Hybrid branches face stern test

The US Internal Revenue Service has signalled its intention to limit the tax advantages available to some hybrid branches. Joseph DeCarlo of Price Waterhouse LLP, and Alan Granwell and Dirk Suringa of Ivins, Phillips & Barker, Washington DC report

An important element in international tax planning has involved the use of entities, instruments, and arrangements that are treated differently in different jurisdictions. For example, an entity may be treated as a fiscally transparent entity in one jurisdiction and as a separate taxable entity in another jurisdiction. Similarly, an instrument may be treated as debt in one jurisdiction and as equity in another jurisdiction, or a transaction may be characterized as a lease in one jurisdiction and as a financing in another jurisdiction.

Inconsistent treatment of these structures, commonly known as hybrids, frequently results in advantageous tax arbitrage.

Increasing sensitivity to hybrids

The US Treasury has become increasingly sensitive to the use of hybrids. In the preambles to recently issued regulations dealing with check-the-box entity classification and the use of hybrids to obtain treaty benefits, the Treasury has indicated that it is continuing to study the area and might issue additional guidance. In the past few months, the US Internal Revenue Service (IRS) and the Treasury have issued three written public pronouncements on the use of hybrids that significantly curtail a variety of hybrid arrangements.

First, in Notice 98-5, the IRS announced its intention to issue, with the Treasury, regulations to limit the use of hybrid and other transactions to obtain foreign tax credits. Second, Notice 98-11 announced that the IRS and the Treasury would issue regulations concerning certain uses of hybrid entities to obtain US tax-favoured results. Third, the US Administration has included in its 1998 budget proposals a legislative proposal that would give the Treasury additional regulatory authority to issue administrative guidance, both to prevent inappropriate US tax results and to provide taxpayers with greater certainty regarding the US tax consequences of hybrid transactions.

This article will focus primarily on Notice 98-11 and the legislative proposals.

Branch arrangements

In Notice 98-11, the IRS announced that it would issue regulations to prevent the use of certain hybrid arrangements. The Notice deals with hybrid entities, ie entities that are disregarded for US tax purposes, but are non-trans-parent for foreign tax purposes. As discussed in the Notice, the IRS is specifically concerned with the use of hybrid entity structures that reduce the foreign tax base while avoiding the corresponding creation of subpart F income.

The regulations may apply to a wider range of hybrid arrangements – and even to non-hybrid arrangements that merely involve branches

According to the IRS, the availability of such structures has the effect of eroding the US tax base by encouraging US companies to invest abroad rather than within the US.

Notice 98-11 identifies two particular tax-advantaged arrangements that the IRS considers to be contrary to the policies and rules of subpart F (see Box 1). The effective date of the regulations announced in Notice 98-11 is January 16 1998, the date on which the IRS publicized the Notice.

According to one Treasury official, the January 16 effective date will apply solely to branch arrangements that feature the four main characteristics of the above examples in Box 1:

- a hybrid that is a transparent entity for US tax purposes but a separate, non-transparent entity for foreign tax purposes;
- a CFC that reduces its non-subpart F income with a deductible payment to the hybrid;
- a resulting reduction in the CFC's foreign tax base; and
- a low or nil rate of tax on the receipt of the payment by the hybrid.

While the effective date of the Notice will apply only to this narrow range of cases, the tax press reports that government officials have stated that the regulations may apply to a wider range of hybrid arrangements – and even to non-hybrid arrangements that merely involve branches, regardless of how the foreign country treats them.

For example, according to one IRS official, an arrangement may be subject to the regulations even if it does not involve a reduction in non-subpart F income of the CFC. Thus, the regulations presaged by Notice 98-11 may apply to a broad range of branch arrangements. On February 6, a Treasury official indicated that the regulations would be issued soon.

Implications for tax planning

Notice 98-11 carries several implications for international tax planning.

First, the Notice indicates that the

IRS and the Treasury may seek to limit the scope of elective entity classification under the check-the-box regulations, at least for purposes of subpart F. As noted above, in January 1997, the Treasury issued final regulations that allow taxpayers, within certain parameters, to elect the tax classification of their business enterprise. In the preamble to those regulations, the Treasury indicated that it would:

"continue to monitor carefully the uses of partnerships in the international context and .... take appropriate action when partnerships are used to achieve results that are inconsistent with the policies and rules of particular Code provisions or of US tax treaties".

Notice 98-11 proposes to do for foreign personal holding company income what Revenue Ruling 97-48 did for foreign base company sales income

According to one Treasury official, Notice 98-11 represents a first step towards applying this language in the context of branch arrangements. The official stressed that Notice 98-11 should not be seen as a general attack on the check-the-box regime. Rather, it should be seen as an attempt to limit abuses that were possible even before check-the-box, but which check-the-box has facilitated.

Nevertheless, practitioners have voiced concern that the certainty and simplicity of check-the-box would be undermined if the Treasury were to promulgate regulations that overrule a taxpayer's check-the-box election for purposes of subpart F and other Code provisions.

Second, by focusing on branches, Notice 98-11 indirectly relates to the subject of Revenue Ruling 97-48, which held that the activities of a contract manufacturer could no longer be attributed to a CFC for purposes of the manufacturing exception to subpart F.

One result of that ruling was to expand the application of the so-called branch rule under Code section 954(d)(2). The branch rule provides that, in certain manufacturing or sales situations, a CFC's branch or similar establishment will be treated as a separate corporation.

The branch rule is designed, in part to cause the recognition of foreign base company sales income, a component of subpart F income, where the CFC conducts its manufacturing or sales activities through a branch in another country, and that entity resembles a separate corporate subsidiary of the CFC.

Notice 98-11 proposes to do for foreign personal holding company income what Revenue Ruling 97-48 did for foreign base company sales income – seek to bring certain branch structures into the realm of subpart F. In addition, government officials have informally indicated that they are considering applying some sort of branch rule for services which, if adopted, would affect when foreign base company services income arises.

There is, however, no statutory underpinning for a branch rule in circumstances that do not involve foreig

Box 1: Examples of tax-advantaged arrangements

The first scenario discussed in Notice 98-1 involves the use of the same country exception to subpart F. Section 954(c)(3) excludes from foreign personal holding company income – a component of subpart F income – interest received from a related corporation that is organized in the same country as the controlled foreign corporation (CFC), and which maintains a substantial part of its assets there.

In the example in Notice 98-11, CFC1 owns CFC2, and both CFCs are Country A corporations. CFC1 also maintains a branch in Country B, a low-tax jurisdiction. The tax laws of Country A and Country B regard CFC1, CFC2, and the CFC1 branch as separate, non-transparent entities. The CFC1 branch loans money to CFC2 and receives interest on the loan. Country A allows a deduction to CFC2 for the payment of interest, but Country B, the low-tax jurisdiction, imposes little or no tax on the CFC1 branch for the receipt of the interest payments.

According to the Notice, if the branch status of the CFC1 branch were respected for US tax purposes, then the same-country exception would apply because CFC1 would be deemed to be loaning money to CFC2, all within Country A. Accordingly, CFC1 would earn no foreign personal holding company income from the transaction. If, however, the CFC1 branch were considered to be a separate, non-transparent Country B entity, then the CFC1 branch would derive foreign personal holding company income in the transaction.

Notice 98-11 indicates that the proposed regulations will cause the CFC1 branch to be treated as a separate corporation for subpart F purposes, thus producing the second, less-favourable outcome.

In the second scenario discussed by Notice 98-11, a Country A corporation, CFC3, receives a loan from its branch in Country B, again a low-tax jurisdiction. The tax laws of Country A and Country B regard CFC3 and its branch as separate, non-transparent entities. Hence, Country A allows a deduction for payments made by CFC3 to its foreign branch, but Country B imposes little or no tax on the branch.

According to the Notice, if the branch is disregarded, then CFC3 would be deemed to have made a loan to itself; there would be no foreign personal holding company income and subpart F would not apply. If, on the other hand, CFC3 and its branch were treated as separate, non-transparent entities, then interest on the loan from the branch to CFC3 would be subpart F income. Once again, the Notice concludes that the two entities must be regarded as separate corporations to prevent the creation of a tax incentive for US companies to invest their capital abroad.

Notice 98-11 therefore announces that the Treasury and the IRS will issue regulations to prevent the use of the above types of hybrid arrangements by providing, in these types of cases, that the branch and the CFC will be treated as separate corporations for purposes of subpart F.

base company sales income. Notice 98-11 has produced among practitioners a response similar to that which greeted Revenue Ruling 97-48, and some have questioned the Treasury's authority to promulgate the regulations predicted by the Notice.

The legislative proposal

Perhaps for this reason, among others, the US Administration has submitted a proposal to authorize the Treasury to prescribe regulations clarifying the tax consequences of hybrid transactions in general. According to the Treasury's explanation of the proposal, these regulations would set forth the appropriate tax results under hybrid transactions in which the intended results are inconsistent with the purposes of US tax law (including treaties).

The regulations would apply not just to hybrid entity classification, as discussed in Notice 98-11, but also to transactions as described in Notice 98-5, and, more broadly, to any transaction that involves the inconsistent treatment of entities, items and transactions (ie tax arbitrage).

However, in that regard, the proposal indicates that the regulations would not be authorized to deny tax benefits or results that arise in connection with hybrid transactions solely because such transactions involve the inconsistent treatment of entities, items and transactions. The proposal illustrates this by reference to a transaction that is treated as a lease in one country and a financing in another country.

The US Adminstration's budget proposal contains an example of the type of hybrid instrument the proposed regulations would target. In exchange for cash, a CFC issues an instrument to its US parent that is viewed as an original issue discount debt obligation for purposes of the CFC's home jurisdiction, but as equity under US tax laws. The original issue discount instrument gives rise to imputed interest deductions to the CFC. US tax law, however, views the instrument as an equity interest, and therefore does not cause the parent to include the original issue discount interest payments in income.

Commentators have questioned whether the Treasury should assume the role of policing the tax base of foreign countries

Through the use of such hybrid instruments, the Treasury proposal explains, the CFC can reduce its effective tax rate in its home jurisdiction, achieving inappropriate tax results similar to those described in Notice 98-11.

Denial of foreign tax

Finally, as mentioned above, the proposed regulations may deny foreign tax credits generated in certain transactions with no substantial profit motive, such as tax arbitrage transactions involving the exploitation of differences between US and foreign tax law.

For example, the regulations may target the duplication of tax benefits resulting from the inconsistent treatment of all or part of a transaction.

Where such transactions lack a substantial profit motive, the regulations may lead to the conclusion that the US taxpayer has effectively purchased foreign tax credits. Notice 98-5 announced that the proposed regulations would deny foreign tax credits in such situations, effective with respect to taxes paid or accrued on or after December 23 1997.

These Treasury initiatives clearly signal heightened hostility towards certain hybrids. The initiatives were precipitated because the Treasury viewed some hybrid tax planning as circumventing the purposes of US law, including tax treaty provisions.

Defenders of such types of transactions have argued that much of the planning had the effect of reducing foreign taxes, an objective that historically has been viewed as a good business objective from a US perspective. Commentators have also questioned whether the Treasury should assume the role of policing the tax base of foreign countries. Further, it has been asserted that the Treasury and the IRS may not have the authority to do all that they seek to do in this area.

It remains to be seen whether the Treasury's legislative proposal will be enacted. What is clear, however, is that soon the Treasury will issue regulations in this area – the warning shot has been fired. Tax planners need to be alert and stay tuned for the next round of developments. ❑