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Ladies and Gentlemen:

The attached NYSBA Tax Section Report 1004, prepared by the Committee on U.S. Activities of Foreign Taxpayers and approved by the Tax Section Executive Committee, comments on Proposed Treasury Regulations Section 1.894-1(d)(2)(ii)-(iv) (the “Proposed Regulations”). The Proposed Regulations provide both a general and a special anti-abuse rule for the application of income tax treaties to payments made by domestic reverse hybrid entities. A domestic reverse hybrid (“DRH”) entity is a domestic entity that is not fiscally transparent under U.S. tax law but is fiscally transparent under the laws of a person claiming treaty benefits in respect of the entity (such as a U.S. general partnership that has “checked the box” to be treated as a corporation for U.S. federal income tax purposes that has one or more foreign partners).

The principal focus of our report is on the proposed special anti-abuse rule (the “Special Rule”), which addresses a structure frequently used by foreign acquirors to finance their acquisitions of U.S. target corporations. To illustrate the structure, suppose that two affiliated corporations organized in the United Kingdom become the partners in a general partnership organized under Delaware state law. Suppose also that the partnership elects to be classified as a corporation for U.S. federal income tax purposes, but for U.K. tax purposes it is regarded as a partnership, *i.e.*, as a “transparent” flowthrough entity. The partnership would be a domestic reverse hybrid entity within the meaning of the Proposed Regulations - - that is, fiscally transparent under U.K. law but not for U.S. federal income tax purposes.

In this example, the domestic reverse hybrid entity would borrow from one of its U.K. partners or from another foreign affiliate and use the

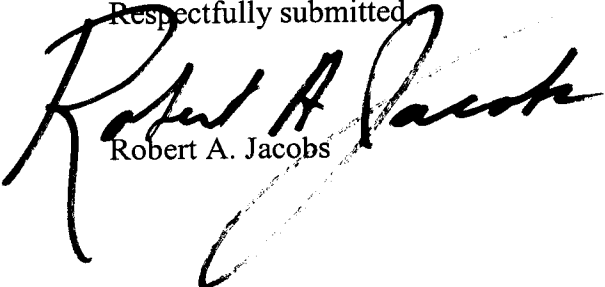
loan proceeds to acquire the stock of a U.S. target corporation. The U.S. target is then included in a consolidated return with the parent domestic reverse hybrid, and dividends paid to the hybrid by the U.S. target are eliminated from the hybrid's income under the consolidated return regulations. The hybrid's dividend income from the U.S. target also may be exempt from tax, or offset by foreign tax credits, in the U.K. when it is taken into account by the U.K. partners. In addition, subject to applicable limitations such as the earnings-stripping rules, the interest expense incurred by the hybrid is deductible in both the United States and the U.K., providing a "double dip."

In effect, the Special Rule treats otherwise deductible interest or royalty payments made by a domestic reverse hybrid entity to a related foreign interest holder as dividends to the extent the domestic reverse hybrid entity has received taxable or nontaxable dividend income (in the current or prior years) from a related U.S. entity. The effect of this dividend treatment is to disallow the domestic reverse hybrid a deduction for the purported interest payment and, in most cases, to invoke a 5% or 15% rate of U.S. withholding tax under the governing income tax treaty. So, in the example above, the "interest" paid by the domestic reverse hybrid entity to its U.K. partner would not be deductible for U.S. tax purposes to the extent of the dividend income received by the hybrid from the U.S. target corporation, and the interest would be treated as a dividend payment for purposes of determining the applicable withholding tax rate under the U.S.-U.K. tax treaty.

We agree the Special Rule serves a legitimate anti-avoidance purpose: avoiding the "double dip." However, we believe the approach of the Special Rule does not well serve this purpose and undermines the simplification objective of the "check-the-box" regulations. We recommend instead that the government address the domestic reverse hybrid structure by adopting rules under Section 1503(d) of the Code, relating to the treatment of dual consolidated losses. This approach would address the "double dip" without requiring the recharacterization (as a dividend) of the payment by the domestic reverse hybrid to its foreign interest holders. This is because we believe that the potential for a reduced withholding rate is neither the driving force behind the DRH Structure nor the principal source of concern.

We also have included in this report several technical comments on the general rule of the Proposed Regulations and, in the event that it is retained, the Special Rule.

Respectfully submitted



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