the payment would have qualified for the exception if the payor were a separate controlled foreign corporation created or organized in the jurisdiction where foreign tax is reduced and the payee were a separate controlled foreign corporation created or organized under the laws of the jurisdiction in which the payment is subject to tax (other than a withholding tax).

(ii) *Exception where no tax reduction or tax disparity.* Paragraph (a)(6)(i) of this section shall not apply unless the payment would have met the foreign tax reduction test of §1.954–9T(a)(3) and the tax disparity test of §1.954–9T(a)(5)(iv) if those provisions had been applicable to the payment.

(iii) *Effective date.* The rules of this section shall apply to all amounts paid or accrued on or after January 16, 1998, except for amounts paid or accrued pursuant to arrangements entered into before January 16, 1998, and not substantially modified (including, for example, by expansion of the arrangement (whether by exercise of an option or otherwise) such as by an increase in the amount of or term of any borrowing, leasing or licensing constituting the arrangement, changes in direct or indirect control of any entity that is a party to the arrangement, or any similar measure which materially increases the tax benefit of the arrangement) on or after January 16, 1998.

(b) through (h) [Reserved]. For further guidance, see §1.954–2(b) through (h).

Par. 8. Section 1.954–9T is added to read as follows:

§1.954–9T Hybrid branches (temporary).

(a) *Subpart F income arising from certain payments involving hybrid branches*—(1) *Payment causing foreign tax reduction gives rise to additional subpart F income.* The non-subpart F income of the controlled foreign corporation will be recharacterized as subpart F income, to the extent provided in paragraph (a)(5) of this section, if—

(i) A hybrid branch payment, as defined in paragraph (a)(6) of this section, is made between the entities described in paragraph (a)(2) of this section;

(ii) The hybrid branch payment reduces foreign tax, as determined under paragraph (a)(3) of this section; and

(iii) The hybrid branch payment is treated as falling within a category of foreign personal holding company income under the rules of paragraph (a)(4) of this section.

(2) *Hybrid branch payment between certain entities*—(i) *In general.* Paragraph (a)(1) of this section shall apply to hybrid branch payments between—

(A) A controlled foreign corporation and its hybrid branch;

(B) Hybrid branches of a controlled foreign corporation;

(C) A partnership in which a controlled foreign corporation is a partner (either directly or through one or more branches or other partnerships) and a hybrid branch of the partnership; or

(D) Hybrid branches of a partnership in which a controlled foreign corporation is a partner (either directly or through one or more branches or other partnerships).

(ii) *Hybrid branch payment involving partnership*—(A) *Fiscally transparent partnership.* To the extent of the controlled foreign corporation's proportionate share of a hybrid branch payment, the rules of paragraphs (a)(3), (4) and (5) of this section shall be applied by treating the hybrid branch payment between the partnership and the hybrid branch as if it were made directly between the controlled foreign corporation and the hybrid branch, or as if the hybrid branches of the partnership were hybrid branches of the controlled foreign corporation, if the hybrid branch payment is made between—

(*1*) A fiscally transparent partnership in which a controlled foreign corporation is a partner (either directly or through one or more branches or other fiscally transparent partnerships) and the partnership's hybrid branch; or

(*2*) Hybrid branches of a fiscally transparent partnership in which a controlled foreign corporation is a partner (either directly or through one or more branches or other fiscally transparent partnerships).

(B) *Non-fiscally transparent partnership.* To the extent of the controlled foreign corporation's proportionate share of a hybrid branch payment, the rules of paragraphs (a)(3) and (4) and (a)(5)(iv) of this section shall be applied to the non-fiscally transparent partnership as if it were the controlled foreign corporation, if the hybrid branch payment is made between—

(*1*) A non-fiscally transparent partnership in which a controlled foreign corporation is a partner (either directly or through one or more branches or other partnerships) and the partnership's hybrid branch; or

(*2*) Hybrid branches of a non-fiscally transparent partnership in which a controlled foreign corporation is a partner (either directly or through one or more branches or other partnerships).

(C) *Examples.* The following examples illustrate the application of this paragraph (a)(2)(ii).

Example 1. CFC, a controlled foreign corporation in Country A, is a 90 percent partner in partnership P, which is treated as fiscally transparent under the laws of Country A. P has a hybrid branch, BR,

in Country B. P makes an interest payment of $100 to BR. Under Country A law, CFC's 90 percent share of the payment reduces CFC's Country A income tax. Under paragraph (a)(2)(ii)(A) of this section, the recharacterization rules of this section are applied by treating the payment as if made by CFC to BR. Ninety dollars of CFC's non-subpart F income, to the extent available, and subject to the earnings and profits and tax rate limitations of §1.954–9T(a)(5), is recharacterized as subpart F income.

Example 2. CFC, a controlled foreign corporation in Country A, is a 90 percent partner in partnership P, which is treated as fiscally transparent under the laws of Country A. P has two branches in Country B, BR1 and BR2. BR1 is treated as fiscally transparent under the laws of Country A. BR2 is a hybrid branch. BR1 makes an interest payment of $100 to BR2. Under paragraph (a)(2)(ii)(A) of this section, the payment by BR1, the fiscally transparent branch, is treated as a payment by P, and the deemed payment by P, a fiscally transparent partnership, is treated as made by CFC. Under Country A law, CFC's 90 percent share of BR1's payment reduces CFC's Country A income tax. Ninety dollars of CFC's non-subpart F income, to the extent available, and subject to the earnings and profits and tax rate limitations of §1.954–9T(a)(5), is recharacterized as subpart F income.

(3) *Application when payment reduces foreign tax.* For purposes of paragraph (a)(1) of this section, a hybrid branch payment reduces foreign tax when the foreign tax imposed on the income of the payor or any owner of the payor is less than the foreign tax that would have been imposed on such income had the hybrid branch payment not been made, or the hybrid branch payment creates or increases a loss or deficit or other tax attribute which may be carried back or forward to reduce the foreign income tax of the payor or any owner in another year (determined by taking into account any refund of such tax made to the payor, payee or any other person).

(4) *Hybrid branch payment that is included within a category of foreign personal holding company income*—(i) *In general.* For purposes of paragraph (a)(1) of this section, whether the hybrid branch payment is treated as income included within a category of foreign personal holding company income is determined by treating a hybrid branch that is either the payor or recipient of the hybrid branch payment as a separate wholly-owned subsidiary corporation of the controlled foreign corporation that is incorporated in the jurisdiction under the laws of which such hybrid branch is created, organized for foreign law purposes, or has substantial assets. Thus, the hybrid branch payment will be treated as included within a category of foreign personal holding company income if, taking into account any specific exceptions for that category, the payment would be included within a category of foreign personal holding company income if the branch or branches were treated as separately incorporated for U.S. tax purposes.

(ii) *Extent to which controlled foreign corporation and hybrid branches treated as separate entities.* For purposes other than the determination under paragraph (a)(4)(i) of this section, a controlled foreign corporation and its hybrid branch, a partnership and its hybrid branch, or hybrid branches shall not be treated as separate entities. Thus, for example, if a controlled foreign corporation, including all of its hybrid branches, has an overall deficit in earnings and profits to which section 952(c) applies, the limitation of such section on the amount includible in the subpart F income of such corporation will apply. Similarly, for purposes of applying the de minimis and full inclusion rules of section 954(b)(3), a controlled foreign corporation and its hybrid branch, or hybrid branches shall not be treated as separate corporations. Further, a hybrid branch payment that would reduce foreign personal holding company income under section 954(b)(5) if made between two separate entities will not create an expense if made between a controlled foreign corporation and its hybrid branch, a partnership and its hybrid branch, or hybrid branches.

(5) *Recharacterization of income attributable to current earnings and profits as subpart F income*—(i) *General rule.* Non-subpart F income of a controlled foreign corporation in an amount equal to the excess of earnings and profits of the controlled foreign corporation for the taxable year over subpart F income, as defined in section 952(a), will be recharacterized as subpart F income under paragraph (a)(1) of this section only to the extent provided under paragraphs (a)(5)(ii) through (vi) of this section.

(ii) *Subpart F income.* For purposes of determining the excess of current earnings and profits over subpart F income under paragraph (a)(1) of this section, the amount of subpart F income is determined before the application of the rules of this section but after the application of the rules of sections 952(c) and 954(b). Further, such amount is determined by treating the controlled foreign corporation and all of its hybrid branches as a single corporation.

(iii) *Recharacterization limited to gross amount of hybrid branch payment*—(A) *In general.* The amount recharacterized as subpart F income under paragraph (a)(1) of this section is limited to the amount of the hybrid branch payment.

(B) *Exception for duplicative payments.* [Reserved].

(iv) *Tax disparity rule*—(A) *In general.* Paragraph (a)(1) of this section will apply only if the hybrid branch payment falls within the tax disparity rule. The hybrid branch payment falls within the tax disparity rule if it is taxed in the year when earned at an effective rate of tax that is less than 90 percent of, and at least 5 percentage points less than, the hypothetical effective rate of tax imposed on the hybrid branch payment, as determined under paragraph (a)(5)(iv)(B) of this section.

(B) *Hypothetical effective rate of tax*—(1) *In general.* The hypothetical effective rate of tax imposed on the hybrid branch payment is—

(*i*) For the taxable year of the payor in which the hybrid branch payment is made, the amount of income taxes that would have been paid or accrued by the payor if the hybrid branch payment had not been made, less the amount of income taxes paid or accrued by the payor; divided by

(*ii*) The amount of the hybrid branch payment.

(2) *Hypothetical effective rate of tax when hybrid branch payment causes or increases loss or deficit.* If the hybrid branch payment causes or increases a loss or deficit of the payor for foreign tax purposes, and such loss or deficit can be carried forward or back, the hypothetical effective rate of tax imposed on the hybrid branch payment is the effective rate of tax that would be imposed on the taxable income of the payor for the year in which the foreign law payment is made if the payor's taxable income were equal to the amount of the hybrid branch payment.

(C) *Examples.* The application of this paragraph (a)(5)(iv) is illustrated by the following examples.

Example 1. In 1998, CFC organized in Country A had net income of $60 from manufacturing for

Country A tax purposes. It also had a branch (BR) in Country B. BR is a hybrid entity under paragraph (a)(1) of this section. CFC made a payment of $40 to BR, which was a hybrid branch payment under paragraph (a)(6) of this section, and was treated by CFC as a deductible payment for Country A tax purposes. CFC paid $30 of Country A taxes in 1998. It would have paid $50 of Country A taxes without the deductible payment. Country A did not impose any withholding tax on the $40 payment to BR. Country B also did not impose a tax on the $40 received by BR. Therefore, the effective rate of tax on that payment is 0%. Furthermore, the hypothetical effective rate of tax on the $40 hybrid branch payment is 50% ($50-$30/$40). The effective rate of tax (0%) is less than 90% of, and more than 5 percentage points less than, this hypothetical rate of tax of 50%. As a result, the $40 hybrid branch payment falls within the tax disparity rule of this paragraph (a)(5)(iv).

Example 2. Assume the same facts as in *Example 1*, except that CFC has a loss of $100 for the year for Country A tax purposes. Under Country A law, CFC can carry the loss forward for use in subsequent years. CFC paid no Country A taxes in 1998. The rate of tax in Country A is graduated from 20% to 50%. If the $40 hybrid branch payment were the only item of taxable income of CFC, Country A would have imposed tax at an effective rate of 30%. The effective rate of tax (0%) is less than 90 percent of, and more than 5 percentage points less than, the hypothetical effective rate of tax (30%) imposed on the hybrid branch payment. As a result, the $40 hybrid branch payment falls within the tax disparity rule of this paragraph (a)(5)(iv).

Example 3. Assume the same facts as in *Example 1*, except that Country B imposes tax on the $40 hybrid payment to BR at an effective rate of 50%. The effective rate of 50% is equal to the hypothetical effective rate of tax. As a result, the hybrid branch payment does not fall within the tax disparity rule of this paragraph (a)(5)(iv) and, thus, the recharacterization rules of paragraph (a)(1) of this section do not apply. See also the special high tax exception of paragraph (a)(5)(v) of this section.

(v) *Special high tax exception*—(A) *In general.* Paragraph (a)(1) of this section shall not apply if the non-subpart F income recharacterized as subpart F income under this section was subject to foreign income taxes imposed by a foreign country or countries at an effective rate that is greater than 90 percent of the maximum rate of tax specified in section 11 for the taxable year of the controlled foreign corporation.

(B) *Effective rate of tax.* The effective rate of tax imposed on the net amount of the hybrid branch payment is determined under the principles of §1.954–1(d)(2) and (3). See paragraph (c) of this section for the application of section 960 to amounts recharacterized as subpart F income under this section.

(vi) *No carryback or carryforward of amounts in excess of current year earnings and profits limitation.* To the extent that some or all of the amount required to be recharacterized under this section is not recharacterized as subpart F income because the hybrid branch payment exceeds the amount that can be recharacterized, as determined under paragraph (a)(5)(i) of this section, this excess shall not be carried back or forward to another year.

(6) *Definitions.* For purposes of this section—

Entity means any person that is treated by the United States or any jurisdiction as other than an individual.

Hybrid branch means an entity that—

(i) Has a single owner (including ownership through branches) that is either a controlled foreign corporation or a partnership in which a controlled foreign corporation is a partner (either directly or indirectly through one or more branches or partnerships);

(ii) Is treated as fiscally transparent by the United States; and

(iii) Is treated as non-fiscally transparent by the country in which the payor entity, any owner of a fiscally-transparent payor entity, the controlled foreign corporation, or any intermediary partnership is created, organized or has substantial assets.

Hybrid branch payment means the gross amount of any payment (including any accrual) which, under the tax laws of any foreign jurisdiction to which the payor is subject, is regarded as a payment between two separate entities but which, under U.S. income tax principles, is not income to the recipient because it is between two parts of a single entity.

(7) *Fiscally transparent and non-fiscally transparent.* For purposes of this section an entity shall be treated as fiscally transparent with respect to an interest holder of the entity, if such interest holder is required, under the laws of any jurisdiction to which it is subject, to take into account separately, on a current basis, such interest holder's share of all items which, if separately taken into account by such interest holder, would result in an income tax liability for the interest holder in such jurisdiction different from that which would result if the interest holder did not take the share of such items into account separately. A non-fiscally transparent entity is an entity that is not fiscally transparent under this paragraph (a)(7).

(b) *Election to change classification*—(1) *In general.* If a hybrid branch subject to the provisions of paragraph (a) of this section is an entity that has made an election under §301.7701–3(c)(1) of this chapter to be disregarded as an entity separate from its owner, such entity may elect to change its classification to that of an association taxable as a corporation, under the procedures described in §301.7701–3(c) of this chapter, without regard to the limitation of §301.7701–3T(c)(1)(iv) of this chapter, but only if such election is made on or before the last day of the first taxable year beginning on or after January 1, 1998. An election made pursuant to this paragraph (b)(1) is effective as of the first day of such taxable year. The 75 day limitation on retroactivity in §301.7701–3(c)(1)(iii) of this chapter does not apply.

(2) *Limitation.* An entity can elect to change its classification under the provisions of this paragraph only one time.

(c) *Application of section 960.* For purposes of determining the amount of taxes deemed paid under section 960, the amount of non-subpart F income recharacterized as subpart F income under this section shall be treated as attributable to income in separate categories, as defined in §1.904–5(a)(1), in proportion to the ratio of non-subpart F income in each such category to the total amount of non-subpart F income of the controlled foreign corporation for the taxable year.

(d) *Effective dates*—(1) *Hybrid branches of controlled foreign corporations.* With respect to hybrid branch payments described in paragraph (a)(2)(i)(A) and (B) of this section, the rules of this section shall apply to all amounts paid or accrued on or after January 16, 1998, except for amounts paid or accrued pursuant to arrangements entered into before January 16, 1998, and not substantially modified (including, for example, by expansion of the arrangement (whether by exercise of an option or otherwise) such as by an increase in the amount of or term of any borrowing, leasing or licensing constituting the arrangement, changes in direct or indirect control of any entity that is a party to the arrangement, or any similar measure which materially increases the tax benefit of the arrangement) on or after January 16, 1998.

(2) *Hybrid branches of partnerships in which controlled foreign corporations are partners.* With respect to hybrid branch payments described in paragraph (a)(2)(i)(C) and (D) of this section, the rules of this section shall apply to all amounts paid or accrued on or after March 23, 1998, except for amounts paid or accrued pursuant to arrangements entered into before March 23, 1998, and not substantially modified (including, for example, by expansion of the arrangement (whether by exercise of an option or otherwise) such as by an increase in the amount of or term of any borrowing, leasing or licensing constituting the arrangement, changes in direct or indirect control of any entity that is a party to the arrangement, or any similar measure which materially increases the tax benefit of the arrangement) on or after March 23, 1998.

PART 301—PROCEDURE AND ADMINISTR ATION

Par. 9. The authority citation for 26 CFR part 301 continue to read in part as follows:

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

Par. 10. In §301.7701–3, paragraph (f)(1) is amended by adding a sentence at the end to read as follows:

§301.7701–3. Classification of certain business entities.

* * * * *

(f)(1) * * * Paragraphs (a), (c)(1)(iv) and (f) of this section do not apply on or after March 23, 1998. For rules applicable on or after March 23, 1998, see §301.7701–3T(a), (c)(1)(iv) and (f).

Par. 11. Section 301.7701–3T is added to read as follows:

§301.7701–3T Classification of certain business entities (temporary).

(a) *In general.* A business entity that is not classified as corporation under §301.7701–2(b)(1), (3), (4), (5), (6), (7), or (8) (an eligible entity) can elect its classification for federal tax purposes as provided in this section . An eligible entity with at least two members can elect to be classified as either an association (and thus a corporation under §301.7701–2(b)(2)) or a partnership, and an eligible entity with a single owner can elect to be classified as an association or to be disregarded as an entity separate from its owner. Paragraph (b) of this section provides a default classification for an eligible entity that does not make an election. Thus, elections are necessary only when an eligible entity chooses to be classified initially as other than the default classification or when an eligible entity chooses to change its classification . An entity whose classification is determined under the default classification retains that classification (regardless of any changes in the members ' liability that occurs at any time during the time that t enti's classification is relevant as defined in paragraph (d) of this section) until the entity makes an election to change that classification under paragraph (c)(1) of this section. Paragraph (c) of this section provides rules for making express elections. Paragraph (d) provides special rules for foreign eligible entities. Paragraph (e) of this section provides special rules for classifying entities resulting from partnership terminations and divisions under section 708(b). Paragraph (f) of this section sets forth the e ffective date of this section and a special rule relating to prior periods. An entity that has elected to be disregarded as an entity separate from its owner may nevertheless be treated as a corporation for the limited purposes of §1.954–9T(a)(4)(i) of this chapte r.

(b) through (c)(1)(iii) [Reserved]. For further guidance, see §301.7701–3(b) through (c)(1)(iii).

(c)(1)(iv) *Limitation.* If an eligible entity makes an election under paragraph (c)(1)(i) of this section to change its classification (other than an election made by an existing entity to change its classification as of the e ffective date of this section), the entity cannot change its classification by election again during the sixty months succeeding the e ffective date of the election. Howeve r, the Commissioner may permit the entity to change its classification by election within the sixty months if more than fifty percent of the ownership interests in the entity as of the effective date of the subsequent election are owned by person that did not own any interests in the entity on the filing date or on the e ffective date of the entity 's prior election. See §1.954–9T(b) of this chapter, for circumstances under which certain eligible entities may make an election to change their classification within the sixty-month period.

(c)(1)(v) through (e) [Reserved]. For further guidance, see §301.7701–3(c)-(1)(v) through (e).

(f) *Effective date.* Section 301.7701–3T(a) and (c)(1)(iv) applies on or after March 23, 1998. For rules prior to March 23, 1998, see §301.7701–3(a) and (c)(1)(iv).

Michael P. Dolan,
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Donald C. Lubick,
Assistant Secretary of the Treasury.

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