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Report No. 1373
June 13, 2017

The Honorable Thomas C. West
Acting Assistnant Secretary (Tax Policy)
Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

The Honorable John Koskinen
Commissioner
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

The Honorable William M. Paul
Acting Chief Counsel
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

Re: *Report No. 1373 on the Application of Section 894 to Effectively Connected Income of Hybrid Entities*

Dear Messrs. West, Koskinen, and Paul:

I am pleased to submit the attached report of the Tax Section of the New York State Bar Association. The report comments on the appropriate application of treaty limitations to source-country taxation of "non-FDAP" income and the branch profits tax when the underlying income is earned by or through an entity that is fiscally transparent under the laws of one treaty partner but fiscally opaque under the other treaty partner's laws (a "hybrid entity"). This report is intended to provide a more detailed and comprehensive discussion and exploration of the issues presented, augmenting our previous reports on this issue.

The basic principle of the hybrid entity regulations under Section 894 is that when the entity classification laws of the United States and those of a foreign treaty jurisdiction conflict, treaty benefits are determined based on the treaty eligibility of the income in the hands of the person treated as deriving the income in that person's home country (the "Derived By Rule").

Regulations under Section 894(c) currently address eligibility for income tax treaty relief only with respect of the taxes imposed by Sections 871(a), 881(a), 1443, 1461 and 4948(a) of the Code on items of income received by hybrid

entities. Thus, they do not apply, for example, to business profits derived by or through a hybrid entity, although the statutory authority under Section 894(c)(2) for regulations addressing income earned through a hybrid entity is not limited to "FDAP" income, and business profits would clearly be within the scope of the regulatory authority. The attached report contains our recommendations and requests for guidance with respect to potential application of the Derived By Rule to non-FDAP income earned through hybrid entities.

The Report makes the following principal recommendations:

1. Non-FDAP Income.

- We believe that, as a matter of policy, the Derived By Rule (as defined below) should be extended to apply to non-FDAP income. Applying the Derived By Rule to non-FDAP income earned through certain types of hybrid entities, such as domestic hybrid entities, should be relatively straightforward and would reduce taxpayer uncertainty as well as limit the potential for government whipsaw.

- We have identified reasons for and against extending the Derived By Rule to non-FDAP income earned through other structures, such as foreign reverse hybrid entities, because these scenarios raise a number of practical and administrative questions. If Treasury and the IRS were to extend the Derived By Rule to these scenarios, even limited guidance on these issues would help reduce uncertainty.

2. Tax-Exempt Income. We recommend, as we have previously, that the Derived By Rule be clarified to allow treaty benefits for income (whether FDAP or non-FDAP income) of a hybrid entity that would have been exempt from tax in the country of the investor's residence, had it been earned directly (and had the same character as the underlying income).

3. Branch Profits Tax.

- In general, we believe that the Derived By Rule should be applied without modification to the BPT. This approach would deny treaty benefits for the BPT imposed on business profits earned through a domestic or foreign hybrid entity, and would allow treaty benefits in the case of non-FDAP income earned through a foreign reverse hybrid.

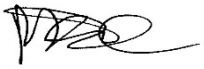
- We also identify an alternative approach that would favor a modification to the Derived By Rule as it applies to the BPT on non-FDAP income earned through a domestic hybrid entity. Under this approach, the Derived By Rule would be applied to the BPT only if treaty benefits would have been available to the taxpayer under the Derived By Rule with respect to the dividend withholding tax had the non-FDAP income been earned through a domestic subsidiary and repatriated as dividends to the taxpayer.

- In the case of the BPT imposed on a foreign corporation with respect to non-FDAP income earned through a foreign hybrid entity, we believe that the foreign hybrid should be permitted to claim its own treaty benefits with respect to the BPT imposed on its corporate interest holder.

- Finally, we review a number of additional considerations and alternative approaches in circumstances in which the BPT is imposed on a foreign reverse hybrid entity with treaty-eligible individual interest holders. While we identify more than one approach, we recommend an approach that would allow the individual interest holders to claim treaty benefits as a result of their status as individuals only if their portion of the ECI earned by the foreign reverse hybrid is subject to tax at individual tax rates.

We appreciate your consideration of our recommendations. If you have any questions or comments on this report, please feel free to contact us and we would be happy to assist in any way.

Respectfully submitted,



Michael Farber, Chair

Attachment

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