Notice of Proposed Rulemaking and Notice of Public Hearing

Treaty Guidance Regarding Payments With Respect to Domestic Reverse Hybrid Entities

REG–107101–00

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking and notice of public hearing.

SUMMARY: This document contains proposed regulations under section 894 of the Internal Revenue Code relating to the eligibility for treaty benefits of items of income paid by domestic entities that are not fiscally transparent under U.S. law but are fiscally transparent under the laws of the jurisdiction of the person claiming treaty benefits (a domestic reverse hybrid entity). The proposed regulations affect the determination of tax treaty benefits with respect to U.S. source income of foreign persons. This document also provides notice of a public hearing on these proposed regulations.

DATES: Written or electronic comments must be received by May 28, 2001. Requests to speak (with outlines of oral comments to be discussed) at the public hearing scheduled for June 26, 2001, at 10 a.m., must be submitted by June 5, 2001.

ADDRESSES: Send submissions to: CC:M&SP:RU (REG–107101–00), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered between the hours of 8 a.m. and 5 p.m. to: CC:M&SP:RU (REG–107101–00), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC. Alternatively, taxpayers may submit comments electronically via the Internet by selecting the "Tax Regs" option on the IRS Home Page, or by submitting comments directly to the IRS Internet site at *http://www.irs.gov/tax_regs/regslist.html*. The public hearing will be held in the auditorium, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, Elizabeth U. Karzon or Karen Rennie-Quarrie at (202) 622-3880; concerning submissions and the hearing, Guy R. Traynor at (202) 622-7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

On June 30, 1997, the IRS and Treasury issued temporary regulations (T.D. 8722, 1997–2 C.B. 81) in the **Federal Register** (62 FR 35673, as corrected at 62 FR 46876, 46877) under section 894 of the Internal Revenue Code relating to eligibility for benefits under income tax treaties for payments to certain entities. These regulations addressed, among other matters, the eligibility for treaty benefits of U.S. source payments made to domestic reverse hybrid entities, concluding that treaty benefits were not available for such payments. A notice of proposed rulemaking (REG–104893–97, 1997–2 C.B. 646) cross-referencing the temporary regulations was also published in the same issue of the **Federal Register** (62 FR 35755). On July 3, 2000, the IRS and Treasury issued final regulations (T.D. 8889, 2000–30 I.R.B. 124), reaffirming the position taken in the temporary regulations with respect to payments made to domestic reverse hybrid entities. The final regulations, however, did not address the question of whether payments made by domestic reverse hybrid entities to their interest holders are eligible for treaty benefits. Section 1.894–1(d)(2)(ii) was reserved for further guidance on that issue.

Explanation of Provisions

These proposed regulations provide guidance with respect to the previously reserved paragraph. They provide rules on the character of such payments for treaty purposes and the extent to which such payments are eligible for a reduced rate of U.S. tax under a U.S. income tax treaty. The use of domestic reverse hybrid entities may give rise to inappropriate and unintended results under income tax treaties, such as double non-taxation or double taxation, unless the income tax treaties are interpreted to resolve the conflict of laws. These regulations provide guidance regarding how to apply U.S. income tax treaties under these circumstances.

Section 1.894–1T(d)(3) provided guidance on the appropriate treatment of items of income paid to a domestic reverse hybrid entity. That section provided that §1.894–1T(d)(1) may not be applied to reduce the amount of Federal income tax on U.S. source income received by a domestic reverse hybrid entity through application of an income tax treaty. Thus, neither the domestic reverse hybrid entity nor its interest holders could claim a reduction under an income tax treaty with respect to a payment to a domestic reverse hybrid entity, notwithstanding that the interest holder might otherwise derive the income as a resident of a treaty jurisdiction under §1.894–1T(d)(1). The rationale for the rule was the U.S. tax treaty principle that the United States retains taxing jurisdiction over items of U.S. source income paid to its residents. The final regulations published in the **Federal Register** on July 3, 2000, retain the rule that a domestic reverse hybrid entity remains subject to the taxing jurisdiction of the United States on U.S. source payments, but reserve with respect to the treatment of payments made by domestic reverse hybrid entities.

Commentators on the previously issued temporary and proposed regulations noted that it was unclear how items of income paid by a domestic reverse hybrid entity to its interest holders should be treated. In particular, the general rule contained in §1.894–1T(d)(1) required the item of income to be "received by" a person resident in a treaty jurisdiction and for that item of income to be "subject to tax" in the hands of the person deriving the item

of income. Commentators expressed concern that an item of income paid by a domestic reverse hybrid entity could be viewed as neither "received by" the interest holder nor "subject to tax" because the interest holder's jurisdiction treats the domestic reverse hybrid entity as fiscally transparent. The interest holder's jurisdiction views the interest holder as "receiving" the items of income paid to the domestic reverse hybrid entity and as being "subject to tax" on those items of income on an immediate basis. The interest holder's jurisdiction does not recognize the items of income paid by the domestic reverse hybrid entity to the interest holder. Based on this analysis, commentators questioned whether the items of income paid by the domestic reverse hybrid entity to an interest holder in that entity would be subject to a 30-percent tax under the Code. The IRS and Treasury believe similar questions may also arise under the recently issued final regulations.

Accordingly, these proposed regulations provide rules on the treatment of payments made by domestic reverse hybrid entities. Paragraph (d)(2)(ii) of this section provides a general rule that an item of income paid by a domestic reverse hybrid entity to an interest holder shall be characterized under U.S. tax law. This means that U.S. tax principles are first applied to characterize the item of income paid by the domestic reverse hybrid entity to the interest holder for purposes of applying an applicable income tax treaty provision. Once the item of income is so characterized, it is necessary to determine if the interest holder derives the item of income. In determining whether the interest holder derives the item of income, paragraph (d)(2)(ii)(A) of this section provides a special rule for determining whether the interest holder is fiscally transparent with respect to the item of income. Under that rule, whether the interest holder is fiscally transparent with respect to the item of income for purposes of §1.894–1(d)(3)(ii) is made based on the treatment that would have resulted had the item of income been paid by an entity that was not fiscally transparent under the laws of the interest holder's jurisdiction with respect to any item of income. Accordingly, if the interest holder is not fiscally transparent, then it will be considered to have derived the item of income, even if, for example, the item of income were characterized differently or treated as received at an earlier date under the laws of the interest holder's jurisdiction than the item of income paid by the domestic reverse hybrid entity.

The IRS and Treasury have learned, however, that domestic reverse hybrid entities are being established by related parties to manipulate differences in U.S. and foreign entity classification rules to reduce inappropriately the amount of tax imposed on items of income paid from the United States to related foreign interest holders. In a typical scenario, a foreign investor, resident in a treaty jurisdiction, establishes a domestic reverse hybrid holding company with a combination of debt and equity contributions. The domestic reverse hybrid entity holds the stock of a wholly-owned U.S. operating company. The operating company pays a dividend to the domestic reverse hybrid entity, but the domestic reverse hybrid entity primarily pays interest to its foreign owner within the earning stripping limits of section 163(j). The foreign jurisdiction views the foreign owner as receiving dividends, but the United States views the domestic reverse hybrid entity as receiving the dividends and making deductible interest payments. In circumstances when the income tax treaty between the United States and the applicable foreign jurisdiction applies a zero withholding rate on interest and a 5-percent rate on related party dividends, the domestic reverse hybrid entity treats its payment to the foreign owner as an interest payment and the foreign owner avoids the withholding tax on the dividends that its jurisdiction treats it as receiving. In addition, the domestic reverse hybrid entity receives the benefit of an interest deduction in the United States while the foreign interest holder receives either a tax credit or exclusion on the dividend amount in its jurisdiction.

The IRS and Treasury believe that it is inappropriate for related parties to use domestic reverse hybrid entities for the purpose of converting higher taxed U.S. source items of income to lower taxed, or untaxed, U.S. source items of income. To do so defeats the expectation of the United States and its treaty partners that treaties should be used to reduce or eliminate double taxation for legitimate transactions, not to reward the manipulation of inconsistencies in the laws of the treaty partners. The legislative history of section 894(c) supports this analysis. Congress specifically expressed its concern about the potential tax avoidance opportunities available for foreign persons that invest in the United States through hybrid entities that are designed to avoid both U.S. and foreign income taxes. See H.R. Conf. Rep. No 220, 105th Cong, 1st Sess. 573 (1997); Joint Committee on Taxation, 105th Cong., 1st Sess., General Explanation of Tax Legislation Enacted in 1997 (JCS–23–97), at 249 (December 17, 1997). The approach contained in §1.894–1(d)(2), as revised, is also consistent with the general tax treaty principle that contracting states may adopt provisions in their domestic laws to counter structures and transactions intended to take advantage of the differences in the tax laws of the contracting states. See Commentaries to Article 1 of The 1998 OECD Model Tax Convention on Income and Capital; S. Rep. No. 445, 100th Cong. 2d Sess. 322–23 (1988)

The IRS and Treasury are further concerned by the ability of foreign acquiring entities to obtain tax advantaged financing through domestic reverse hybrid entities by exploiting differences between U.S. and foreign law. Such financing unfairly disadvantages similarly situated U.S. domestic acquiring entities. Congress has expressed concern about the use of analogous hybridized structures that were effected to provide foreign acquiring entities with tax advantaged acquisition financing not available to similarly situated domestic companies. See Joint Committee on Taxation, 100th Congress, 1st Sess., General Explanation of the Tax Reform Act of 1986 (JCS–10–87), at 1064, 1065 (May 4, 1987).

For these reasons, the proposed regulations provide a special rule in paragraph (d)(2)(ii)(B) of the regulations, such that if: (1) a domestic entity makes a payment to a related domestic reverse hybrid entity that is considered to be a dividend either under the laws of the United States or under the laws of the jurisdiction of a related foreign interest holder in the domestic reverse hybrid entity, and the related foreign interest holder is treated as deriving its proportionate share of the payment to the domestic reverse hybrid

entity under the laws of the related foreign interest holder's jurisdiction; and (2) the domestic reverse hybrid entity makes a payment to the related foreign interest holder of a type that is deductible for U.S. tax purposes and for which a reduction in the U.S. withholding tax rate would be allowed under the general rule, but for this exception, then to the extent the amount of the payment by the domestic reverse hybrid entity to the related foreign interest holder does not exceed the total amount of the interest holder's proportionate share of any payments by the domestic entity to the domestic reverse hybrid entity treated as dividends under either jurisdiction's laws, the payment by the domestic reverse hybrid entity shall be treated as a dividend for all purposes of the Code and the applicable income tax treaty.

For purposes of determining the amount of the payment from the domestic reverse hybrid entity to the related foreign interest holder to be recharacterized as a dividend, the portion of the payments treated as derived by the related foreign interest holder shall be reduced by the amount of any prior actual dividend payments, under U.S. law, made by the domestic reverse hybrid entity to the related foreign interest holder and by the amount of any payments from the domestic reverse hybrid entity to the related foreign interest holder previously recharacterized under this special rule. The tax withheld from the payment from the domestic reverse hybrid entity to the related foreign interest holder shall be determined based on the appropriate rate of withholding that would be applicable to dividends paid by the domestic reverse hybrid entity to the related foreign interest holder under the U.S. treaty with the related foreign interest holder's jurisdiction had that jurisdiction viewed the domestic reverse hybrid entity as not fiscally transparent. Because any payment subject to the provisions of this special rule is treated as a dividend for all purposes of the Code and the applicable treaty, the domestic reverse hybrid entity will not be able to claim a deduction on the payment to the related foreign interest holder.

The regulations provide an 80% ownership test to determine if the parties are related to one another and a special rule that treats accommodation parties as related foreign interest holders. The foregoing rules also apply to recharacterize payments when more than one domestic reverse hybrid entity or other fiscally transparent entity is involved.

The proposed regulations further provide that a taxpayer may not affirmatively use the rules of paragraph (d)(2) of this section if a principal purpose for using such rules is the avoidance of any tax imposed by the Code. Thus, with respect to such a taxpayer, the Commissioner may depart from the rules of this section and recharacterize (for all purposes of the Code) the arrangement in accordance with its form or its economic substance. The regulations further provide that, if a taxpayer enters into an arrangement the effect of which is to circumvent the principles of this paragraph (d)(2), the Commissioner may recharacterize (for all purposes of the Code) the arrangement in accordance with the principles of this paragraph (d)(2).

Comments are requested on potential rules with respect to transaction when the domestic reverse hybrid entity is sold to unrelated parties who later receive distributions.

Proposed Effective Dates

These proposed regulations apply to items of income paid by a domestic reverse hybrid entity on or after the date these regulations are published as final regulations in the **Federal Register** with respect to amounts received by the domestic reverse hybrid entity on or after the date these regulations are published as final regulations in the **Federal Register**. No inference is intended as to the treatment of transactions entered into prior to the date of applicability of the final regulations.

Special Analysis

It has been determined that this notice of proposed rulemaking 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 Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations and, because these regulations do not impose on small entities a collection of information requirement, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (preferably a signed original and eight (8) copies) that are submitted timely to the IRS. The IRS and Treasury Department specifically request comments on the clarity of the proposed regulations and how they can be made easier to understand. All comments will be available for public inspection and copying.

A public hearing has been scheduled for June 26, 2001, at 10 a.m. in the auditorium, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC. Because of access restriction, visitors will not be admitted beyond the Internal Revenue Building lobby more than 15 minutes before the hearing starts.

The rules of 26 CFR 601.601(a)(3) apply to the hearing.

Persons that wish to present oral comments at the hearing must submit written comments by May 28, 2001, and submit an outline of the topics to be discussed and the time to be devoted to each topic (preferably a signed original and eight (8) copies) by June 5, 2001.

A period of 10 minutes will be allotted to each person for making comments.

An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal author of these regulations is Shawn R. Pringle of the Office of the Associate Chief Counsel (International). However, other personnel from the IRS and Treasury Department participated in their development.

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Proposed Amendments to the Regulations

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

PART 1—INCOME TAXES

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

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

Section 1.894–1(d)(2) also issued under 26 U.S.C. 894 and 7701(l).* * *

Par. 2. In §1.894–1, paragraph (d)(2)(ii) is revised and paragraphs (d)(2)(iii) and (d)(2)(iv) are added to read as follows:

§1.894–1 Income affected by treaty.

* * * * *

(d) * * *

(2) * * *

(ii) *Payments by domestic reverse hybrid entities*—(A) *General rule*. Except as otherwise provided in paragraph (d)(2)(ii)(B) of this section, an item of income paid by a domestic reverse hybrid entity to an interest holder in such entity shall have the character of such item of income under U.S. law and shall be considered to be derived by the interest holder, provided the interest holder is not fiscally transparent in its jurisdiction, as defined in paragraph (d)(3)(iii) of this section, with respect to the item of income. In determining whether the interest holder is fiscally transparent with respect to the item of income under this paragraph (d)(2)(ii)(A), the determination under paragraph (d)(3)(ii) of this section shall be made based on the treatment that would have resulted had the item of income been paid by an entity that is not fiscally transparent under the laws of the interest holder's jurisdiction with respect to any item of income.

(B) *Payment made to related foreign interest holder*—(*1*) *General rule*. If—

(*i*) A domestic entity makes a payment to a related domestic reverse hybrid entity that is treated as a dividend under either the laws of the United States or the laws of the jurisdiction of a related foreign interest holder in the domestic reverse hybrid entity, and under the laws of the jurisdiction of the related foreign interest holder in the domestic reverse hybrid entity, the related foreign interest holder is treated as deriving its proportionate share of the payment under the principles of paragraph (d)(1) of this section; and

(*ii*) The domestic reverse hybrid entity makes a payment of a type that is deductible for U.S. tax purposes to the related foreign interest holder and for which a reduction in the U.S. withholding tax rate would be allowed under paragraph (d)(2)(ii)(A) of this section but for this paragraph (d)(2)(ii)(B), then

(*iii*) To the extent the amount of the payment described in paragraph (d)(2)(ii)(B)(*1*)(*ii*) of this section does not exceed the sum of the portion of the payment described in paragraph (d)(2)(ii)(B)(*1*)(*i*) of this section treated as derived by the related foreign interest holder and the portion of any other prior payments described in paragraph (d)(2)(ii)(B)(*1*)(*i*) of this section treated as derived by the related foreign interest holder, the amount of the payment described in (d)(2)(ii)(B)(*1*)(*ii*) of this section will be treated for all purposes of the Internal Revenue Code and the applicable income tax treaty as a dividend, and the tax to be withheld from the payment described in paragraph (d)(2)(ii)(B)(*1*)(*ii*) of this section shall be determined based on the appropriate rate of withholding that would be applicable to dividends paid from the domestic reverse hybrid entity to the related foreign interest holder under the U.S. treaty with the related foreign interest holder's jurisdiction had that jurisdiction viewed the domestic reverse hybrid entity as not fiscally transparent; and

(*iv*) For purposes of determining the amount to be recharacterized under paragraph (d)(2)(ii)(B)(*1*)(*iii*) of this section, the portion of the payments described in paragraph (d)(2)(ii)(B)(*1*)(*i*) of this section treated as derived by the related foreign interest holder shall be reduced by the amount of any prior actual dividend payments made by the domestic reverse hybrid entity to the related foreign interest holder and by the amount of any payments from the domestic reverse hybrid entity to the related foreign interest holder previously rechacterized under paragraph (d)(2)(ii)(B)(*1*)(*iii*) of this section.

(*2*) *Tiered entities*. The principles of this paragraph (d)(2)(ii)(B) shall also apply to payments referred to in this paragraph (d)(2)(ii)(B) made among related entities when there is more than one domestic reverse hybrid entity or other fiscally transparent entities involved.

(*3*) *Definition of related*. Related shall mean any entity satisfying the ownership requirements of section 267(b) or 707(b)(1), except that 80 percent shall be substituted for 50 percent. For purposes of determining whether a person is related to another person, the constructive ownership rules of section 318 shall apply, and the attribution rules of section 267(c) also shall apply to the extent they attribute ownership to persons to whom section 318 does not attribute ownership. If a person enters into a transaction (or series of transactions) with the domestic reverse hybrid entity, its related interest holders, or its related entities, and the effect of the transaction (or series of transaction) is to avoid the principles of this paragraph (d)(2)(ii)(B), then that person shall be treated as related to the domestic reverse hybrid entity for purposes of this section.

(C) *Commissioner's discretion*. The Commissioner may, as the Commissioner determines to be appropriate, recharacterize for all purposes of the Internal Revenue Code all or part of any transaction (or series of transactions) between related parties if the effect of the transaction (or series of transactions) is to avoid the principles of this paragraph (d)(2).

(iii) *Examples*. The rules of this paragraph (d)(2) are illustrated by the following examples:

Example 1. Treatment of payment by unrelated entity to domestic reverse hybrid entity. (i) *Facts*. Entity A is a domestic reverse hybrid entity, as defined in paragraph (d)(2)(i) of this section, with respect to the U.S. source dividends it receives from B, a domestic corporation to which A is not related, within the meaning of paragraph (d)(2)(ii)(B)(*3*) of this section. A's 85-percent shareholder FC is a corporation organized under the laws of Country X, which has an income tax treaty in effect with the United States. Under Country X law, FC is not fiscally transparent with respect to the dividend, as defined in paragraph (d)(3)(ii) of this section. In year 1, A receives a $100 of dividend income from B. Under Country X law, FC is treated as deriving $85 of the $100 dividend payment received by A. The applicable rate of tax on dividends under the U.S.-Country X income tax treaty is 5 percent with respect to a 10-percent or more corporate shareholder.

(ii) *Analysis*. Under paragraph (d)(2)(i) of this section, the U.S.-Country X income tax treaty does not apply to the dividend income received by A because the income is paid by B, a domestic corporation, to A, another domestic corporation. A remains fully taxable under the U.S. tax laws as a domestic corporation with regard to that item of income. Further, pursuant to paragraph (d)(2)(i) of this section, notwithstanding the fact that under the laws of Country X A is treated as fiscally transparent with respect

to the dividend income, FC may not claim a reduced rate of taxation on its share of the U.S. source dividend income received by A.

Example 2. Treatment of payment by domestic reverse hybrid entity to related foreign interest holder involving unrelated party. (i) *Facts*. The facts are the same as in *Example 1*. Both the United States and Country X characterize the payment by B in year 1 as a dividend. In addition, in year 2, A makes a payment of $25 to FC that is characterized under U.S. tax laws as an interest payment to FC on a loan from FC to A. Under the U.S.-Country X income tax treaty, the rate of tax on interest is zero. Under Country X laws, had the interest been paid by an entity that is not fiscally transparent under Country X's laws with respect to any item of income, FC would not be fiscally transparent as defined in paragraph (d)(2)(ii) of this section with respect to the interest.

(ii) *Analysis*. The analysis is the same as in *Example 1* with respect to the $100 payment from B to A. With respect to the $25 payment from A to FC, paragraph (d)(2)(ii)(B) of this section will not apply because, although FC is related to A, A is not related to the payor of the dividend income it received. Under paragraph (d)(2)(ii)(A) of this section, the $25 interest income paid from A to FC in year 2 will be characterized under U.S. law as interest . Accordingly, in year 2, FC may obtain the reduced rate of withholding applicable to interest under the U.S.-Country X income tax treaty, assuming all other requirements for claiming treaty benefits are met.

Example 3. Treatment of payment by domestic reverse hybrid entity to related foreign interest holder. (i) *Facts*. The facts are the same as in *Example 2*, except the $100 dividend income received by A in year 1 is from A's wholly owned subsidiary S.

(ii) *Analysis*. The analysis is the same as in *Example 1* with respect to the $100 dividend payment from S to A. However, the $25 interest payment in year 2 by A to FC will be treated as a dividend for all purposes of the Internal Revenue Code and the U.S.-Country X income tax treaty because $25 does not exceed FC's share of the $100 dividend payment made by S to A ($85). Since FC is not fiscally transparent with respect to the payment as determined under paragraph (d)(2)(ii)(A) of this section, FC will be entitled to obtain the reduced rate applicable to dividends under the U.S.-Country X income tax treaty with respect to the $25 payment. Because the $25 payment in year 2 is recharacterized as a dividend for all purposes of the Internal Revenue Code and the U.S.-Country X income tax treaty, A would not be entitled to an interest deduction with respect to that payment and FC would not be entitled to claim the reduced rate of withholding applicable to interest.

(iv) *Effective date*. This paragraph (d)(2) applies to items of income paid by a domestic reverse hybrid entity on or after the date these regulations are published as final regulations in the **Federal Register** with respect to amounts received by the domestic reverse hybrid entity on or after the date these regulations are published as final regulations in the **Federal Register**.

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Robert E. Wenzel,
Deputy Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on February 26, 2001, 8:45 a.m., and published in the issue of the Federal Register for February 27, 2001, 66 FR 12445)