

**COMMENTS CONCERNING PROPOSED REGULATIONS UNDER SECTION 894(c)
RELATING TO PAYMENTS MADE BY DOMESTIC REVERSE HYBRID ENTITIES**

The following comments (the “Comments”) constitute the individual views of the members of the Section of Taxation who prepared them and do not represent the position of the American Bar Association or the Section of Taxation.

These Comments were prepared by individual members of the Committee on U.S. Activities of Foreigners and Tax Treaties (the “Committee”) Principal responsibility was exercised by Joan C. Arnold and Lisa Askenazy Felix. Substantive contributions were made by Sam Kaywood. The Comments were reviewed by John P. Barrie of the Section’s Committee on Government Submissions and by David L. Raish, Council Director for the Committee on U.S. Activities of Foreigners and Tax Treaties.

Although the members of the Section of Taxation who participated in preparing these Comments have clients who would be affected by the federal tax principles addressed by these Comments or have advised clients on the application of such principles, except as noted below, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments.

On July 3, 2001 comments with respect to the anti-abuse provisions in the proposed Regulations were submitted by Richard Gordon of Arthur Andersen on behalf of a client. Mr. Gordon did not participate in the development of these comments and Ms. Felix did not participate in the development of Mr. Gordon’s comments. In addition, the issues addressed by Mr. Gordon are not addressed herein.

Contact Persons:

Joan C. Arnold
215-981-4362
arnoldj@pepperlaw.com

Lisa Askenazy Felix
202-481-7708
lisa.askenazy.felix@us.Andersen.com

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These Comments respond to the request for comments regarding the regulations proposed by the Treasury Department (the “Treasury”) and the Internal Revenue Service (the “Service”) in the Federal Register on February 27, 2001 (the “Proposed Regulations”),¹ concerning the treatment of certain payments made by an entity that is a corporation for U.S. tax purposes, but is fiscally transparent under the laws of the interest holders jurisdiction.² The Proposed Regulations expand on the general principles set forth in Treas. Reg. § 1.894-1(d)(2)(i) of the regulations that were issued on June 30, 2000 (the “Final Regulations.”).³

I. EXECUTIVE SUMMARY

The recommendations in these Comments include the following:

1. The final regulations should clarify the perceived abuse and incorporate in a manner similar to Treas. Reg. § 1.881-3(b) and Treas. Reg. § 1.7701(l)-3(c), relief from the operation of the regulations if the arrangements do not have as the principal purpose the avoidance of U.S. tax.
2. The final regulations should clarify that payments not subject to withholding under § 1441 should not be recharacterized.
3. The final regulations should clarify that an interest holder is a person that is treated as deriving its proportionate share of the payment made by the U.S. subsidiary under the principles of Treas. Reg. § 1.894(c)-1(d)(1).
4. The relationship of the related person anti-abuse rules found in Prop. Treas. Reg. § 1.894-1(d)(2)(ii)(B)(3) and the general anti-abuse rule of Prop. Treas. Reg. § 1.894-1(d)(2)(ii)(C) needs to be clarified.
5. Based on the perceived abuse identified in the preamble to the Proposed Regulations, the final regulations should provide that if as a result of the recharacterization the U.S. withholding tax would increase, no recharacterization should occur.
6. The final regulation should confirm that certain specified structures are not subject to the anti-abuse provisions.

II. BACKGROUND

The Final Regulations address payments of U.S. source income paid to an entity that is treated as fiscally transparent in one jurisdiction but not in another jurisdiction - a “hybrid

¹ 66 Fed. Reg. 12,445 (February 27, 2001).

² Unless otherwise specified, all “section” references in these Comments are to the Code, and all references to Prop. Treas. Reg. § 1.894-1(d)(2)(ii)(A) through 1.894-1(d)(2)(ii)(C) are to the Proposed Regulations.

³ T.D. 8889. The 2000 Final Regulations reserved comment on the items covered in the Proposed Regulations.

entity.” An entity is fiscally transparent with respect to an item of income if the laws of the entity’s jurisdiction require the interest holder, wherever resident, to take the item of income into account on a current basis, whether or not distributed, and if the source and character of the income are determined as if realized directly.⁴ The Final Regulations generally provide that U.S. tax treaties may be applied to reduce the U.S. tax imposed under §§ 871, 881(a), 1461 and 4948(a) only if the income is derived by a resident of the applicable treaty jurisdiction. If the payment is made to an entity that is fiscally transparent under the laws of its county of residence, the entity may not claim the benefits of the tax treaty between its county of residence and the U.S. to reduce the U.S. tax due on dividends, interest, royalties or other items subject to tax under § 871 or § 881.

The Final Regulations generally provide that the benefits of a U.S. treaty may be claimed by an interest holder in the entity-recipient of the income if (i) the entity-recipient is viewed as fiscally transparent under the laws of the interest holder’s jurisdiction and (ii) the interest holder itself is not fiscally transparent under the laws of its jurisdiction.⁵

Notwithstanding this general rule, the Final Regulations provide that an interest holder in a “domestic reverse hybrid entity” (“DRH”) cannot claim the benefits of reduced U.S. taxes under a treaty on payments received by DRH.⁶ A DRH is an entity that is not fiscally transparent for U.S. tax purposes, but is fiscally transparent under the laws of the interest holder’s jurisdiction. For example, a limited partnership that is formed under the laws of Delaware and that elects to be taxed as a corporation under § 7701 will not be fiscally transparent for U.S. tax purposes, but the jurisdiction in which a partner resides may well require the partner to include the income on a current basis, because the limited partnership is fiscally transparent under the laws of such jurisdiction.

The Final Regulations generally do not preclude the interest holder from claiming the benefits of a tax treaty on items of U.S. source interest paid to it by DRH, and the Proposed Regulations generally confirm that so long as the interest holder is not itself fiscally transparent, or within the scope of the dividend recharacterization rule described below, it may claim treaty benefits.⁷

Section 7701(l) grants the Secretary the right to prescribe regulations recharacterizing any multiple party financing transaction as a transaction directly among two or more of the parties if appropriate to prevent avoidance of U.S. tax.⁸ Citing the authority of § 894 and

⁴ Treas. Reg. § 1.894-1(d)(3)(ii).

⁵ Treas. Reg. § 1.894-1(d)(1).

⁶ Treas. Reg. § 1.894-1(d)(2)(i).

⁷ Prop. Treas. Reg. § 1.894-1(d)(2)(ii).

⁸ § 7701(l).

§ 7701(l) the IRS issued the Proposed Regulations on February 27, 2001.⁹ These Comments do not address the validity of the regulations, either under the provisions of the Code or under the provisions of existing treaties with other jurisdictions.

The Proposed Regulations confirm that DRH interest holders that are not themselves fiscally transparent may claim the benefits of a U.S. treaty to reduce taxes on payments received from DRH. In addition, the IRS identified two specific concerns relating to cross border payments made by DRHs. It is the IRS' view that (i) it is inappropriate for related parties to use DRHs to convert higher taxed U.S. source items of income to lower taxed, or untaxed U.S. source items of income and (ii) it is a concern that DRHs are being used by related parties to obtain tax advantaged financing by exploiting differences between U.S. and foreign law.¹⁰

To address these concerns the Proposed Regulations provide that:

- If a domestic entity (the “U.S.Co.”) makes a payment to a related DRH that is treated as a dividend
 - under the laws of the U.S., or the laws of a related foreign interest holder (“RFIH”) in DRH, and
 - under the laws of the jurisdiction of RFIH, RFIH is treated as having derived its proportionate share of the payment, and
 - DRH makes a payment of a type that is deductible for U.S. tax purposes to RFIH, and for which a reduction in U.S. withholding tax would be allowed (but for this provision), then
- All or a portion of the payment that would otherwise be deductible will be treated as a dividend for all purposes of the Code and the applicable tax treaty (the “dividend recharacterization rule”).

The fact pattern that raised the concerns is understood to be as follows:

RFIH forms DRH, funding it with debt and equity. DRH uses the funds to acquire more than 80% of the stock of U.S.Co.. U.S.Co. pays dividends to DRH, which are not taxable to DRH because DRH and U.S.Co. are members of the same consolidated group. DRH pays interest to RFIH. Absent the Proposed Regulations, the interest is deductible in the U.S. consolidated return, offsetting operating income earned by U.S.Co. The interest is generally subject to a treaty withholding tax rate that would be lower than that applicable to dividends (the “Base Case”).

⁹ 66 Fed. Reg. 12,445. The citation of authority pursuant to § 7701(l) was made in Treaty Guidance Regarding Payments With Domestic Reverse Hybrid Entities Correction 66 Fed. Reg. 14,3252 (March 12, 2001).

¹⁰ See Preamble.

From the perspective of RFIH, it generally has no net taxable income from the payments. In some cases the dividend that is deemed derived by RFIH through DRH is excludable from taxable income under the laws of the jurisdiction of residence of RFIH (i.e., a jurisdiction providing for a so-called “participation exemption”) or, if includable, any tax may be offset by credit for U.S. taxes paid by U.S.Co.. Alternatively, it is possible that the laws of the jurisdiction of RFIH may require that RFIH include the dividend in income but allow the interest deduction.

Thus, it appears that the “inappropriate result” is that there is a deduction for U.S. purposes but no income tax cost for the RHIP in its county of residence, and that a lower U.S. withholding rate has been achieved.

The Comments focus on the application of these rules, request relief for situations in which the principal purpose of the arrangement is not U.S. tax avoidance and provide suggestions for clarification of key points.

III. COMMENTS

A. The Scope of the Regulations is Overly Broad and Should be Narrowed

Based on the language of the preamble, the concern appears to arise from the Base Case, in which the sole purpose of DRH is to obtain tax favored financing to facilitate the acquisition of U.S.Co. The rules of the Proposed Regulations are, however, self-executing. There is no purpose test nor is there an avenue to establish that the Proposed Regulations should not apply.

The authority for the provisions of the Proposed Regulation that recharacterize the otherwise deductible amounts is claimed to be § 7701(l). The purpose of that section is to allow the Secretary to recharacterize transactions in situations in which U.S. tax avoidance is present. The authority under § 7701(l) has been exercised previously with anti-conduit regulations under Treas. Reg. § 1.881-3 and in regulations under Treas. Reg. § 1.7701(l)-3 addressing “fast-pay stock” arrangements.¹¹ The grant of authority under § 7701(l) is broad enough to allow the IRS to craft exceptions for multiple-party financing arrangements where there is no U.S. tax avoidance purpose present. See, for example Treas. Reg. § 1.881-3(b)(2) (ii) that allows the taxpayer to show that the intermediary entity had the ability to engage in financing transactions independently, and Treas. Reg. § 1.881-3(b)(2)(iii) which directs the district director to consider the independence of the related party financings. See, also, Treas. Reg. § 1.881-3(e) ex. 17, 18, 19 and 20. The fast pay stock regulations also require a determination of principal purpose of reducing U.S. tax.¹²

The result of the Proposed Regulations is to ignore DRH and to treat payments as having been made directly from U.S.Co. to RFIH. This treatment appears to disregard the flexibility granted to taxpayers under the check-the-box regulations¹³ to elect corporate status. Generally,

¹¹ See also, Prop. Treas. Reg. § 1.7701(l)-2 involving “obligation-shifting” transactions.

¹² Treas. Reg. § 1.7701(l)-3(c).

¹³ Treas. Reg. § 301.7701-1, et seq.

the separate existence of an entity should be respected for tax purposes. Moline Properties, Inc. v. Commissioner, 319 U.S. 436 (1943); National Carbide Corp. v. Commissioner, 336 U.S. 422 (1949). In situations in which the entity is not, however, exercising dominion and control over income that it receives, it may be appropriate to treat the entity as not receiving the income, and viewing the payment as made directly to the beneficial recipient. In this narrow situation, application of common law conduit principles may well be the correct approach. See e.g., Aiken Industries v. Commissioner, 56 T.C. 925 (1975); Commissioner v. Bollinger, 485 U.S. 340 (1988).

There are situations however, in which DRH is the parent of a U.S. affiliated group for reasons wholly unrelated to cross border tax planning. In the closely held sector for example, DRHs are used when the flexibility in governance and structure afforded by a partnership or LLC is desired, but consolidation is desired for tax purposes. If such DRH were acquired by a RFIH, DRH may, at some point in time need to license intangibles or borrow funds from RFIH. It may also receive dividends from its U.S. subsidiaries that are used to fund operations or service debt.

If the debt is not incurred or the license agreement is not implemented for the principal purpose of achieving the perceived abuse, the taxpayer should have a mechanism for relief from the Proposed Regulations. We suggest that the final regulations (i) clarify the perceived abuse and (ii) incorporate a tax avoidance test. This would be consistent with the other regulations promulgated pursuant to § 7701(l), and with the history of that section.

In developing the principal purpose test the following factors should be considered:

(1) The ability of DRH to satisfy the debt independent of dividends or other payments from U.S.Co.;

(2) Whether DRH would be deemed the owner of the dividend under general federal income tax principles such as Aiken; and

(3) The time lapse between the date that RFIH, DRH and U.S.Co. became related persons and the date that the intercompany debt is incurred. To this end, if the debt is not incurred as part of the transaction in which RFIH and U.S.Co. become related, the abuse identified in the preamble, which focuses on the acquisition of U.S.Co., is not present. We suggest that if the debt is not incurred as part of the acquisition, the recharacterization rule should not apply. The principles of § 279 would be instructive in determining if the debt is incurred as part of the acquisition.

B. Payments Not Subject to Withholding under the Code Should Not Be Recharacterized

Prop. Treas. Reg. § 1.894-1(d)(2)(ii)(B)(1)(ii) identifies a payment as one for which a reduction in U.S. withholding tax rate would be allowed but for the Proposed Regulations. We request clarification that if the payment would not have been subject to withholding without regard to a treaty, it is not a payment subject to recharacterization under the Proposed Regulation.

Example B1: DRH issues a note payable to RFIH with a maturity of less than 183 days. The interest is original issue discount, not subject to tax or withholding.¹⁴

Result: The payment of the interest is not subject to recharacterization under Prop. Treas. Reg. § 1.894-1(d)(2)(ii)(B)(1)(iii).

C. Payments Made When Relationship Doesn't Exist Should not Be Relevant

The final regulations should clarify that only those payments made to and by DRH while DRH is related to U.S. Co. are taken into account for purposes of the recharacterization rule. For example, if DRH receives a dividend from U.S.Co. while DRH is not related to a foreign interest holder, and DRH subsequently becomes related to the foreign interest holder, such dividend should not be one described in Prop. Treas. Reg. § 1.894-1(d)(2)(ii)(B)(1)(i).

Similarly, the determination of actual dividends made by DRH to RFIH under Prop. Treas. Reg. § 1.894-1(d)(2)(ii)(B)(iv) should include only those paid while DRH and RFIH are related.

D. Definition of a Related Interest Holder

Both the dividend recharacterization rule and the general rule in Prop. Treas. Reg. § 1.894-1(d)(2)(ii)(A) require a “related foreign interest holder.” There is no definition of an “interest holder.” The term “related” is defined by reference to the ownership requirements in §§ 267(b) and 707(b)(1) using an 80% (rather than 50%) threshold.¹⁵ The constructive ownership rules of § 318 shall also be utilized to determine relatedness, and the attribution rules of § 267(c) are used to fill in any gaps left by § 318. In addition, a person not otherwise related, may be treated as related to DRH under an anti-abuse rule.¹⁶

We believe that the term interest holder is intended to mean the person who holds an equity interest directly, and not indirectly or through attribution, in DRH. We believe the modifier related is intended to define the class of direct interest holders the payments of interest to which are subject to recharacterization.

The Proposed Regulations should clarify that for every item of dividend income described under Prop. Treas. Reg. § 1.894-1(d)(2)(ii)(B)(i), there can be only one RFIH, which is the related person that is treated as deriving its proportionate share of the dividend payment under the principles of Treas. Reg. § 1.894-1(d)(1). For example, if FP, a foreign corporation, owned 100% of the stock of FS, another foreign corporation and FS owns 90% of the interest in DRH, FS would be RFIH, and not FP. Similarly, if FP owns the stock of FS1, FS2, FS3 and FS4

¹⁴ § 871(a).

¹⁵ Prop. Treas. Reg. § 1.894-1(d)(2)(ii)(B)(3)

¹⁶ Prop. Treas. Reg. § 1.894-1(d)(2)(ii)(B)(3)

each of which owns 25% of DRH, each of FS1, FS2, FS3 and FS4 would be a related foreign interest holder, and FP would not be a related foreign interest holder.

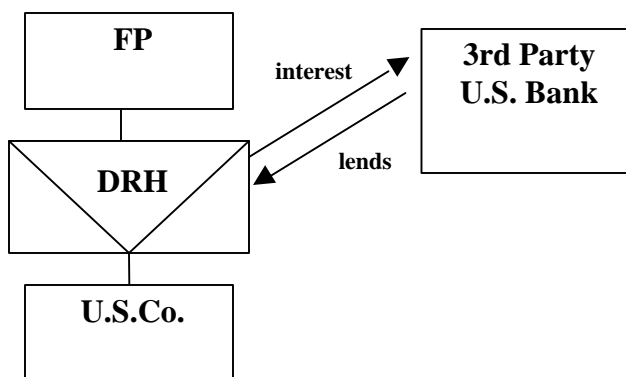
A more expansive definition of interest holder that includes indirect owners and owners through application of attribution rules could give rise to an overly broad application of the anti-abuse rules. We discuss certain such situations in section G below.

E. Related Person Anti-Abuse Regulations

We request that guidance be provided on what will and will not be considered abusive under Prop. Treas. Reg. § 1.894-1(d)(2)(ii)(B)(3). In particular, we are concerned with the application of the rules to third party lenders.

There are three bank lending situations that we believe require specific rules:

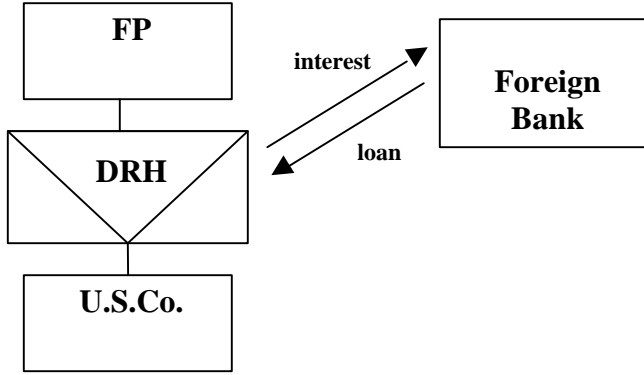
U.S. Lender or Foreign Lender Taxed in U.S.



We believe that where DRH is paying interest to a third party bank that is a domestic corporation or a foreign corporation as to which the interest is taxable under § 882, it should be recognized that there can be no abuse. This would apply whether or not FP has guaranteed the debt of DRH because the interest will be included in the taxable income of the U.S. Bank.

Foreign Lender Not Taxed in U.S.

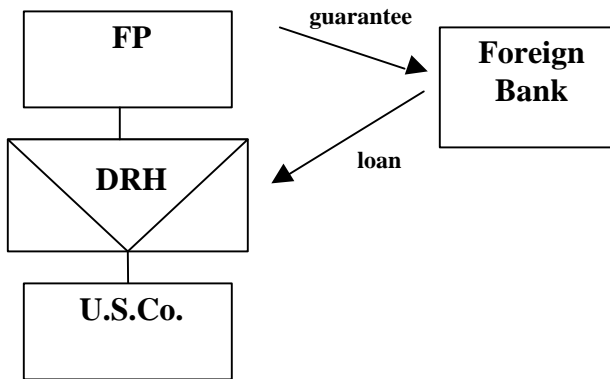
In the scenario depicted below, DRH borrows money from an unrelated foreign bank that is not taxed in the U.S. on a “net” basis. Neither FP or another person related to DRH has guaranteed the loan.



We believe that in situations in which FP has not guaranteed the loan or the interest payments, the otherwise unrelated Foreign Bank should not be treated as related under the related person anti-abuse rule. The Foreign Bank will be required to account for the interest income in its taxable income, so the perceived abuse is not present. This would be consistent with the approach of § 163(j).

Foreign Lender Not Taxed in U.S. with Guarantee

This scenario is the same as the previous scenario, except that FP guarantees the loan made by Foreign Bank to DRH.



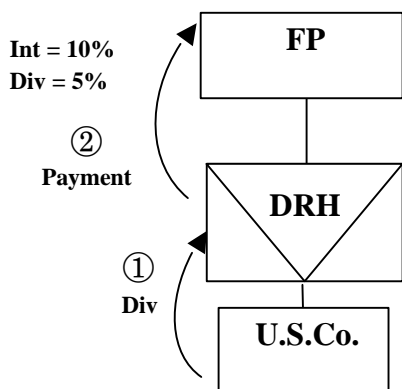
There is the potential for abuse in this structure if under generally applicable tax principles the FP would be deemed to be the actual borrower on the loan. On the other hand, if DRH has the economic resources to support the loan and the guarantee is merely a credit enhancement to produce a lower interest rate, there is no abuse present.

F. The Regulation Should Not Recharacterize Payments of Interest Where Withholding on Deductible Payments is Higher than Withholding on Dividends.

The preamble explains that the perceived abuse occurs when there is both a reduction in U.S. withholding rates as compared to dividend payments and a reduction in U.S. tax without a concomitant increase in foreign income. If there is no reduction in withholding taxes, there should be no recharacterization of the interest.

Example F1: Foreign parent (FP) owns DRH that is resident in Country X (a treaty jurisdiction with a 10-percent withholding rate on interest and a five-percent withholding rate on direct dividends). A domestic corporation (US) pays dividends to DRH and DRH makes a deductible interest payment to FP, as depicted below:

Example F1



Result: This transaction falls within the literal language of Prop. Treas. Reg. § 1.894-1(d)(2)(ii)(B) because there is a reduction from the standard 30% withholding tax, and therefore the interest payment by DRH would be recharacterized as a dividend for all purposes of the Code. Under such a recharacterization, DRH would lose its U.S. interest deduction. In addition, as a dividend, the payment would be entitled to a lower rate of withholding (e.g., 5%) than it would have qualified for as an interest payment (e.g., 10%).

Application of the dividend recharacterization rule in this situation is inconsistent with one of the key principles espoused in the preamble: “it is inappropriate for related parties to use domestic reverse 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.” We recommend that the regulations provide an exception from the dividend recharacterization rule such that a payment that would be subject to a higher rate of withholding tax, if recharacterized as a dividend, is not so recharacterized.

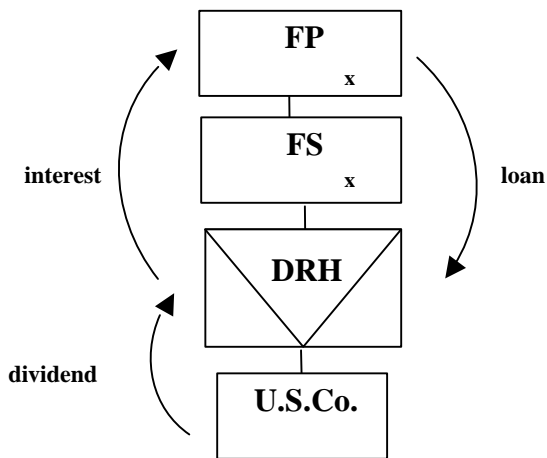
G. Final Regulations Should Narrow the Scope of the Commissioner’s Discretion by Articulating the Principles of the Anti-abuse Rule

The Proposed Regulations permit the Commissioner, as he deems appropriate, to recharacterize for all purposes of the Code all, or any part, of any transaction (or series of transactions) between related parties if its effect is to avoid the “principles” of these proposed regulations.¹⁷

This rule is troublesome for a number of reasons. First, its scope is extremely ambiguous in light of the availability of transactions that accomplish the same tax result yet are almost certainly not intended to be affected by the proposed regulations. Whereas the dividend recharacterization rule in paragraph (d)(2) allows recharacterization of deductible payments if certain carefully enumerated criteria are met, the anti-abuse rule allows the Commissioner to recharacterize a transaction, a part of a transaction, or a series of transactions without any articulated criteria. The Commissioner is only guided by what he determines to be the effect of avoiding the principles of paragraph (d)(2), without giving any context or guidance as to the principles at issue. We recommend that the final regulations clarify and narrow the scope of the Commissioner’s discretion by articulating the principles of the regulations as specific factors or elements. We would be pleased to work with you to develop specific language that would be helpful in guiding taxpayers.

We identified certain structures that we do not believe should be subject to recharacterization, and request that the following structures be confirmed as non-abusive:

Linear Relationship

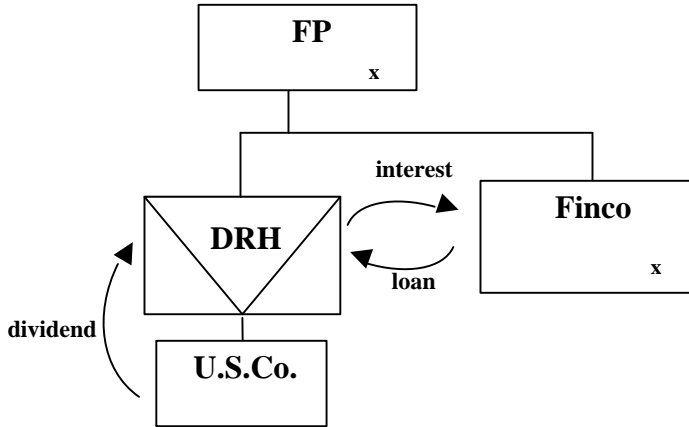


FP is incorporated in Country X, as is FS. FS is the related foreign interest holder; not FP. FP and FS do not consolidate for Country X tax purposes. As a result, FP has a net income

¹⁷ Treas. Reg. § 1.894-2(d)(2)(C).

increase in Country X as a result of the interest payment. The anti-abuse rule should not apply to this transaction.

Brother-Sister Relationships



FP is incorporated in Country X, as is Finco. Finco is not a related foreign interest holder, FP and Finco do not consolidate for Country X purposes. As a result Finco has a net income increase in Country X as a result of the interest payment. The anti-abuse rule should not apply to this transaction.

In addition, if Finco is incorporated in Country Y, so long as Country Y does not permit consolidation with FP for Country Y purposes, the anti-abuse rules should not apply.