The IRS has promulgated its final regulations governing qualification for treaty benefits on U.S.-source payments by so-called "reverse hybrid" U.S. entities. These regulations generally allow such payments to qualify for treaty benefits. As under the earlier proposed regulations, however, certain otherwise deductible payments made by a reverse hybrid entity to related parties will be recharacterized as dividends.

On June 12, 2002, the Internal Revenue Service (IRS) promulgated final regulations governing the qualification for U.S. treaty benefits of certain U.S.-source payments made by a "reverse hybrid" U.S. entity ("domestic reverse hybrid" or "DRH"). A DRH is an entity that is characterized as a corporation for U.S. tax purposes and as a partnership (or disregarded entity) for non-U.S. tax purposes. Such DRH structures are said to have been in wide usage in Canada.

The final DRH regulations apply only to payments made by a DRH on or after June 12, 2002, with respect to amounts received by the DRH on or after June 12, 2002.2 Following a brief description of the background of the final regulations, the column considers certain aspects of the final DRH regulations. References to the "existing regulations" herein refer to the regulations as in effect prior to the promulgation of the final DRH regulations.

Background

The regulations under Code section 8943 generally govern the eligibility of payments for a reduced rate of U.S. withholding tax pursuant to an income tax treaty to which the U.S. is a party. The existing regulations generally provide that a payment of U.S. source income received by an entity (whether U.S. or foreign) is eligible for otherwise applicable treaty benefits only if the payment is "derived by" a resident of an applicable treaty jurisdiction.4 A payment is treated as derived by a resident of a treaty jurisdiction if either: (1) the entity receiving the payment is not treated as fiscally transparent in the jurisdiction under the laws of which it was formed; or (2) the entity receiving the payment is treated as fiscally transparent.

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2 As discussed below, the characterization of payments by a DRH may depend on the character of the underlying amounts received by the DRH.
3 All references to the Code herein refer to the Internal Revenue Code of 1986, as amended.
by the jurisdiction in which the entity's owners are resident and the owners ("foreign interest holders") of the entity are not treated as fiscally transparent in their jurisdiction.\(^5\)

Under this general rule, a dividend payment made to a DRH could arguably have qualified for treaty benefits if its owners were non-transparent residents of one or more jurisdictions with an income tax treaty with the U.S. Nevertheless, since a DRH is treated as a corporation in the U.S., and since U.S. treaties typically include a "savings clause", the existing regulations specifically prohibit treaty benefits from being claimed by a DRH.\(^6\) The existing regulations had simply reserved on the question of whether a payment made by a DRH could qualify for treaty benefits.

On February 27, 2001, the IRS published proposed regulations addressing this last issue.\(^7\) The proposed regulations generally would have allowed treaty benefits for otherwise eligible payments made by a DRH to its foreign interest holders, as long as the interest holders were not fiscally transparent. The proposed regulations included an important exception, however, intended to address "double dip" structures, which were used by Canadian and other non-U.S. taxpayers to repatriate U.S. earnings without paying any income tax on those amounts in the U.S., Canada, or any other jurisdiction. Those structures typically involved a loan made to a DRH by its non-U.S. owner. Under the existing regulations, payments made on the loan by the DRH could have qualified for treaty benefits under the (often more favorable) interest provision of the applicable treaty. Such payments were also deductible by the DRH for U.S. income tax purposes. Under the law of the jurisdiction where the owners of the DRH are resident, interest income on the loan could be offset by the interest deduction incurred by the DRH, which would flow through to the entity's owners. Thus, the payment could have given rise to an interest deduction in the U.S. and qualify for favorable (interest) treatment under the U.S. treaty.

In one common version of the structure, the U.S. operations of the DRH were conducted through U.S. subsidiaries that would distribute their earnings to the DRH as dividends; the DRH used the cash to make interest payments on its loan to its owners or other related parties. Since the DRH was fiscally transparent in the owners' jurisdiction, they were treated as earning their proportionate share of the dividends paid by the U.S. subsidiary. Such dividends may not be subject to income tax to the owners of the DRH, however, by reason of foreign tax credits, a dividend exclusion or a participation exemption. In the U.S., the dividend income of the DRH was not subject to tax, either by virtue of Code section 243(a)(3) (the dividends-received deduction) or the consolidated return regulations (which exclude from income intercompany dividends).\(^8\)

The proposed DRH regulations would have provided for an exception to the general rule for payments made by a DRH where: (1) a DRH receives a payment that is characterized as a dividend under the laws of either the U.S. or the jurisdiction of a "related"\(^9\) foreign interest holder of the DRH, (2) the DRH makes a payment to the related foreign interest holder that is otherwise deductible for U.S. tax

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\(^5\) Thus, it is possible for a payment to be treated as derived by both the entity and its interest holders, in which case the payment could be eligible for benefits under two (or more) income tax treaties.

\(^6\) Treas. Reg. '1.894-1(d)(3). A "savings clause" is a provision that generally prohibits U.S. persons from claiming a reduction in U.S. tax under an income tax treaty.

\(^7\) 66 FR 12445. For a detailed discussion of the proposed regulations, see IRS Proposes Regulations on Treaty Benefits for Payments By "Reverse Hybrid" U.S. Entities, Peter A. Glicklich & Michael J. Miller, 49 Can. Tax J. 501 (2001).


\(^9\) The proposed regulations included a very broad definition of "related" persons for this purposes, under which persons are treated as related if they are related under either of Code sections 267(b) or 707(b)(1). The regulations also treat stock owned by a person as owned by certain related persons, under the rules of Code section 318(a), for purposes of determining whether the latter persons are related to the issuer of the stock under the recharacterization rule. Prop. Reg. '1.894-1(d)(2)(ii)(B)(3).
purposes, and (3) for which a reduction in the U.S. withholding tax would otherwise be permitted.\textsuperscript{10} Where the exception applies, the payment to the foreign interest holder would have been recharacterized as a nondeductible dividend for all purposes of the Code (the "recharacterization rule").\textsuperscript{11}

The proposed DRH regulations also would have included two anti-abuse rules, to prevent taxpayers from avoiding the recharacterization rule. One anti-abuse rule applied narrowly to transactions entered into by (presumably unrelated) persons with the DRH, a DRH subsidiary, or foreign interest holders, where the "effect" of the transaction would be to avoid the recharacterization rule.\textsuperscript{12} Under the second rule, the proposed regulations would have given the IRS broad discretion to recharacterize for all purposes of the Code all or any part of any transaction between related parties if the "effect" of the transaction was to avoid the principles of the recharacterization rule.\textsuperscript{13}

Final DRH Regulations

The final DRH regulations largely follow the proposed regulations. As in those proposed rules, the final regulations generally allow a reduction in withholding rates for payments made by a DRH to its foreign interest holders. The final regulations also include the recharacterization rule described above, in substantially the same form as the proposed regulations, for otherwise deductible payments made by the DRH to its foreign interest holder after the DRH receives a dividend from its U.S. subsidiary.

In choosing to retain the recharacterization rule, Treasury rejected significant criticism of the proposed regulations by a number of commentators. In particular, commentators and practitioners questioned whether Treasury had the authority to promulgate the recharacterization rule. These questions were grounded both in the statutory language of Code section 894(c) and general principles of interpretation contained in most income tax treaties. Specifically, the disallowance rule of Code section 894(c)(1) is expressly limited to "an item of income derived through an entity which is treated as a partnership (or is otherwise fiscally transparent) for purposes of this title" [emphasis added], which would clearly not include income earned through a DRH, which is treated as a corporation for Code purposes. Section 894(c)(2) similar authorizes Treasury to issue regulations disallowing treaty benefits for any payment received by or income attributable to "an entity . . . that is treated as a partnership or is otherwise treated as fiscally transparent for purposes of this title . . . and is treated as fiscally nontransparent for purposes of the tax laws of the jurisdiction of residence of the taxpayer." Moreover, the legislative grant of authority in Section 894(c)(2) is limited to the denial of treaty benefits and does not appear to give Treasury the power to recharacterize payments for all purposes of the Code.

One commentator also pointed out that treaties typically define interest to include payments that qualify as interest under the domestic tax laws of the source country. While it may be argued that the recharacterization rule changes U.S. tax law on what qualifies as interest, this argument is ultimately circular because the change is being made for treaty purposes.\textsuperscript{14}

The preamble to the final regulations addresses these comments by noting that: "The IRS and Treasury have concluded that the regulations are consistent with U.S. law, including U.S. treaties. These final regulations are issued under the authority of sections 894(a), 894(c), 7805 and 7701(l). Further, as noted above, contracting states to an income tax treaty may adopt provisions in their domestic laws to

\textsuperscript{10} Prop. Reg. \textsuperscript{1} 1.894-1(d)(2)(ii)(B).

\textsuperscript{11} The amount recharacterized would be reduced by any dividends previously paid by the DRH to the foreign interest holder (or any amounts previously treated as dividends under the recharacterization rule).

\textsuperscript{12} Prop. Reg. \textsuperscript{1} 1.894-1(d)(2)(ii)(B)(3).

\textsuperscript{13} Prop. Reg. \textsuperscript{1} 1.894-1(d)(2)(ii)(C).

\textsuperscript{14} Report on Proposed Regulations under Section 894 Regarding Payments Made by Domestic Reverse Hybrid Entities, New York State Bar Association, Report No. 1004 (referred to herein as the "NYSBA Report on the Proposed Regulations").
counter inappropriate uses of the treaty." As noted, section 894 does not actually appear to authorize the recharacterization rule. Section 7805 is the general statutory grant to Treasury to issue regulations under the Code, and is generally understood to authorize interpretive rather than legislative regulations. Section 7701(l) is a specific grant of authority to Treasury to issue regulations recharacterizing multi-party financing transactions as a financing transaction directly between two of the parties to the transaction. Thus, there appears to be a real possibility that Treasury has exceeded its authority with regard to the recharacterization rule. It would not be surprising if the validity of the recharacterization rule were ultimately to be successfully challenged in court.

Moreover, in adopting the recharacterization rule, the U.S. Treasury Department also rejected some questions over the basic approach of the rule. As noted by one commentator, the real problem underlying the "double dip" DRH structure is not an abuse of treaty rules but rather that it permits taxpayers to obtain a deduction for the same payment both in the U.S. and in the foreign interest holder's jurisdiction. The commentator highlighted this point by noting that in several of the jurisdictions where the structure is most frequently used, the withholding rate for dividends from large shareholders is lower than the withholding rate for interest. Thus, taxpayer are actually subjecting themselves to a higher rate of withholding tax to obtain the benefits of the double deduction of interest. The commentator suggested that the potential abuse of the DRH structure would be more appropriately addressed in the context of the dual-consolidated loss rules of Code section 1503(d).

The preamble to the final regulations responds to this comment by agreeing that a re-examination of the dual-consolidated loss rules may be appropriate, but noting that "the commentator misconstrues the concern of the IRS and Treasury with respect to the issues associated with the use of DRH structures" and claiming that Treasury is primarily concerned with inappropriate use of income tax treaties.

A related flaw in the narrow approach taken by Treasury is that the recharacterization rule does not prevent the double-dip benefit where the DRH operates its business directly or through an entity that is treated as fiscally transparent for U.S. tax purposes. In that case, the entity can still reap the benefits of an interest deduction in the U.S., while using the foreign interest holder's proportionate share of the entity's interest deduction to offset the foreign interest holder's income in the jurisdiction where the foreign interest holder is resident. The operating income of the DRH would also flow through to the foreign interest holder under the tax laws of the interest holder's jurisdiction, but this income may be offset by foreign tax credits.

Similarly, the recharacterization rule does not appear to apply where the interest on the loan from the foreign interest holder is paid before the DRH receives any dividend payments from its subsidiary. Thus, the DRH could borrow money from a third party to fund the interest payment on the loan (perhaps pledging the stock of the subsidiary as collateral or obtaining a guarantee from the foreign interest holder), and then repay the loan subsequently when it receives the dividend distribution from its subsidiary.

The preamble notes that a number of commentators recommended that the recharacterization apply only where the DRH is structured for the purpose of tax avoidance. The IRS and Treasury did not adopt that suggestion, instead retaining solely objective tests. In the authors' opinion, this was a wise
decision, and one that the IRS and Treasury will hopefully emulate in future regulations issued in other areas of the Code. A tax avoidance purpose requirement would have made the recharacterization rule more difficult to administer and less certain in its application, and would not have been self-enforcing.19

The preamble to the final regulations also responds to an important question that had been raised regarding the proposed regulations, but which Treasury concluded did not require additional clarifying language. The preamble confirms that the recharacterization rule does not apply to a payment made by the DRH to its foreign interest holders, which would exempt from U.S. withholding tax without regard to a treaty. Thus, for example, payments made under a notional principal contract entered into by the DRH with a foreign interest holder, which are sourced according to the residence of the foreign interest holder, will not be subject to the recharacterization rule. Similarly, payments made by the DRH to its foreign interest holders for services performed outside of the U.S. would not be subject to the recharacterization rule.

Changes From the Proposed Regulations

The final regulations do depart from the proposed regulations, however, in a number of respects. First, the recharacterization rule is expanded to apply to situations where the loan to the DRH is made by an entity other than the foreign entity that is the owner of the DRH (say, a sister company), but only if the interest deduction that flows through from the DRH to the interest holder may be used to offset income of the lender.20

The final regulations also eliminate the proposed anti-abuse rules, replacing them with a much narrower, objective anti-abuse rule. Under the final regulations, the authority of the Commissioner of the IRS to recharacterize a transaction that is not within the literal scope of the regulations applies only in two situations: (1) if a deductible payment is made to a person (other than the foreign interest holder) that is related to the DRH, but does not otherwise fall under the regulations (perhaps because the interest holder's deduction is not available to offset the income of the lender) and the payment is made in connection with one or more transactions the "effect" of which is to avoid the application of the recharacterization rule (as perhaps in the case of two reciprocal hybrid arrangements), then the IRS may treat the payment as if it were received directly by the foreign interest holder; and (2) the IRS may treat a deductible payment made by a DRH to an unrelated person as being made directly to a foreign interest holder if the unrelated person makes a payment to the related foreign interest holder, the two payments are made in connection with a series of transactions which constitute a "conduit financing arrangement",21 and the transactions have the "effect" of avoiding the application of the recharacterization rule.

The anti-abuse rule for payments made by the DRH to unrelated parties is particularly narrow. Thus, Example 7 of the final regulations confirms that interest payments made by a DRH to an unrelated foreign bank are not subject to the recharacterization rule.22 Taxpayers may be able to take advantage of this example to obtain the "double dip" benefits of a loan to a DRH by having the loan made by a foreign

19 Compare the approach taken by Treasury in the conduit financing regulations, which authorize the IRS to disallow treaty benefits in certain cases by ignoring the participation of a conduit entity in a financing transaction. Treas. Reg. '1.881-3. Those rules include a subjective tax-avoidance purpose test, including an elaborate set of rules for applying the test. Treas. Reg. '1.881-3(b).
20 It is not entirely clear whether the recharacterization rule would apply if the interest deduction were not currently available to offset income of the lender, but could become available for this purpose in the future, as a result of an affirmative election or otherwise.
21 A "conduit financing arrangement" is one that generally could be subject to recharacterization under Treas. Reg. '1.881-3 (if certain other requirements (including a tax avoidance plan) not applicable here are satisfied.
bank, backed by a guarantee from the foreign interest holder.\footnote{The existence of a parent guarantee would subject the DRH's interest deductions to "interest stripping" limitations, under Code section 163(j), which also applied to most direct foreign interest holder loans prior to the promulgation of the final DRH regulations. Taxpayers can avoid the interest stripping rules by keeping the DRH's debt to equity ratio under 1.5 to 1. }\footnote{See Plantation Patterns, Inc. v. Comm'r, 462 F.2d 712 (5th Cir. 1972).} This allows the foreign interest holder to use the interest deductions flowing through to it from the DRH to offset other income, including interest income it earns on its funds invested with a different foreign bank, and puts the foreign interest holder in substantially the same position it would have been if it had loaned the same funds to the DRH, absent the recharacterization rule. Note, however, that under existing U.S. case law a parent guarantee may be recharacterized as a loan to the parent (with interest payments by the subsidiary being treated as dividends to the parent), if the subsidiary is inadequately capitalized or is not expected to have sufficient funds to repay the loan itself.\footnote{Conclusion}

**Conclusion**

The final DRH regulations generally permit payments made by a DRH to its foreign interest holders to qualify for treaty benefits, but the recharacterization rule would deny treaty benefits to an objectively defined class of transactions that the IRS and Treasury consider to be abusive. It remains to be seen whether the recharacterization rule of the final DRH regulations will be invalidated by a court. Even if that rule were to be upheld upon such a challenge, however, taxpayers should be able to continue to use DRH structures to obtain U.S. and foreign tax benefits, as illustrated by the discussion above of the fact pattern set forth in Example 7 of the final DRH regulations.