Part III

Administrative, Procedural, and Miscellaneous

Treatment of Hybrid Arrangements under Subpart F

Notice 98-11

The Treasury Department and the Internal Revenue Service understand that certain taxpayers are using arrangements involving "hybrid branches" to circumvent the purposes of subpart F (sections 951-964 of the Internal Revenue Code). These arrangements generally involve the use of deductible payments to reduce the taxable income of a controlled foreign corporation (CFC) under foreign law, thereby reducing the 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, this income is not taxed under subpart F.

The recent entity classification regulations, §§301.7701-1 through -3 of the Income Tax Regulations (the "check-the-box" regulations), have facilitated the creation of the hybrid branches used in these arrangements. The preamble to these regulations, in stating that Treasury and the Service would be monitoring the use of partnerships in the international context, indicated a concern that fiscally-transparent entities could be used in a manner inconsistent with the policies and rules of particular Code provisions.

Treasury and the Service have concluded that the use of certain hybrid branch arrangements, such as the ones illustrated below, is contrary to the policies and rules of subpart F. This notice announces that Treasury and the Service will issue regulations to address such arrangements, and requests public comments with respect to these subpart F issues.

I. BACKGROUND

Subpart F was enacted by Congress to limit the deferral of U.S. taxation of certain income earned outside the United States by CFCs, which are foreign corporations controlled by United States shareholders. Limited deferral was retained after the enactment of subpart F to protect the competitiveness of CFCs doing business overseas. This limited deferral allows a CFC engaged in an active business, and located in a foreign country for appropriate economic reasons, to compete in a similar tax environment with non-U.S. owned corporations located in the same country.

Under subpart F, however, transactions of CFCs that involve related persons frequently give rise to subpart F income, unless an exception, for example the same country exception, applies. Related person transactions can be more easily manipulated to reduce both United States and foreign taxes. One of the purposes of Subpart F is to prevent CFCs (including those engaged in active businesses) from structuring transactions designed to manipulate the inconsistencies between foreign tax systems to inappropriately generate low- or non-taxed income on which United

States tax might be permanently deferred.

U.S. international tax policy seeks to balance the objective of neutrality of taxation as between domestic and foreign business enterprises (seeking neither to encourage nor to discourage one over the other), with the need to keep U.S. business competitive. Subpart F strongly reflects and enforces that balance. These hybrid transactions upset that balance.

II. ARRANGEMENTS INVOLVING HYBRID BRANCHES

A hybrid branch is one that is viewed under United States tax principles to be part of the CFC (i.e., fiscally transparent), but under the law of the CFC's country of incorporation as an entity separate from the CFC (i.e., non-fiscally transparent). The types of hybrid branch arrangements Treasury and the Service have identified as being inconsistent with the policies and rules of subpart F may be illustrated by the following examples.

Example 1. CFC1 owns all of the stock of CFC2. CFC1 and CFC2 are both incorporated in Country A. CFC1 also has a branch (BR1) in Country B. The tax laws of Country A and Country B classify CFC1, CFC2 and BR1 as separate, non-fiscally transparent entities. CFC2 earns only non-subpart F income and uses a substantial part of its assets in a trade or business in Country A. BR1 makes a transfer to CFC2 that the tax laws of both Country A and Country B recognize as a loan from BR1 to CFC2. CFC2 pays interest to BR1. Country A allows CFC2 to deduct the interest from taxable income. Little or no tax is

paid by BR1 to Country B on the receipt of interest.

If BR1 is disregarded, then for U.S. tax purposes the loan would be regarded as being made by CFC1 to CFC2 and the interest as being paid by CFC2 to CFC1. While interest received by a CFC is normally subpart F income under section 954(c) (foreign personal holding company income), in this case, if BR1 is disregarded, the "same country" exception of section 954(c)(3) would apply to exclude the interest from subpart F income. If BR1 instead were considered to be a CFC, however, this payment would be between two CFCs located in different countries. In that case, subpart F income would arise because the same-country exception would not apply. Thus, if BR1 is disregarded CFC1 will have lowered its foreign tax on deferred income and created a significant tax incentive to invest abroad rather than in the United States. As this arrangement creates income intended to be subpart F income which is not subject to subpart F in this case, the result of the arrangement is inconsistent with the policies and rules of subpart F.

Example 2. CFC3 is incorporated in Country A. CFC3 has a branch (BR2) in Country B. The tax laws of Country A and Country B classify CFC3 and BR2 as separate, non-fiscally transparent entities. BR2 makes a transfer to CFC3 that the tax laws of both Country A and Country B recognize as a loan from BR2 to CFC3. CFC3, which earns only non-subpart F income, pays interest to BR2 that Country A allows as a deduction against taxable income. Little or no tax is paid by BR2 on the receipt of interest.

If BR2 is disregarded, then U.S. tax law would not recognize the income flows (neither the loan nor the interest payment) between the CFC and its branch and, therefore, subpart F would not apply. If this transaction were between two CFCs, however, the interest would be subpart F income under section 954(c) and no exception would apply. Thus, if BR2 is disregarded, by use of this arrangement the CFC will have lowered its foreign tax on deferred income in a manner inconsistent with the policies and rules of subpart F.

Treasury and the Service believe that it is appropriate to prevent taxpayers from using these types of hybrid branch arrangements to reduce foreign tax while avoiding the corresponding creation of subpart F income. Treasury and the Service will issue regulations to prevent the use of these types of hybrid branch arrangements. Regulations will provide that, when such arrangements are undertaken, the branch and the CFC will be treated as separate corporations for purposes of subpart F.

III. PARTNERSHIPS AND TRUSTS

Treasury and the Service are aware that the issues under subpart F raised by hybrid branch arrangements may also be raised by certain partnership or trust arrangements. Treasury and Service intend to address these issues in separate ongoing regulations projects addressing partnerships and trusts.

IV. EFFECTIVE DATE

The regulations on hybrid branch arrangements will apply to

all such arrangements entered into (or substantially modified, including, for example, by acceleration of payments or increases in principal) on or after January 16, 1998, the date on which this Notice was issued to the public. In addition, for all hybrid branch arrangements entered into before January 16, 1998, these regulations will apply to all payments (or other transfers) made or accrued after June 30, 1998.

V. PUBLIC COMMENTS

Comments are requested regarding the treatment of hybrid branch arrangements under subpart F.

For further information regarding this notice, contact Valerie Mark of the Office of the Associate Chief Counsel (International) at (202) 622-3840 (not a toll-free call).