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Memorandum

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to:

from: Elizabeth U. Karzon
Chief, Branch 1
Office of Associate Chief Counsel (International)

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subject:

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

LEGEND

Business	=
Country A	=
Country A Parent	=
Country A Exchange	=
Country A Co	=
Country A Sub 1	=
Country A Sub 2	=

US Sub	=	
US Parent	=	
US Hold Co	=	
a%	=	
b%	=	
Number C	=	
Amount D	=	$
e%	=	
Number F	=	
Amount G	=	$
Amount H	=	$
Amount I	=	$
Amount J	=	$
Amount K	=	$
State L	=	
m%	=	
Year 1	=	
Year 2	=	
Year 3	=	
Year 4	=	
Date 5	=	
Date 6	=	
Date 7	=	
Date 8	=	
Date 9	=	
Month 10	=	

ISSUES

Whether Treas. Reg. § 1.894-1(d)(2)(ii)(B) may be applied to recharacterize deemed interest payments treated as made on or after June 12, 2002, by US Parent to Country A Co as section 301(a) dividend distributions and accordingly disallow US Parent's interest expense deductions associated with the deemed interest payments.

CONCLUSIONS

Section 1.894-1(d)(2)(ii)(B) of the Treasury Regulations may be applied to recharacterize the deemed interest payments by US Parent to Country A Co as section 301(a) dividend distributions and disallow US Parent's interest expense deductions associated with the deemed interest payments. Under the terms of the United States-Country A income tax treaty the US Parent-to-Country A Co deemed dividend payments would be subject to U.S. withholding tax at the rate of five percent.

FACTS

I. **The parties**

Country A Parent is a Country A public company traded on the Country A Exchange and the parent of a multinational group of entities engaged in Business. Country A Co is a Country A corporation wholly owned by Country A Parent.

Country A Co wholly owns two Country A companies, Country A Sub 1 and Country A Sub 2.

US Parent is a State L general partnership that is wholly owned by Country A Sub 1 (a% interest) and Country A Sub 2 (b% interest). US Parent elected under the check-the-box regulations to be taxed as a corporation for U.S. federal income tax purposes. For Country A tax purposes, however, US Parent is treated as a partnership.

US Sub is a domestic corporation that is wholly owned by US Parent. US Sub was included on US Parent's consolidated federal income tax return for the taxable periods at issue (US Parent's taxable years ending Date 7, Year 2, and Date 7, Year 3).

II. **The agreements**

In connection with certain restructuring and acquisition activities, Country A Co, US Parent, and US Sub entered into the following agreements:

- The Procurement Agreement. On or about Date 6, Year 1, US Parent and US Sub entered into an agreement under which US Parent agreed to procure a purchaser willing to pay Amount D for one share of US Sub Series A Preferred Stock. The Procurement Agreement provided that if US Parent failed to secure the payment of the subscription price within Number C days, then US Parent would pay the subscription price to US Sub and would be deemed to be the subscriber.

- The Subscription Agreement. On Date 6, Year 1, US Sub and Country A Co entered into an agreement under which US Sub agreed to issue one share of Series A Preferred Stock ("the Preferred Share") to Country A Co in exchange for Amount D. Country A Co agreed not to sell, transfer, pledge, or otherwise dispose of the

Preferred Share, other than pursuant to the Pledge and Security Agreement (see below), without first giving notice to US Sub. Any transferee of the Preferred Share would have to assume all of Country A Co's obligations under the Subscription Agreement, the Call Option Agreement (see below), the Put Option Agreement (see below), and the Pledge and Security Agreement (see below) (these agreements are collectively referred to hereinafter as the "Transaction Agreements").

- The Preferred Share. The Preferred Share carries no voting rights and is mandatorily redeemable upon the tenth anniversary of its issuance (Date 6, Year 4) for its original issue price of Amount D. It has a fixed annual coupon rate of e% on its Amount D stated value, payable quarterly. The Preferred Share has a liquidation preference of Amount D plus any accrued and unpaid dividends.

- The Call Option Agreement. On Date 6, Year 1, in consideration of US Parent entering into the Transaction Agreements, Country A Co granted US Parent a call option with respect to the Preferred Share. Upon the occurrence of certain option events,[1] US Parent has the option to purchase the Preferred Share from Country A Co. If an option event has not occurred by Date 5, Year 4, US Parent may exercise the option at any time during the one-month period from Date 5, Year 4, through Date 6, Year 4. If, as of Date 6, Year 4, US Parent has not exercised its call option and Country A Co has not exercised its put option (see below), US Parent will be deemed to exercise its call option.

- The Put Option Agreement. On Date 6, Year 1, in consideration of Country A Co entering into the Transaction Agreements, US Parent granted Country A Co a put option with respect to the Preferred Share. Upon the occurrence of certain option events,[2] Country A Co can require US Parent to purchase the Preferred Share. If an option event has not occurred by Date 5, Year 4, Country A Co may exercise the option at any time during the one-month period from Date 5, Year 4, through Date 6, Year 4.

- Provisions common to the Call Option Agreement and Put Option Agreement. Under both the Call Option Agreement and the Put Option Agreement (the "Option Agreements"), Country A Co appointed, irrevocably and by way of security, US Parent (or its nominee) as Country A Co's attorney-in-fact to do anything Country A Co was obligated to do under the Option Agreements. The exercise price under both Option Agreements is the original purchase price of the Preferred Share (Amount D) plus a supplemental amount equal to the present value of any payable but unpaid dividends. The exercise price can be paid, at US Parent's discretion, in cash or with a Number F-year note. The rights and obligations under the Option

[1] Option events under the Call Option Agreement include Country A Co's bankruptcy, dissolution, or failure to perform pursuant to the Transaction Agreements, or the declaration of a dividend by US Sub.
[2] Option events under the Put Option Agreement include the bankruptcy of US Parent or US Sub, failure to perform pursuant to the Transaction Agreements, any obligation of US Parent (or its subsidiaries) in excess of Amount G becoming prematurely payable, or the declaration of a dividend by US Sub.

Agreements are assignable only with the counter-party's prior written consent. Until such time as it may sell the Preferred Share, Country A Co retained all rights to dividends when declared and all other rights pertaining to the Preferred Share.

- The Pledge and Security Agreement. On Date 6, Year 1, Country A Co granted US Parent, as security for Country A Co's obligation to deliver the Preferred Share under the Option Agreements, a security interest in Country A Co's interest in certain property including the Preferred Share.[3] Country A Co retained all rights pertaining to the Preferred Share, which included dividends.

- The U.S. Tax Letter. The Option Agreements refer to a one-page "U.S. Tax Letter," entered into by US Parent and Country A Co and dated Month 10, Year 1, as one of the Transaction Agreements. The U.S. Tax Letter states that, for U.S. federal income tax purposes, the parties intend:

  - That the transactions entered into under the Transaction Agreements be treated as a secured loan by Country A Co and a secured borrowing by US Parent;
  - That US Parent be treated as the beneficial owner of the Preferred Share; and
  - That U.S. income tax returns be filed on a basis consistent with this intent.

  Notwithstanding the agreement with respect to the intended U.S. tax treatment, the parties agreed that it was not intended that Country A Co or US Parent would be required to treat the Preferred Share as owned by US Parent for purposes of Country A tax law.

III. The intended U.S. tax treatment of the transactions

As noted in the preceding discussion of the U.S. Tax Letter, Country A Co, US Parent, and US Sub undertook these transactions with the intent that they be treated for U.S. federal income tax purposes as a secured financing. The parties intended that US Parent be treated as owning the Preferred Share, and, consistent with the treatment of the transactions as a secured financing, that payments made by US Sub to Country A Co with respect to the Preferred Share be treated as non-deductible dividend payments from US Sub to US Parent, followed by deductible interest payments from US Parent to Country A Co.

In the taxable years at issue, US Sub made monthly payments directly to Country A Co with respect to the Preferred Share. The payments made by US Sub to Country A Co

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[3] This property includes: (1) the Preferred Share, which upon issuance will be delivered to US Parent by Country A Co to be held as security; (2) any other securities, certificates of deposit, or other instruments or documents representing the Preferred Share that shall be lodged with or delivered to US Parent or its nominees as security for the obligations; (3) the products and proceeds of the foregoing, and any substitutions or replacements therefore, other than dividends payable on the Preferred Share; and (4) all books, documents, and records related to the foregoing.

with respect to the Preferred Share totaled Amount H in the taxable year ending Date 7, Year 2, and Amount I in the taxable year ending Date 7, Year 3.

US Parent filed consolidated U.S. federal income tax returns for the taxable periods at issue consistent with its intent to treat the transactions as a secured financing – that is, for U.S. tax purposes, US Parent treated the direct payments by US Sub to Country A Co as (1) deemed dividends from US Sub to US Parent, followed by (2) deemed interest payments from US Parent to Country A Co. These amounts were booked as interest expense and were reflected on the US Parent consolidated income tax returns for the relevant taxable years as interest expense deductions.

The adjustments at issue in the present memorandum are limited to amounts paid after June 12, 2002, and before Date 9, Year 3,[4] with respect to the Preferred Share – that is, Amount J in the taxable year ending Date 7, Year 2, and Amount K in the taxable year ending Date 7, Year 3.

For purposes of the present memorandum, we assume that these transactions, in the aggregate, were appropriately treated as a secured financing for U.S. federal income tax purposes, but we express no opinion as to whether such treatment was correct.

IV. **The reorganization**

In Year 3, US Parent decided to reorganize its holdings in certain of its U.S. subsidiaries. As part of this reorganization, on Date 8, Year 3, US Parent organized US Hold Co as a State L corporation and a m%-owned subsidiary of US Parent.[5] US Hold Co was included on US Parent's consolidated federal income tax return beginning with the taxable year ending Date 7, Year 3. US Hold Co was treated as a corporation for purposes of both U.S. and Country A tax law.

On Date 9, Year 3, US Hold Co, US Parent, US Sub, and certain other U.S. subsidiaries of US Parent entered into a "Reorganization, Subscription and Share Cancellation Agreement" (the "Reorganization Agreement"). Pursuant to the Reorganization Agreement, US Hold Co became a direct wholly owned subsidiary of US Parent, and US Sub became a wholly owned subsidiary of US Hold Co. The Reorganization Agreement also provided, inter alia, that US Hold Co would assume from US Parent all of US Parent's rights and obligations under the Put Option, Call Option, and Pledge and Security Agreements.

[4] Paragraphs (d)(2)(i) and (d)(2)(ii) of Treas. Reg. § 1.894-1 apply to items of income paid by a domestic reverse hybrid entity after June 12, 2002. Given our assumption that the taxpayer's option transaction structure no longer involved payments to or from a domestic reverse hybrid entity after the Reorganization Agreement (see below), Treas. Reg. § 1.894-1(d)(2) would not be applicable to the structure after Date 9, Year 3.

[5] The remaining US Hold Co shares were owned by a domestic subsidiary of US Parent.

It is our understanding that the parties to the Reorganization Agreement intended that the contractual arrangements with respect to the Preferred Share would continue to be treated as a secured financing for U.S. federal income tax purposes. Following the Reorganization Agreement, however, the parties intended that US Hold Co (rather than US Parent) would be treated as owning the Preferred Share. Accordingly, for U.S. tax purposes, the parties intended that the direct payments by US Sub to Country A Co with respect to the Preferred Share would be treated as (1) deemed dividend payments from US Sub to US Hold Co, followed by (2) deemed interest payments from US Hold Co to Country A Co.

The Reorganization Agreement did not affect US Parent's treatment of the transactions with respect to the Preferred Share as a secured financing for purposes of filing its consolidated U.S. federal income tax return for the second of the taxable years at issue (taxable year ending Date 7, Year 3).

For purposes of the present memorandum, we assume that the option transaction structure no longer involved deemed payments to or from a domestic reverse hybrid entity following the Reorganization Agreement (that is, after Date 9, Year 3). We express no opinion as to whether this assumption is correct.

In addition, we express no opinion as to whether it was correct to continue to treat these transactions, in the aggregate, as a secured financing for U.S. federal income tax purposes following the Reorganization Agreement.

V. Treatment of the transactions for purposes of the United States-Country A income tax treaty

Consistent with the treatment of the transactions at issue as a secured financing for U.S. tax purposes, Country A Co, US Parent, and US Sub also intended that the transactions be treated in the same manner for purposes of the United States-Country A income tax treaty[6] (the "Treaty"), and that the deemed US Parent-to-Country A Co interest payments be exempt from U.S. withholding tax pursuant to Article (Interest) of the Treaty.[7] For purposes of the present memorandum, we assume that Country A

[6] . Please note that the United States and Country A signed a new income tax treaty on , which entered into force on .

[7] For purposes of this memorandum, we assume that, post-Reorganization Agreement, the parties intended that the transactions at issue would continue to be treated as a secured financing for purposes of the Treaty – that is, that the deemed US Hold Co-to-Country A Co interest payments would be exempt from U.S. withholding tax pursuant to Article of the Treaty. A discussion of the application of the Treaty to the deemed US Hold Co-to-Country A Co interest payments is beyond the scope of the present memorandum.

Co was a resident of Country A entitled to the benefits of the Treaty in the taxable years at issue, but we express no opinion as to whether that assumption is correct.

VI. **Treatment of the transactions for purposes of Country A tax law**

It is our understanding that, for Country A tax purposes, the transactions at issue were treated in accordance with their form: the direct payments made by US Sub to Country A Co with respect to the Preferred Share were taxable dividends for Country A tax purposes. The US Parent-to-Country A Co interest payments were deemed to exist for U.S. tax purposes only.[8] The deemed interest payments did not exist for Country A tax purposes and, accordingly, no Country A entity claimed an interest deduction associated with these payments for Country A tax purposes. It is our understanding that Country A Co paid Country A tax on the Preferred Share dividends. In accordance with Country A tax law, Country A Co would have been allowed to claim a foreign tax credit for a pro rata share of the U.S. taxes on the US Sub income out of which the dividends were paid.[9]

LAW AND ANALYSIS

I. **The section 894 domestic reverse hybrid regulations**

Section 1.894-1(d)(2) of the Treasury Regulations provides special rules that apply with respect to payments made and received by a domestic reverse hybrid entity (DRH). The term "domestic reverse hybrid entity" is defined by Treas. Reg. § 1.894-1(d)(2)(i) as "a domestic entity that is treated as not fiscally transparent for U.S. tax purposes and as fiscally transparent under the laws of the interest holder's jurisdiction, with respect to the item of income received by the domestic entity." In general, an item of income paid by a DRH to an interest holder in the DRH shall have the character of such item of income under U.S. law. Treas. Reg. § 1.894-1(d)(2)(ii)(A).

Section 1.894-1(d)(2)(ii)(B)(*1*) of the Treasury Regulations contains a general rule that applies when: (1) a domestic entity makes a payment to a related DRH that is treated as a dividend under either U.S. law or the laws of the jurisdiction of a related foreign interest holder in the DRH; and (2) the DRH makes a payment of a type that is deductible for U.S. tax purposes to the related foreign interest holder or to certain other related persons and for which a reduction in U.S. withholding tax would be allowed under an applicable income tax treaty. In such cases, in general, to the extent that the payment by the DRH does not exceed the sum of the portion of the payment made to the DRH (by the related domestic entity) treated as derived by the related foreign interest holder, the payment by the DRH will be treated for all purposes of the Internal Revenue Code (the "Code") and any applicable income tax treaty as a dividend

[8] Similarly, following the Reorganization Agreement, the US Hold Co-to-Country A Co interest payments were deemed to exist for U.S. tax purposes only.
[9] We have not been provided information on the Country A foreign tax credits claimed in the taxable years at issue in respect of dividends on the Preferred Share.

distribution within the meaning of Code section 301(a). Treas. Reg. § 1.894-1(d)(2)(ii)(B)(*1*)(*iii*). Accordingly, the U.S. tax to be withheld from the payment by the DRH is determined based on the appropriate rate of withholding applicable to dividends paid from the DRH to the related foreign interest holder. Section 1.894-1(d)(2)(ii)(B)(*2*) of the Treasury Regulations provides a special rule for determining the amount to be recharacterized as a dividend under Treas. Reg. § 1.894-1(d)(2)(ii)(B)(*1*)(*iii*).

Paragraphs (d)(2)(ii) and (d)(2)(iii) of Treas. Reg. § 1.894-1 apply to items of income paid by a domestic reverse hybrid entity on or after June 12, 2002, with respect to amounts received by the domestic reverse hybrid entity on or after June 12, 2002. Treas. Reg. § 1.894-1(d)(6).

II. Withholding tax under the Code and the treatment of interest and dividends under the Treaty

Section 881(a) of the Code generally imposes a 30-percent tax on the amount received by a foreign corporation as interest or dividends from sources within the United States to the extent that the interest or dividends are not effectively connected with the conduct of a trade or business within the United States.

Section 894 of the Code provides that the provisions of the Code shall be applied to any taxpayer with due regard to any treaty obligation of the United States that applies to such taxpayer. Section 1.871-12(c) of the Treasury Regulations provides that, with respect to items of income the tax on which is limited by a tax convention, the tax is determined upon the gross amount of each separate item of income at the reduced rate applicable to that item under the convention.

Paragraph of Article (Dividends) of the Treaty provides in relevant part that dividends paid by a U.S. corporation to a Country A resident corporation that controls, directly or indirectly, at least 10 percent of the voting stock of the U.S. corporation paying the dividends may be taxed by the United States at a rate not to exceed five percent.

Paragraph of Article (Interest) of the Treaty provides generally that interest derived and beneficially owned by a resident of Country A shall be exempt from tax by the United States.

III. Discussion

A. Application of Treas. Reg. § 1.894-1(d)(2)(ii)(B) to deemed payments

US Parent is domestic entity that is treated as a corporation for U.S. tax purposes. For Country A tax purposes, US Parent is treated as a fiscally transparent entity within the meaning of Treas. Reg. § 1.894-1(d)(3)(iii). US Parent is thus a DRH as that term is defined in Treas. Reg. § 1.894-1(d)(2)(i). Because US Parent is a DRH, Treas. Reg.

§ 1.894-1(d)(2)(ii)(B) may apply to recharacterize certain deductible payments made by US Parent on or after June 12, 2002,[10] as nondeductible dividends for U.S. tax purposes. In discussing whether Treas. Reg. § 1.894-1(d)(2)(ii)(B) will apply in the present factual context, it is first necessary to address the threshold issue whether the "payments" described in Treas. Reg. § 1.894-1(d)(2) include payments that are deemed to occur for U.S. tax purposes.

In the present case, US Parent has taken the position that substance-over-form principles should apply to treat a series of contractual arrangements in the same manner as a secured financing for certain Code purposes and for purposes of the Treaty. Under the present facts, we believe that the same substance-over-form principles should prevail for purposes of applying the section 894 rules on payments by domestic reverse hybrid entities – that is, that Treas. Reg. § 1.894-1(d)(2) should apply with respect to payments that occur (or are deemed to occur) for purposes of the Code as part of a secured financing transaction. Section 1.894-1(d)(2)(ii) of the Treasury Regulations provides expressly that "an item of income paid by a domestic reverse hybrid entity … shall have the character of such item of income under U.S. law." This reference to U.S. law cannot be limited to situations where there is an actual payment, but rather incorporates all U.S. tax principles in determining whether there has been a deductible payment and to whom that payment was made.

We additionally believe that, to the extent a taxpayer may characterize a transaction in a manner inconsistent with its form, equitable considerations would require that the taxpayer be held to such substance-over-form re-characterization for purposes of the section 894 domestic reverse hybrid regulations. Cf. Comdisco, Inc. v. United States, 756 F.2d 569, 578 (7th Cir. 1985) (taxpayer may assert the priority of substance over form "where his tax reporting and actions show an honest and consistent respect for the substance of a transaction," quoting Weinert's Estate v. Commissioner, 294 F.2d 750 (5th Cir. 1961)); Taiyo Hawaii Co. v. Commissioner, 108 T.C. 590, 602 (1997) (taxpayer permitted to assert substance over form where tax reporting and actions show honest and consistent respect for substance (citing FNMA v. Commissioner, 90 T.C. 405, 426 (1988))); Illinois Power Co. v. Commissioner, 87 T.C. 1417, 1430 (1986), aff'd, 896 F.2d 580 (D.C. Cir. 1990) (taxpayer asserting priority of substance of a transaction must show honest and consistent respect for substance in tax reporting and actions (citing Comdisco)). This is especially true where, as here, the taxpayer's transactions create, in substance, precisely the type of DRH structure targeted by the section 894(c) regulations: a DRH structure "established by related parties to manipulate differences in U.S. and foreign entity classification rules to reduce, through inappropriate use of an income tax treaty, the amount of tax imposed on items of income paid by domestic corporations to related foreign companies." 2002-2 C.B. 78, 79 (preamble to the final section 894(c) regulations relating to domestic reverse hybrids). As explained in the preamble to the regulations:

[10] See Treas. Reg. § 1.894-1(e).

> The overall effect of these transactions, if respected, would be (1) a deduction under U.S. law for the “outbound” payment of an item of income; (2) the reduction or elimination of U.S. withholding tax on that item of income under an applicable treaty, and (3) the imposition of little or no tax by the treaty partner on the item of income. This result is inconsistent with the expectation of the United States and its treaty partners that treaties should be used to reduce or eliminate double taxation of income.

Id. The overall effect of the transactions at issue in the present case, if respected, follows this framework: (1) a deduction under U.S. law for US Parent’s outbound interest payment to Country A Co; (2) the elimination of U.S. withholding tax on the interest payment under the Treaty, and (3) the imposition of little or no tax by Country A on the item of income characterized for Country A tax purposes as a dividend, as a result of the Country A foreign tax credit. This result is inconsistent with the intent of the Treaty to reduce or eliminate double taxation of income, but not to result in double non-taxation of income. The deemed payments at issue in the present case are thus clearly within the intended scope of the section 894(c) regulations, and the “payments” described in Treas. Reg. § 1.894-1(d)(2) include deemed payments.

B. Application of Treas. Reg. § 1.894-1(d)(2)(ii)(B) to the present facts

The discussion below addresses the application of Treas. Reg. § 1.894-1(d)(2)(ii)(B) to the present facts. As noted above, given our assumption that the option transaction structure no longer involved actual or deemed payments to or from a DRH following the Reorganization Agreement, this discussion is not relevant with respect to payments made by US Sub or US Hold Co occurring after Date 9, Year 3. Given the complexity of the section 894 DRH regulations, the relevant portion of the regulations is reproduced in italics immediately preceding the corresponding discussion.

1. Treas. Reg. § 1.894-1(d)(2)(ii)(B)(*1*)(*i*)

> *(B) Payment made to related foreign interest holder. (*1*) General rule. If—*
>
> *(*i*) A domestic entity makes a payment to a related domestic reverse hybrid entity that is treated as a dividend under either the laws of the United States or the laws of the jurisdiction of a related foreign interest holder in the domestic reverse hybrid entity, …*

In the taxable years at issue, US Sub was deemed for U.S. law purposes to pay dividends to US Parent, a related[11] domestic reverse hybrid entity. The condition described in the first clause of Treas. Reg. § 1.894-1(d)(2)(ii)(B)(*1*)(*i*) is thus satisfied under the present facts.

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[11] See Treas. Reg. § 1.894-1(d)(2)(ii)(B)(*4*).

> *… and under the laws of the jurisdiction of the related foreign interest holder in the domestic reverse hybrid entity, the related foreign interest holder is treated as deriving its proportionate share of the payment under the principles of paragraph (d)(1) of this section; …*

Under the laws of Country A, the related[12] foreign interest holders in US Parent (Country A Sub 1 and Country A Sub 2) were not treated as deriving their proportionate share of the deemed dividend payments. However, under Treas. Reg. § 1.894-1(d)(2)(ii)(B)(*2*), the portion of the dividend payments treated as derived by the related foreign interest holders is increased by the portion of the dividend payments derived by any other person described in Treas. Reg. § 1.894-1(d)(2)(ii)(B)(*1*)(*ii*) – that is, "a person, wherever organized, the income and losses of which are available, under the laws of [Country A], to offset the income and losses of the related foreign interest holder." For Country A tax purposes, Country A Co derived the dividend payment on the Preferred Share.[13] Country A's group relief provisions allow a company to claim tax relief for the losses (and certain other tax reliefs) of another company if both companies are members of the same group.[14] In response to an IDR, US Sub has indicated that the Country A group relief provisions would apply to make available Country A Co's income and losses to offset the income and losses of Country A Sub 1 and Country A Sub 2, the related foreign interest holders. Country A Co is accordingly a "person described in Treas. Reg. § 1.894-1(d)(2)(ii)(B)(*1*)(*ii*)," and the portion of the dividend payments treated as derived by Country A Sub 1 and Country A Sub 2 is increased by the amount of the dividends with respect to the Preferred Share derived (for Country A tax purposes) by Country A Co.

In the present factual context, we do not consider it significant that Country A does not view any payment as being made between US Sub and US Parent (that is, that Country A does not recharacterize the transaction as a secured financing). Because US Parent is fiscally transparent for purposes of Country A law, there is no (economic or tax) difference between a dividend payment from US Sub to US Parent and a dividend payment from US Sub directly to its related foreign interest holders (or to any other person described in Treas. Reg. § 1.894-1(d)(2)(ii)(B)(*1*)(*ii*)).

In the present case, the condition described in the second clause of Treas. Reg. § 1.894-1(d)(2)(ii)(B)(*1*)(*i*) is thus satisfied.

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[12] Id.

[13] Under the principles of Treas. Reg. § 1.894-1(d)(1), an entity is considered to derive an item of income if the entity is not fiscally transparent under the laws of the entity's jurisdiction with respect to the item of income. Country A Co was not fiscally transparent under Country A law with respect to the dividends on the Preferred Share.

[14] See generally

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2. **Treas. Reg. § 1.894-1(d)(2)(ii)(B)(*1*)(*ii*)**

… and

(ii*) The domestic reverse hybrid entity makes a payment of a type that is deductible for U.S. tax purposes to the related foreign interest holder or to a person, wherever organized, the income and losses of which are available, under the laws of the related foreign interest holder, to offset the income and losses of the related foreign interest holder, and for which a reduction in U.S. withholding tax would be allowed under an applicable income tax treaty; …*

In the taxable years at issue, US Parent was deemed for U.S. law purposes to make deductible interest payments to Country A Co, a person the income and losses of which are available under Country A law to offset the income and losses of the related foreign interest holders in US Parent.[15] Under the Treaty, a reduction in U.S. withholding tax (to zero) would be allowed if the interest were beneficially owned by a resident of Country A entitled to the benefits of the Treaty. In the present case, the condition described in Treas. Reg. § 1.894-1(d)(2)(ii)(B)(*1*)(*ii*) is thus satisfied.

The taxpayer in the present case has argued, in part, that Treas. Reg. § 1.894-1(d)(2)(ii)(B)(*1*)(*ii*) is intended to cover situations where there is an interest expense deduction in the United States and under the law of the foreign interest holder. The language of the regulation, however, requires solely that the payment be "deductible for U.S. tax purposes" – there is no requirement that the interest expense be deductible under the laws of the related foreign interest holder. As noted in the preamble to the domestic reverse hybrid regulations, the deduction targeted by the regulations is the deduction under U.S. law for the outbound payment of the item of income (i.e., the U.S. deduction for the outbound interest payment by the DRH). See 2002-2 C.B. 78, 79. Taxpayer's argument in this regard appears to ignore the circumstance that a DRH is, by definition, fiscally transparent under the laws of the interest holder's jurisdiction. Interest payments by a DRH to its interest holder will generally not have any (net) tax effect in the foreign jurisdiction that considers the DRH to be fiscally transparent.[16]

3. **Treas. Reg. § 1.894-1(d)(2)(ii)(B)(*1*)(*iii*)**

As discussed above, under the present facts the conditions described in Treas. Reg. § 1.894-1(d)(2)(ii)(B)(*1*)(*i*) and (*ii*) are satisfied. We thus turn to Treas. Reg. § 1.894-1(d)(2)(ii)(B)(*1*)(*iii*) to determine the consequences with respect to post-June 12, 2002, interest payments from US Parent to Country A Co.

… then

[15] See the discussion of the Country A group relief provisions in section III.B.1 above.
[16] Under the law of the foreign jurisdiction, a payment from a fiscally transparent entity to its interest holder will likely either be (1) disregarded or (2) offset by a corresponding income inclusion.

> (iii*) To the extent the amount of the payment described in paragraph (d)(2)(ii)(B)(*1*)(*ii*) of this section does not exceed the sum of the portion of the payment described in paragraph (d)(2)(ii)(B)(1)(i) of this section treated as derived by the related foreign interest holder and the portion of any other prior payments described in paragraph (d)(2)(ii)(B)(1)(i) of this section treated as derived by the related foreign interest holder, the amount of the payment described in (d)(2)(ii)(B)(1)(ii) of this section will be treated for all purposes of the Internal Revenue Code and any applicable income tax treaty as a distribution within the meaning of section 301(a) of the Internal Revenue Code, and the tax to be withheld from the payment described in paragraph (d)(2)(ii)(B)(1)(ii) of this section (assuming the payment is a dividend under section 301(c) of the Internal Revenue Code) shall be determined based on the appropriate rate of withholding that would be applicable to dividends paid from the domestic reverse hybrid entity to the related foreign interest holder in accordance with paragraph (d)(2)(ii)(A) of this section.*

In the present case, it is our understanding that the amounts of the payments described in paragraph (d)(2)(ii)(B)(*1*)(*ii*) are equal to the amounts of the payments described in paragraph (d)(2)(ii)(B)(*1*)(*i*) treated as derived by the related foreign interest holders and by other persons described in paragraph (d)(2)(ii)(B)(*1*)(*ii*). See Treas. Reg. § 1.894-1(d)(2)(ii)(B)(*2*) (determining the amount to be recharacterized under paragraph (d)(2)(ii)(B)(*1*)(*iii*)). The amounts of the payments described in paragraph (d)(2)(ii)(B)(*1*)(*ii*) (i.e., the deemed US Parent-to-Country A Co interest payments) are accordingly treated for all purposes of the Code and the Treaty as dividend distributions within the meaning of section 301(a). No interest expense deduction is permitted in respect of payments treated as section 301(a) dividends. Under the terms of the Treaty – and assuming that Country A Co was a resident of Country A entitled to the benefits of the Treaty in the taxable years at issue – the US Parent-to-Country A Co deemed dividend payments would be subject to U.S. withholding tax at a rate not to exceed five percent.[17]

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

[redacted]

[17] It is our understanding that Country A Co indirectly controlled 100 percent of the voting stock of US Parent at all relevant times during the taxable years at issue and would thus satisfy the conditions set out in Article of the Treaty to qualify for the five-percent dividend rate. We express no opinion as to Country A Co's residence for Treaty purposes.

[redacted]

This writing may contain privileged information. Any unauthorized disclosure of this writing may undermine our ability to protect the privileged information. If disclosure is determined to be necessary, please contact this office for our views.

Please call (202) 622-3880 if you have any further questions.

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