OCS as well as my concern that the extension of jurisdiction, light-handed as it may be, to currently non-jurisdictional OCS companies prevents me from providing the instant NOPR with my support. Accordingly, I dissent from the issuance of this proposed rulemaking.

Respectfully,

Curt Hébert, Jr.,

Commissioner.

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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Parts 1 and 301

[REG–113909–98]

RIN 1545–AW63

Withdrawal of Guidance Under Subpart F Relating to Partnerships and Branches and Issuance of New Guidance Under Subpart F Relating to Certain Hybrid Transactions

AGENCY: Internal Revenue Service (IRS), Treasury.

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

SUMMARY: This document withdraws the notice of proposed rulemaking and notice of proposed rulemaking by cross-reference to temporary regulations that was published in the **Federal Register** on March 26, 1998, providing guidance under subpart F relating to partnerships and branches. This document contains new proposed regulations relating to the treatment under subpart F of certain transactions involving hybrid branches. These regulations are necessary to provide guidance on transactions relating to such entities. This document also provides notice of a public hearing on these proposed regulations.

DATES: Written comments, and outlines of oral comments to be discussed at the public hearing scheduled for December 1, 1999, must be received by November 10, 1999.

ADDRESSES: Send submissions to: CC:DOM:CORP:R (REG–113909–98), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 5 p.m. to: CC:DOM:CORP:R (REG–113909–98), 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.ustreas.gov/prod/tax__regs/regslist.html. The public hearing will be held in room 2615, Internal Revenue Building, 1111 Constitution Avenue NW., Washington, DC 20224.

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, Valerie Mark, (202) 622–3840; concerning submissions of comments, the hearing, and/or to be placed on the building access list to attend the hearing, LaNita Van Dyke (202) 622–7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

On March 23, 1998 (63 FR 14669, March 26, 1998), the IRS issued proposed regulations (REG–104537–97) relating to the treatment under subpart F of certain partnership and hybrid branch transactions. The provisions of the proposed regulations relating to hybrid branch transactions were also issued as temporary regulations (TD 8767) (63 FR 14613, March 26, 1998). Certain members of Congress and taxpayers raised concerns about the proposed and temporary regulations relating to hybrid branch transactions. On June 19, 1998, the Treasury announced in Notice 98–35 (1998–27 I.R.B. 35) that the temporary regulations would be removed and that the proposed regulations relating to hybrid transactions would be re-proposed with new dates of applicability to give Congress the opportunity to consider in greater depth the issues raised by hybrid transactions.

As provided in Notice 98–35, these proposed regulations substantially restate the regulations relating to hybrid transactions issued in March of 1998. These proposed regulations, however, contain certain clarifications requested by taxpayers. Further, as described in greater detail below, unlike the effective date rules announced in Notice 98–35, these regulations are proposed to be effective only for payments made in taxable years commencing after the date that is five years after the date of finalization of these regulations. The permanent grandfather relief described in Notice 98–35 remains unchanged.

These proposed regulations represent the IRS and Treasury's views of how current law should be enforced. Treasury is currently undertaking a comprehensive study of subpart F. These proposed regulations will not control the results of the study. For example, an objective analysis of the policies and goals of subpart F may lead to the conclusion that subpart F should be significantly restructured.

To the extent, however, that Congress does not restructure subpart F in a manner that would alter the rules enforced by these regulations, Treasury and the IRS believe that these regulations will be necessary to preserve the integrity of the current statutory scheme. The use of hybrid arrangements, which is greatly facilitated by the ''check-the-box'' entity classification regulations (§§ 301.7701–1 through 301.7701–3), would otherwise give rise to the following inconsistency: if sales income is shifted from one CFC to a related CFC in a different jurisdiction, subpart F income may arise; if sales income is shifted from one CFC to its branch in a different jurisdiction, subpart F income may arise; if income is shifted through interest payments from one CFC to a related CFC in a different jurisdiction, subpart F income may arise; however, if income is shifted through interest payments from one CFC to its hybrid branch in a different jurisdiction, subpart F income will not arise. This final result does not seem an appropriate policy outcome within the framework of current subpart F, and is almost certainly inconsistent with the Congressional intent underlying the rules being interpreted here.

Treasury anticipates that taxpayers will comment both on the appropriateness of these proposed regulations under current law, and on the contents of its subpart F study, including any conclusions that the study might draw about potential changes to subpart F. To allow proper time to consider all these issues, Treasury and the IRS have significantly modified and liberalized the effective date rules set forth in Notice 98–35. New regulations regarding the treatment of a controlled foreign corporation's distributive share of partnership income will be proposed at a later date.

Explanation of Provisions

I. In General

In these proposed regulations, Treasury and the IRS set forth a framework for dealing with issues arising under subpart F (sections 951 through 964) that relate to the use of certain entities that are regarded as fiscally transparent for purposes of U.S. tax law.

II. Hybrid Branches

Treasury and the IRS understand that certain taxpayers are using arrangements involving hybrid branches

to circumvent the purposes of subpart F. 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.

Under these proposed 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 payment had been taxed in the hands of the payor.

The proposed regulations would 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 § 1.954–9(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, would not be treated as separate corporations.

The proposed regulations would 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 proposed 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.

The proposed regulations would 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.

The proposed regulations would 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).

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.

III. Related Provisions

These proposed regulations would provide rules, contained in § 1.954–1(c)(1)(i)(B), to prevent expenses, including related person interest expense that 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 between the CFC and 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 proposed regulations also would 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.

Under these proposed regulations, if the partnership receives an item of income that reduces the foreign income tax of the payor, the related person exceptions of section 954(c)(3) would 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.

In addition, these proposed regulations contain rules that would apply the related person exceptions to certain payments involving hybrid branches. These rules would apply to payments by a CFC to a hybrid branch of a related CFC. Under these rules, the related person exceptions would 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. Request for Comments

Comments on policy issues that relate to subpart F and deferral, generally, including comments on legislative modifications to the current rules, and comments solicited on the broad policy issues mentioned in Notice 98–35, can be submitted in response to the study mentioned above. Treasury and the IRS invite comments on the appropriateness of these regulations under the current subpart F rules.

Proposed Effective Date

These proposed regulations will not be finalized before July 1, 2000. It is proposed that, when finalized, these regulations would be effective only for payments made in taxable years of a controlled foreign corporation commencing after the date that is five years after the date of finalization of these regulations. These regulations would not, however, apply to any payments made under hybrid arrangements entered into before June 19, 1998. This exception is permanent so long as the arrangement is not substantially modified on or after June 19, 1998. An illustrative list of events that would and would not constitute ''substantial modification'' of an arrangement is included in these regulations.

Special Analyses

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 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, 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.

Request for Comments

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

A public hearing has been scheduled for December 1, 1999, at 10 a.m., in room 2615, Internal Revenue Building, 1111 Constitution Avenue NW., Washington DC. Due to building security procedures, visitors must enter at the 10th Street entrance, located between Constitution and Pennsylvania Avenues, NW. In addition, all visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 15 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see the **FOR FURTHER INFORMATION CONTACT** section of this preamble.

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 and an outline of topics to be discussed and time to be devoted to each topic (signed original and eight (8) copies) by November 10, 1999.

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 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.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Withdrawal of Notice of Proposed Rulemaking and Proposed Amendments to the Regulations

Accordingly, under the authority of 26 U.S.C. 7805, the notice of proposed rulemaking amending 26 CFR parts 1 and 301 that was published in the **Federal Register** on March 26, 1998, 63 FR 14669 (REG–104537–97), is withdrawn. In addition, 26 CFR part 1 is proposed to be 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 (k)(1) is revised to read as follows:

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

* * * * *

(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 § 1.954–1(c)(1)(i) will apply to any expense subject to § 1.954–1(c)(1)(i).

* * * * *

Par. 3. Section 1.954–0 (b) is amended as follows:

1. The entry for § 1.954–1(c)(1)(i) is revised.

2. Entries for § 1.954–1(c)(1)(i)(A) through (c)(1)(i)(E) are added.

3. An entry for § 1.954–2(a)(5) is added.

4. An entry for § 1.954–2(a)(6) is added.

The revision and additions read as follows:

§ 954–0 Introduction.

* * * * *

(b) * * *

Section 1.954–1 Foreign Base Company Income

* * * * *

(c) * * *

(1) * * *

(i) Deductions.

(A) Deductions against gross foreign base company income.

(B) Special rule for deductible payments to certain non-fiscally transparent entities.

(C) Limitations.

(D) Example.

(E) Effective date.

* * * * *

Section 1.954–2 Foreign Personal Holding Company Income

(a) * * *

(5) Special rules applicable to distributive share of partnership income.

(i) Application of related person exceptions where payment reduces foreign tax of payor.

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

(iii) Effective date.

(6) Special rules applicable to exceptions from foreign personal holding company income treatment in circumstances involving hybrid branches.

(i) In general.

(ii) Exception where no tax reduction or tax disparity.

(iii) Effective date.

* * * * *

Par. 4. Section 1.954–1 is amended as follows:

1. Paragraphs (c)(1)(i) heading and introductory text and (c)(1)(i)(A) through (c)(1)(i)(D) are redesignated as paragraphs (c)(1)(i)(A) heading and introductory text and (c)(1)(i)(A)(*1*) through (c)(1)(i)(A)(*4*), respectively.

2. A heading for paragraph (c)(1)(i) is added.

3. Paragraphs (c)(1)(i)(B) through (c)(1))(i)(E) are added.

The additions read as follows:

§ 1.954–1 Foreign base company income.

* * * * *

(c) * * *

(1) * * *

(i) *Deductions*—(A) *Deductions against gross foreign base company income.* * * *

(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 § 1.954–9(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 reduced foreign tax, under § 1.954–9(a)(3), and would have fallen within the tax disparity rule of § 1.954–9(a)(5)(iv), if those provisions had been applicable to the payment.

(C) *Limitations.* Paragraph (c)(1)(i)(B) of this section 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 paragraphs (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 § 1.954–9 to apply if the payment were made between the entities described in § 1.954–9(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 be applicable for all payments made or accrued in taxable years commencing after [date that is 5 years after publication of the final regulations in the **Federal Register**], under hybrid arrangements, unless such payments are made pursuant to an arrangement that would qualify for permanent relief under § 1.954–9(c)(2) if made between a controlled foreign corporation and its hybrid branch, in which case the relief afforded under that section shall also be afforded under this section.

* * * * *

Par. 5. In § 1.954–2, paragraphs (a)(5) and (a)(6) are added to read as follows:

§ 1.954–2 Foreign personal holding company income.

(a) * * *

(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 § 1.954–9(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 paragraph (b)(4) of this section);

(*2*) The partnership is regarded as fiscally transparent, as defined in § 1.954–9(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 in taxable years commencing after [date that is 5 years after publication of the final regulations in the **Federal Register**], under hybrid arrangements, unless such payments are made pursuant to an arrangement which would qualify for permanent relief under § 1.954–9(c)(2) if made between a controlled foreign corporation and its hybrid branch, in which case the relief afforded under that section shall also be afforded under this section.

(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 § 1.954–9(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 reduced foreign tax, under § 1.954–9(a)(3), and fallen within the tax disparity rule of § 1.954–9(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 in taxable years commencing after [date that is 5 years after publication of the final regulations in the **Federal Register**], under hybrid arrangements, unless such payments are made pursuant to an arrangement which would qualify for permanent relief under § 1.954–9(c)(2) if made between a controlled foreign corporation and its hybrid branch, in which case the relief afforded under that section shall also be afforded under this section.

Par. 6. Section 1.954–9 is added to read as follows:

§ 1.954–9 Hybrid branches.

(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 a 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 paragraph (a)(5) of this section, 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 paragraph (a)(5) of this section, 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 person that is a related person with respect to the payor (as determined under the principles of section 954(d)(3)), 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 of this section, 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 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 2006, 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 2006. 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 2006. 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% 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 that would be 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 non-subpart F income that would be recharacterized as subpart F income under this section is determined under the principles of § 1.954–1(d)(2) and (3). See paragraph (b) 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 this section.* For purposes of this section:

(i) *Arrangement* shall mean any agreement to pay interest, rents, royalties or similar amounts. It shall also include the declaration and payment of a dividend (but not an agreement or undertaking to pay future, unspecified dividends). An arrangement shall not, however, include the mere formation or acquisition (or similar event) of a hybrid branch that is intended to become a party to an arrangement.

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

(iii) *Hybrid branch* means an entity that—

(A) Is disregarded as an entity separate from its owner for federal tax purposes and is owned (including ownership through branches) by 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);

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

(C) 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.

(iv) *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) *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.

(c) *Effective dates*—(1) *In general.* This section shall be applicable for all amounts paid or accrued in taxable years commencing after [date that is 5 years after publication of the final regulations in the **Federal Register**], under hybrid arrangements, except as otherwise provided.

(2) *Permanent Relief*—(i) *In general.* This section shall not apply to any payments made under hybrid arrangements entered into before June 19, 1998. This exception shall be permanent so long as the arrangement is not substantially modified, within the meaning of paragraph (c)(2)(ii) of this section, on or after June 19, 1998.

(ii) *Substantial modification*—(A) *In general.* Substantial modification of a hybrid arrangement includes—

(*1*) The expansion of the hybrid arrangement (other than de minimis expansion);

(*2*) A more than 50% change in the U.S. ownership (direct or indirect) of any entity that is a party to the hybrid arrangement, other than—

(*i*) A transfer of ownership of such party within a controlled group determined under section 1563(a), without regard to section 1563(a)(4); or

(*ii*) A change in ownership of the entire controlled group (determined under section 1563(a), without regard to section 1563(a)(4)) of which such party is a member;

(*3*) Any measure taken by a party to the arrangement (or any related party) that materially increases the tax benefit of the hybrid arrangement, regardless of whether such measure alters the legal relationship between the parties to the arrangement. For example, in the case of a hybrid branch payment determined with reference to a percentage of sales, a growth in the amount of the hybrid branch payment (and, thus, the tax benefit) caused by a growth of sales will not, in general, be a substantial modification. However, in the case of a significant sales growth resulting from a transfer of assets by a related party, that transfer would be a measure which materially increased the benefit of the arrangement, and that arrangement would be deemed to have been substantially modified.

(B) *Transactions not treated as substantial modification.* Substantial modification of a hybrid arrangement does not include—

(*1*) The daily reissuance of a demand loan by operation of law;

(*2*) The renewal of a loan, license or rental agreement on the same terms and conditions if—

(*i*) The renewal occurs pursuant to the terms of the agreement and without more than a de minimis amount of action of any party thereto;

(*ii*) As contemplated by the original agreement, the same parties agree to renew the agreement without modification; or

(*iii*) The renewal occurs solely by reason of a subsequent drawdown under a grandfathered master credit facility agreement;

(*3*) The renewal of a loan, license, or rental agreement by the same parties on terms which do not increase the tax benefit of the arrangement (other than a de minimis increase);

(*4*) The making of payments under a license agreement in respect of copyrights or patents (or know-how associated with such copyrights or patents), not in existence at the time the agreement was entered into, but only where the development of such property was anticipated by the agreement, and such property is substantially derived from (or otherwise incorporates substantial features of) copyrights and patents (or know-how associated with such copyrights or patents) in existence at the time of, and covered under, the original agreement;

(*5*) A final transfer pricing adjustment made by the taxation authorities of the jurisdiction in which the tax reduction occurs, so long as such adjustment would not have been a substantial valuation misstatement (as defined in section 6662(e)(1)(B)) if the adjustment had been made by the Internal Revenue Service; or

(*6*) A de minimis periodic adjustment by the parties to the arrangement made annually (or more frequently) to conform the payments to the requirements of section 482.

Charles O. Rossotti,

Commissioner of Internal Revenue.

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