Part III

Administrative, Procedural, and Miscellaneous

Treatment of Hybrid Arrangements under Subpart F

Notice 98-35

In General

On January 16, 1998, the Treasury Department issued Notice 98-11, in which it announced its intention to issue regulations to prevent the use of certain arrangements involving controlled foreign corporations and "hybrid branches" under subpart F. A hybrid branch is regarded as a branch for U.S. tax purposes, but as a separate entity (e.g., a corporation) for foreign tax purposes. On March 23, 1998, temporary and proposed regulations on these matters (TD 8767 and REG-104537-97) were issued. The temporary regulations cover transactions involving hybrid branches and equivalent transactions involving partnerships under subpart F. The proposed regulations, in addition to the provisions also contained in the temporary regulations, cover the treatment of a CFC's distributive share of income of a partnership in which a CFC is a partner.

In this Notice, the Treasury and the IRS announce their intention to withdraw the temporary regulations and proposed regulations issued on March 23, 1998 (TD 8767 and REG-104537-97). Notice 98-11 is also hereby withdrawn. The public hearing announced in the proposed regulations for July 15, 1998, will also be canceled.

Proposed Regulations on Hybrid Transactions

The Treasury and the IRS also hereby announce their intention to issue a notice of proposed rulemaking covering hybrid transactions. Under these proposed regulations, payments (including accruals) between a CFC and its hybrid branch, or between hybrid branches of the CFC, or between a CFC (and its hybrid branch) and the hybrid branch of a related CFC (collectively "hybrid branch payments") will give rise to subpart F income in the circumstances described below. When certain conditions are present, the non-subpart F income of the CFC, in the amount of the hybrid branch payment, will be 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 significant disparity (as described below) between the effective rate of tax on the payment in the hands of the payee and the hypothetical rate of tax that would have applied if the income had been taxed in the hands of the payor.

The proposed regulations will make clear that the CFC and the hybrid branch, or the hybrid branches, will be 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. 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, will not be treated as separate corporations.

The proposed regulations will 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 the rules of the 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 will be no requirement to carry such amounts back or forward to another year.

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

The proposed regulations will 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 will be 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 will be applied to the partnership as if it were a CFC.

The proposed regulations will 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 the payor would have been subject to had the payment not been made. This provision will be similar to the rule in §1.954-3(b), and will adopt the same percentage tests as contained in that provision. The proposed regulations will 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).

These proposed regulations will also provide rules to prevent expenses, including related person interest expense that normally would 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 will apply: (i) to the extent such payment is included in the subpart F income of the CFC; (ii) if the expense arises from any payment by the CFC to a hybrid partnership in which the CFC is a partner; and (iii) if the payment reduces foreign tax and there is a significant disparity in tax rates between the payor and payee jurisdictions.

Certain rules addressing the application of the related person exceptions with respect to hybrid branches and partnerships will be covered in the proposed regulations. In the case of a payment by a CFC to a hybrid branch of a related CFC, the related person exceptions will apply to exclude the payments from the foreign personal holding company income of the recipient CFC only if the payment would have qualified for the exception if the hybrid branch had been a separate CFC incorporated in the jurisdiction in which the payment is subject to tax (other than a withholding tax). Likewise, the regulations will address the situation where a partnership receives an item of income that reduces the income tax of the payor. In such a case, the related person exceptions of section 954(c)(3) apply to exclude the income from the foreign personal holding company income of the CFC partner only where: the exception would have applied if the CFC earned the income directly (testing relatedness and country of incorporation at the CFC partner level); and either the partnership is organized and operates in the CFC's country of incorporation, the partnership is treated as fiscally transparent in the CFC's countries of incorporation and operation, or there is no significant disparity between the effective rate of tax imposed on the income and the rate of tax that would be imposed on the income if earned directly by the CFC partner.

Effective Dates

It is intended that these proposed regulations on hybrid transactions (whether through branches or partnerships) will not be finalized before January 1, 2000. When finalized, the proposed

regulations will be effective for all payments made on or after June 19, 1998, under hybrid arrangements, except as provided below.

Permanent Relief

The proposed regulations will 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 on or after June 19, 1998. "Substantial modification" shall include, for example, expansion of the arrangement, a more than 50% change in the U.S. ownership (direct or indirect) of any entity that is a party to the arrangement (other than a transfer of ownership within a controlled group determined under section 1563(a), without regard to section 1563(a)(4)), or any measure which materially increases the tax benefit of the arrangement, but would not include the daily reissuance of a demand loan by operation of law, or the renewal of a loan, license or rental agreement on the same terms and conditions that occurs pursuant to the terms of the agreement and without action of any party thereto, and would not occur solely by reason of a subsequent drawdown under a grandfathered master credit facility agreement.

Transition relief

Additionally, to the extent that a payment is a "qualifying hybrid branch payment" made under an arrangement entered into on or after June 19, 1998, and before the date of finalization of the regulations, the proposed regulations will not apply earlier than the first taxable year of the United States shareholder

beginning on or after the expiration of five calendar years from the date of finalization of the regulations, to classify as subpart F income any payment which would otherwise give rise to subpart F income under the proposed regulations. This transition relief shall apply for so long as the arrangement is not substantially modified (as described above) after the finalization of the regulations. However, in the case of a United States shareholder that disposes of the business with respect to which the grandfathered hybrid arrangement was established, this transition relief shall also apply to a newly-established hybrid arrangement entered into after the date of finalization of the regulations which does not provide materially greater tax benefits than the prior grandfathered hybrid arrangement (and subject to the limit described below).

For purposes of calculations under this transition relief, the "qualified hybrid branch payments," "maximum payment limit" and "non-subpart F earnings and profits amount" shall be calculated on a country-by-country basis with respect to the United States shareholder (within the meaning of section 951(b)). For purposes of these rules, all United States shareholders that are members of a controlled group (within the meaning of section 1563(a), without regard to section 1563(a)(4)) shall be treated as a single United States shareholder. Therefore the relevant hybrid branch payments for purposes of determining "qualified hybrid branch payments" shall be all hybrid branch payments deductible in a certain country. Likewise the "maximum payment limit" is the limit relating to hybrid branch payments deductible

in that country. Finally, "non-subpart F earnings and profits" is calculated by reference to the earnings and profits of all qualified business units (as defined in section 989(a)) of CFCs carrying on a business in that country (disregarding the net losses of any qualified business unit in that country).

A "qualifying hybrid branch payment" is a payment attributable (within the meaning of that term as set forth below) to a United States shareholder that otherwise would be recharacterized as subpart F income under the proposed regulations (without regard to the permanent grandfather rule contained herein) but that, when aggregated with all other such payments attributable to such United States shareholder for that country in a taxable year, does not exceed the "maximum payment limit" attributable to such United States shareholder for that country (as described below).

The "maximum payment limit" attributable to a United States shareholder for a country is 50% of the total of the "non-subpart F earnings and profits amount" from CFCs (or qualified business units thereof) in that country owned by such shareholder on June 19, 1998. The "non-subpart F earnings and profits amount" of a CFC (or qualified business unit thereof) is the highest of the CFC's non-subpart F earnings and profits (or portion thereof relating to the qualified business unit) for any of its last seven taxable years ending before June 19, 1998. If a CFC owned by a United States shareholder on June 19, 1998, has not been owned by such shareholder for the entire seven-year period, the earnings for the pre-acquisition period may nevertheless be taken

into account in determining the non-subpart F earnings and profits amount. (For purposes of this calculation any short taxable year shall be annualized.) In the case of a new business established after June 18, 1991, the United States shareholder may elect to compute its non-subpart F earnings and profits amount in respect of that business by using an amount equal to 20% of the net active equity of the business on June 19, 1998. (Net active equity means active assets minus indebtedness in excess of passive assets, computed based on tax book value.) For purposes of these calculations, non-subpart F earnings and profits would not include any amounts which would be foreign personal holding company income under section 954(c), but for the application of the high tax exception of 954(b). For purposes of these calculations, active assets shall mean assets which produce non-subpart F earnings and profits (taking into account the preceding sentence). Additionally, non-subpart F earnings and profits would be calculated before reduction by any hybrid branch payments, related party interest payments, or creditable foreign tax. Finally, for purposes of these calculations, non-subpart F earnings and profits shall be computed as if the provisions in H.R. 2513 (with respect to the active financing exception) had been in effect for all relevant periods.

Special rules will apply in the case of a CFC that is not wholly-owned by a United States shareholder. A payment is "attributable" to a United States shareholder if such payment is made by an entity (whether recognized as such for purposes of foreign or domestic law) that is owned more than 50%, directly or

indirectly, by the United States shareholder (a "controlled entity"). Where there is no United States shareholder that directly or indirectly owns greater than 50%, the United States shareholders of the CFC may designate one such shareholder to be deemed the greater-than-50%-owner for purposes of this provision (the regulations will require that such designation be disclosed on an attachment to a Form 5471 filed by the United States shareholder so designated) and, if no such designation is made, no United States shareholder shall be the greater-than-50%-owner. The maximum payment limit, which is computed based on the CFC's total non-subpart F earnings and profits with respect to a country, is attributed entirely to the controlling (or deemed controlling) shareholder. No portion of such maximum payment limit is attributed to any other shareholder. In determining whether a hybrid branch payment made by a controlled entity is a qualifying hybrid branch payment, the entire amount of such payment is applied against the controlling (or deemed controlling) shareholder's maximum payment limit. If such a payment is a qualifying hybrid branch payment with respect to a controlling (or deemed controlling) shareholder, it also is a qualifying hybrid branch payment with respect to all other United States shareholders.

If hybrid branch payments made under pre-June 19 and post-June 18 arrangements exceed the maximum payment limit, then the excess shall be subpart F income under the hybrid branch rules, limited, however, to the amount attributable to post-June 18 arrangements. If hybrid branch payments made under post-June 18

arrangements exceed the maximum payment limit (when aggregated with payments under pre-June 19 arrangements), then the subpart F income shall be deemed to arise under the most recent hybrid branch arrangement entered into (and this rule shall be applied in reverse chronological order to the extent that there is not sufficient non-subpart F earnings and profits (without taking into account the special rules above) in the entity (or entities) entering into the most recent hybrid branch arrangement).

The regulations will require that the existence of post-June 18 arrangements be disclosed on an attachment to a Form 5471.

Proposed Regulations on Treatment of a CFC's Distributive Share of Partnership Income

It is intended, after the current proposed regulations are withdrawn, that the part of the current proposed regulations dealing primarily with the treatment of a CFC partner's distributive share of partnership income (i.e., that part of the proposed regulations not also contained in the current temporary regulations) will be issued as a separate notice of proposed rulemaking and will be finalized separately, in the normal course, from the regulations on hybrid branch transactions. The effective date of these proposed regulations will be no earlier than the date of finalization.

Request for Comments on Hybrid Branch Regulations

The purpose of this action is to allow Congress an appropriate period to review the important policy issues raised by the regulations, including the continuing applicability of the policy rationale of subpart F, and, if appropriate, address these issues by legislation. Also during this period the Treasury will conduct a thorough review of the issues raised by these hybrid regulations with all interested parties. The regulations will request comments on the following issues, among others.

Comments will be requested on what the policy objectives underlying subpart F are and whether these policy objectives are still appropriate. Do these objectives include preventing undue incentives for U.S. businesses to invest in operations abroad? How should subpart F interact with principles of U.S. current taxation of worldwide income from the activities of U.S. persons abroad? Is subpart F intended to prevent the ability to improperly shift income from the United States to a foreign jurisdiction that might be difficult to detect under section 482? Is subpart F intended to prevent opportunities for U.S. businesses operating internationally to achieve lower rates of current taxation than their domestic counterparts? Does subpart F seek to address issues of harmful tax competition between countries?

If a significant policy objective of subpart F is primarily to prevent any undue incentive favoring foreign over domestic investment, is it appropriate and possible to construct an administrable rule (whether administratively or by legislation)

that could distinguish those cases where an investment abroad would not have occurred absent the tax incentive afforded by a hybrid arrangement? For example, would it be appropriate to include an exception from the recharacterization rule of the proposed regulations if at the time a hybrid arrangement is entered into the taxpayer can establish that the capital invested directly or indirectly by the United States shareholder in the CFC making the hybrid branch payments under the hybrid arrangement would have been invested independent of the benefits arising from the hybrid arrangement?

The regulations will also invite comments on the various effective dates contained in the regulations (for example, whether the five-year grandfather provision should be made permanent) and on the restrictions on subsequent changes to arrangements after certain of the effective dates.