Report on Proposed Regulations under Section 894 Regarding Payments Made by Domestic Reverse Hybrid Entities[1]

January 14, 2002

This report comments on Proposed Treasury Regulations Section 1.894-1(d)(2)(ii) - (iv) (the "Proposed Regulations"),[2] which 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 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 and that has one or more foreign partners).

For example, suppose two affiliated corporations organized in the United Kingdom become the partners in a general partnership organized under Delaware law. Suppose also that the partnership "checks the box" to be classified as a corporation for U.S. federal income tax purposes, but for U.K. tax purposes the partnership is regarded as a partnership, *i.e.*, as a 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.

Domestic reverse hybrids frequently have been used by foreign acquirers to finance their acquisitions of U.S. target corporations. Thus, in the example above, 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.

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[2] REG-107101-00, published in the Federal Register on February 27, 2001.

The profitable U.S. target is thereafter included in a consolidated return with the domestic reverse hybrid, and dividends paid to the parent hybrid by the U.S. target are eliminated from the hybrid's income under the consolidated return regulations.[3] The hybrid's dividend income from the U.S. target may also 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".

The regulations under Section 894 do not currently address the treatment of the interest paid by the domestic reverse hybrid to its foreign interest holders (or to another foreign affiliate) for withholding tax purposes. Treasury Regulations Section 1.894-1(d)(2)(i) does provide for the treatment of payments made to domestic reverse hybrids. Under that provision, an income tax treaty may not be applied to reduce the amount of federal income tax on U.S. source payments received by a domestic reverse hybrid entity, and foreign persons that hold interests in a domestic reverse hybrid entity are not entitled to the benefits of a U.S. income tax treaty for U.S. source income received by the entity. The Section 894 Regulations reserve, however, with respect to the treatment of payments made by domestic reverse hybrid entities.

Our recommendations are summarized below, followed by a description of the Proposed Regulations and a more detailed discussion of our comments. We also have noted several technical points in the event the Proposed Regulations are pursued in their present form.

I. Summary of Recommendations

We agree the anti-avoidance purpose of the Proposed Regulation's special rule is a legitimate one. 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 Code §1503(d), relating to the treatment of dual

[3] Treas. Reg. §1.1502-14.

consolidated losses. We have also included below several technical comments on the general rule of the Proposed Regulations and, in the event that it is retained, the special rule.

II. The Proposed Regulations

Under the Proposed Regulations, an item of income paid by a domestic reverse hybrid entity to a foreign interest holder in the entity is characterized under U.S. law (the "General Rule").[4] To determine the availability of treaty benefits, the General Rule provides that the income item is considered to be derived by the foreign interest holder to the extent the interest holder is not fiscally transparent in its jurisdiction with respect to the item of income. However, in determining whether the interest holder is fiscally transparent, the item of income is tested as if it had been paid by a U.S. entity that is not fiscally transparent under the laws of the interest holder's jurisdiction with respect to any item of income (*e.g.*, a Delaware corporation). Thus, if the domestic reverse hybrid entity in the example above makes a distribution to its U.K. partners that is treated as a dividend for U.S. tax purposes, the General Rule is applied by determining whether the U.K. partners would have been fiscally transparent under U.K. law with respect to a dividend received from an actual U.S. corporation, *i.e.*, an entity organized as a corporation under Delaware or other U.S. state law. If the U.K. partners would have been required to take the dividend into account on a current basis for U.K. tax purposes, then they will not be regarded as fiscally transparent with respect to the distribution from the domestic reverse hybrid entity and will be permitted to claim a reduced rate of withholding tax under the tax treaty with the U.K.

The Proposed Regulations also provide a special, anti-abuse rule (the "Special Rule").[5] Under the Special Rule, if

(i) a domestic entity makes a payment to a related domestic reverse hybrid entity that is treated as a dividend under either U.S. law or the laws of the jurisdiction of a

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4 Proposed Regulations §1.894-1(d)(2)(ii)(A).

5 Proposed Regulations §1.894-1(d)(2)(ii)(B).

related foreign interest holder, and under the laws of its jurisdiction the related foreign interest holder is treated as deriving its proportionate share of the payment under the principles of Treasury Regulations Section 1.894-1(d)(1);[6] 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 and for which a reduction in U.S. withholding tax would otherwise be allowed under an applicable income tax treaty and the General Rule (such as an interest or royalty payment); then

(iii) to the extent the amount of the deductible payment described in clause (ii) does not exceed the interest holder's share of the dividend payment described in clause (i) (and of prior similar dividend payments to the extent not previously recharacterized under this rule), the payment to the related foreign interest holder will be treated for all purposes of the Internal Revenue Code and the applicable income tax treaty as a dividend, and the tax to be withheld from the payment will be determined based on the specified applicable treaty rate for dividends.

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 another related U.S. entity. The effect of this dividend treatment is to disallow the domestic reverse hybrid a deduction for the 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.[7]

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[6] In other words, the related foreign interest holder is not itself fiscally transparent with respect to its proportionate share of the payment.

[7] We note, however, that the new U.S.-U.K. income tax treaty signed on July 24, 2001 would provide for a zero rate of withholding tax on dividends (in other words, the same rate that applies to interest

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In determining the amount of a payment to be recharacterized as a dividend under the Special Rule, the dividend income received by the domestic reverse hybrid entity (and treated as derived by the related foreign interest holder) is reduced by the amount of any prior actual dividend payments made by the domestic reverse hybrid entity to the related foreign interest holder and by the amount of any payments from the domestic reverse hybrid entity that previously were recharacterized under the Special Rule. The Proposed Regulations also provide a "tiering" rule under which the principles of the Special Rule apply to payments made among related entities when there is more than one domestic reverse hybrid entity or other fiscally transparent entities involved.

The Proposed Regulations define "related" entities by cross-reference to the rules of Sections 267(b) and 707(b)(1), except that 80 percent is substituted for the 50-percent threshold found in those sections. The Section 318 constructive ownership rules and the Section 267(c) attribution rules also apply. A rule aimed at "accommodation parties" provides that, where an unrelated person enters into a transaction (or series of transactions) with the domestic reverse hybrid entity, its related interest holders or its related entities, and the effect of the transaction is to avoid the principles of the Special Rule, then the "unrelated" person will be treated as related to the domestic reverse hybrid entity.

In addition to the General and Special Rules, the Proposed Regulations provide a broad anti-abuse rule under which the Commissioner can recharacterize, for all purposes of the Internal Revenue Code, all or part of any transaction (or series of transactions) between related parties if the effect of the transaction (or series of transactions) is to avoid the principles of Treas. Regs. Section 1.894-1(d)(2) (including the rules for payments both to and by domestic reverse hybrid entities).[8] The Proposed Regulations also provide three examples illustrating the rules for the application of income

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payments) in cases where an 80-percent ownership test is met. The new protocol to the U.S.-Australia income tax treaty, signed on September 27, 2001, contains a similar provision.

8 Proposed Regulations §1.894-1(d)(2)(C).

tax treaties to payments made to (Example 1) and by (Examples 2 and 3) domestic reverse hybrids.[9]

The Proposed Regulations are to be effective for payments made by a domestic reverse hybrid entity, with respect to amounts received by the domestic reverse hybrid entity, on or after the date the regulations are published in final form.

III. Comments on the Special Rule

A. The Problem. The Special Rule is aimed at the situation illustrated by the example set out above: Affiliated foreign corporations organized in the U.K. or another treaty country establish a domestic reverse hybrid entity (such as a Delaware general partnership that checks the box to be treated as a corporation for U.S. tax purposes) to finance the acquisition of a U.S. target corporation. One of the foreign partners or another foreign affiliate lends funds to the domestic reverse hybrid, which uses the loan proceeds to purchase the U.S. target stock. The U.S. target corporation subsequently operates profitably and pays dividends to the domestic reverse hybrid, and the domestic reverse hybrid pays interest to the foreign partner. The intended tax results are:

(i) Dividends received by the domestic reverse hybrid from its U.S. subsidiary are treated under the applicable foreign law as earned directly by the foreign partner and are eligible for tax relief under the foreign law (*e.g.*, foreign tax credit, dividend exclusion or participation exemption). The foreign partner also may claim an interest deduction for its share of the interest expense of the domestic reverse hybrid, which deduction offsets the foreign partner's inclusion of the interest payment it receives; and

(ii) The dividend income of the domestic reverse hybrid entity is not taxable in the United States, either by virtue of the Code Section 243(a)(3) dividends received deduction or under the consolidated return intercompany dividend exclusion rules. Interest paid by the domestic reverse hybrid is fully deductible in the United States and eligible for a 0% U.S. withholding rate under the applicable income tax treaty.

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9 Proposed Regulations §1.894-1(d)(2)(iii).

The net effect of this arrangement (which we refer to below as the "DRH Structure") is a "double dip" - - that is, a deduction for interest in both the United States and the foreign country, as well as an exemption, or foreign tax credit, in the foreign country for the dividends paid up to the hybrid entity to pay the interest.[10] The double benefit is not caught by the existing dual consolidated loss rules of Section 1503(d), because the domestic reverse hybrid entity is not taxed by the foreign country on its worldwide income or on a residence basis.[11]

The Preamble to the Proposed Regulations expresses concern that domestic reverse hybrid entities are being used in this manner to reduce inappropriately the U.S. tax on U.S. source income. According to the Preamble, this manipulation presents two particular problems: First, it defeats the expectation of the United States and its treaty partners that treaties will be used to reduce or eliminate double taxation for legitimate transactions, and not to reward manipulation of inconsistencies in law. The implication is that the United States might not have agreed to reduce its withholding rate for interest if it had known the effect could be to exempt certain U.S. source income from tax. Second, the Preamble expresses concern that the ability of foreign acquirers to obtain tax-advantaged financing through domestic reverse hybrid entities will unfairly disadvantage otherwise similarly situated potential U.S. acquirers.

As discussed further below, 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. Rather, we believe that the availability of a double interest deduction, in both the U.S. and a foreign country, is the principal concern. The intent of the "check-the-box" regulations was to promote simplification and certainty, and not to create

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[10] We believe, however, that there are relatively few treaty countries for which the DRH Structure really works in this manner. We are aware of only four in which the structure is currently employed: The Netherlands, United Kingdom, Canada and Germany.

[11] Treas. Regs. §1.1503-2(c)(2).

opportunities for erosion of the U.S. tax base.[12] We agree, therefore, that regulations addressing the DRH Structure are appropriate.

Moreover, in our experience, domestic reverse hybrid entities were not common prior to adoption of the "check-the-box" regulations.[13] They have remained relatively uncommon since those regulations were adopted, and their most frequent use now is in connection with the DRH Structure. On balance, therefore, we agree that the need to limit the tax avoidance potential of domestic reverse hybrids should outweigh more general concerns with simplicity. Nonetheless, we do not believe that simplification should be abandoned entirely in this context. As discussed in more detail below, we have a number of concerns with the approach of the Special Rule, and we believe that an alternative approach would ultimately prove simpler and more effective.

B. The Approach of the Special Rule. We have the following concerns with the approach adopted in the Special Rule:

First, the Special Rule attempts to deal very specifically with a particular set of facts. Precisely because it is so specific, it may not apply in a variety of circumstances where the tax results achieved are essentially the same. For example, the Special Rule does not address interest paid by a domestic reverse hybrid on third-party debt (such as bank debt) guaranteed by the domestic reverse hybrid's parent. Other "gaps" in the scope of the Special Rule are noted below in Section IV.[14] However, attempting to address all of

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12 We note, however, that the "check-the-box" regulations have greatly facilitated the use of foreign reverse hybrid entities (*i.e.*, foreign entities that are treated as corporations in the foreign jurisdiction and partnerships or disregarded entities for U.S. tax purposes) by U.S. taxpayers to achieve foreign tax results comparable to those being obtained by foreign taxpayers through the use of U.S. domestic reverse hybrids. For example, a U.S. corporation that acquires a foreign corporation frequently may do so through a locally-organized entity that is treated as a partnership or disregarded entity for U.S. tax purposes but as a corporation for foreign tax purposes. Interest on debt incurred by the acquiring foreign entity would then be deductible for both foreign and U.S. tax purposes, and dividends paid up to the foreign entity to fund its interest expense would be sheltered from U.S. tax by the Section 902 deemed paid foreign tax credit. Here, the benefits to the U.S. acquiring corporation are essentially the same as those that a foreign acquiring corporation might derive from the DRH Structure. Presumably, the United States would not object if a foreign government took similar steps to prevent U.S. taxpayers from utilizing foreign reverse hybrid entities to avoid foreign tax.

13 They did exist, however, as evidenced by Priv. Ltr. Rul. 8338069 (June 21, 1983).

14 We note also that the Special Rule actually has the effect in certain cases of reducing the withholding tax rate that otherwise would apply to the interest payments made by the domestic reverse (...continued)

these additional circumstances in the context of the Special Rule would only add further complication and possibly create additional loopholes.

Second, there may be other tax avoidance structures utilizing the "check-the-box" regulations that the government will wish to address in the future. If a similar approach is adopted each time, the proliferation of "rifle-shot" anti-abuse rules will ultimately overwhelm the simplification benefits achieved by the regulations.[15] We believe that the government would be better served by a more comprehensive review of the effects of the "check-the-box" regulations, to be followed as appropriate by more general limitations on abusive uses of the rules.

Third, it is at least questionable whether dividend treatment can be applied to payments that would otherwise qualify as interest under the definition provided in an income tax treaty. Treaties typically define interest to include payments that qualify as interest under the domestic tax laws of the source country. While it may be argued that the Special Rule changes U.S. tax law on what qualifies as interest, this argument ultimately is circular because the change is being made for treaty purposes.[16]

And finally, as discussed further below, we believe that the true source of the abuse potential presented by the DRH Structure is the availability of an interest (or royalty) deduction in both the United States and a foreign country. Therefore, we believe

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hybrid. In the case of the U.S.-Canadian treaty, for instance, the 10% treaty rate for interest is higher than the 5% rate that applies to related party dividends. It is not clear this result was intended.

15 We have a similar concern with the approach adopted in the "extraordinary transaction" rules of Proposed Regs. §301.7701-3(h). See Report No. 974 of the New York State Bar Association Tax Section on Proposed Treasury Regulations Section 301.7701-2 and -3, May 15, 2000.

16 Although dividend treatment would apply under the Special Rule "for all purposes of the Code", the principal non-treaty effect of this change is to deny an interest deduction. The Code and regulations, however, contain numerous provisions that limit or disallow deductions for interest expense, without changing the interest characterization of the payment. We submit, therefore, that the only reason for altering the character of the interest payment by the domestic reverse hybrid entity is to achieve a different treatment under an income tax treaty.

that the DRH Structure is better addressed in the context of Section 1503(d), a statutory provision that was adopted precisely to deal with problems of this nature.[17]

C. Section 1503(d) Approach.

Section 1503(d) of the Code provides that the dual consolidated loss for any taxable year of any corporation shall not be allowed to reduce the taxable income of any other member of the affiliated group for the taxable year or any other taxable year.[18] For this purpose, the term "dual consolidated loss" means any net operating loss of a domestic corporation that is subject to an income tax of a foreign country on its income without regard to whether the income is from sources in or out of the foreign country, or is subject to tax on a residence basis.[19]

By their terms, Section 1503(d) and the regulations thereunder do not apply to disallow an interest deduction to the domestic reverse hybrid entity in the DRH Structure. This is because the domestic reverse hybrid does not meet the requirement that it be taxed by the foreign country on its worldwide income or on a residence basis.[20] Nonetheless, the dual consolidated loss rules are aimed at circumstances that are analytically very similar to the DRH Structure. Broadly speaking, those rules are designed to prevent a loss incurred by a dual resident corporation from reducing taxable income in both the United States and a foreign country. The effect of allowing an interest (or royalty) deduction to the domestic reverse hybrid is essentially the same. It seems to us more logical, therefore, to address the availability of a deduction in the DRH Structure by expanding the dual consolidated loss rules.

We recognize that this approach would not affect the treatment of the interest or royalties paid by the domestic reverse hybrid for withholding and tax treaty

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[17] The most extreme response to the DRH Structure would be to eliminate the domestic reverse hybrid entity from the "check-the-box" regime. We do not recommend this approach, however, because there are some circumstances in which domestic reverse hybrids are used to achieve legitimate business objectives in structuring cross-border joint ventures and similar arrangements.

[18] Section 1503(d)(1).

[19] Section 1503(d)(2).

[20] Section 1503(d)(2); Treas. Regs. §1.1503-2(c)(2).

purposes. However, we believe that simply limiting the interest deduction would be sufficient to eliminate use of an abusive DRH Structure for all practical purposes. Taxpayers are unlikely to undertake the complexity and cost of establishing a DRH Structure merely to reduce a 5% withholding tax on dividends. Moreover, in certain cases such as Canada, the treaty withholding rate provided for interest payments is actually higher than the 5% rate provided for related party dividends - - and this fact has not dissuaded Canadian taxpayers from utilizing the DRH Structure. It seems reasonably clear, therefore, that the availability of a double deduction is the principal attraction of the DRH Structure, rather than a reduction in withholding rate. Further, in the absence of the "double-dip", the DRH Structure would not seem abusive. There is typically nothing in the terms of the debt issued (or license entered into) by the domestic reverse hybrid entity that would make equity treatment more appropriate, whether for withholding tax or any other purpose.

This approach does require, however, consideration of whether sufficient regulatory authority is available. The existing grants of regulatory authority under Section 1503(d) are fairly specific. In particular, Section 1503(d)(3) grants regulatory authority to the Treasury Department to issue regulations providing that any loss of a separate unit of a domestic corporation shall be subject to the limitations of Section 1503(d) "in the same manner as if such unit were a wholly owned subsidiary of such corporation".[21] As a threshold matter, the domestic reverse hybrid is itself considered a domestic corporation, at least for U.S. federal income tax purposes; thus, it would be necessary to read this provision broadly to encompass entities that are treated as units (rather than actual corporations) for foreign but not U.S. tax purposes. In addition, it is not entirely clear whether the wording of this provision would require application of the same foreign taxation requirement with respect to the separate unit (in this case, the domestic reverse hybrid entity) that the statute imposes on a domestic corporation.[22] Under the

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[21] The second grant of authority in Section 1503(d)(4) relates to the prevention of avoidance of the purposes of the dual consolidated loss rules through contributions of assets to the corporation with the dual consolidated loss after the loss was sustained; the DRH structure does not raise this issue.

[22] The existing regulations under Section 1503(d) do apply this requirement to separate units. See Treas. Regs. §1.1503-2(b)(1) and (c)(2)-(4).

circumstances, we think it would be reasonable to read Section 1503(d)(3) broadly in both respects. Although that section was drafted with "outbound" structures in mind, we believe that the drafters would have intended the grant of authority to cover regulations addressing analogous "inbound" structures if any had been identified at the time. On the other hand, we can understand that the government might prefer to seek additional, more explicit regulatory authority from Congress.

With respect to the new regulations themselves, we note that the existing regulations under Section 1503(d) already include a reservation with regard to "dual consolidated losses of separate units that are partnership interests, including interests in hybrid entities".[23] This reservation is apparently intended to address situations in which a loss is specially allocated by an entity treated as a partnership for U.S. tax purposes so as to offset one stream of income for U.S. tax purposes and a different stream of income for foreign tax purposes.[24] Although the DRH Structure presents a different factual situation, its "double dip" effect is sufficiently analogous to the effect of the special allocation that the two situations can and should be considered and addressed together. We recommend, therefore, that the government follow this approach. If Treasury and the Service are interested in pursuing this approach, we would be happy to consider it further and provide more detailed suggestions for regulations addressing both situations.[25]

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23 Treas. Regs. §1.1503-2(c)(5)(iii).

24 The Preamble to Treas. Regs. §1.1503-2 indicates that the Service is considering adding to the definition of dual consolidated loss in two circumstances where, because of special allocations, a loss is used to offset one stream of income for U.S. tax purposes and a separate stream of income for foreign tax purposes. The first situation involves a special allocation by an ordinary partnership of a single item of loss to a domestic partner for U.S. tax purposes and to a foreign partner for foreign tax purposes. The second situation involves a loss allocation to a domestic partner of a hybrid entity for U.S. tax purposes in a case where there are no affiliates with which the entity can consolidate under foreign law but where the allocation represents a special allocation that is disproportionate to the partner's income allocations. T.D. 8434, 57 FR 41079 (Sept. 9, 1992).

25 Among the questions that merit consideration is the extent to which regulations under Section 1503(d) should address the foreign reverse hybrid structure outlined in footnote 11 (including the extent to which the current regulations under Section 1503(d)(3) apply to such a structure).

IV. Technical Comments on the Proposed Regulations.

In the event that the government decides to proceed with finalizing the Proposed Regulations, we have set out below several technical comments:

1. General Rule. As drafted, the General Rule provides that a payment by a domestic reverse hybrid entity to an interest holder will be considered to be derived by the interest holder if the interest holder is not fiscally transparent with respect to the payment (determined as if the payment were made by a U.S. entity that is not fiscally transparent under the applicable foreign law). This leaves open the question whether a payment made by a domestic reverse hybrid entity to a transparent entity is eligible for treaty benefits if the owner of the transparent entity is eligible for treaty benefits under the existing rules of Treas. Regs. §1.894-1(d)(1). We assume that the answer to this question is yes, and we recommend that the general rule be clarified to provide that the payment by the domestic reverse hybrid may be considered to be derived either by the foreign interest holder (the "First Tier Holder") or by another foreign person (the "Second Tier Holder") that holds an interest in the First Tier Holder -- if the Second Tier Holder is not fiscally transparent under the law of its jurisdiction with respect to the payment, and provided that the law of the jurisdiction of the Second Tier Holder treats the First Tier Holder as fiscally transparent. This treatment would be consistent with the general rule of Treas. Regs. §1.894-1(d)(1). One way to achieve this clarification would be to end the first sentence of Proposed Regs. §1.894-1(d)(2)(ii)(A) with the words "under U.S. law," followed by insertion of a new sentence that would read: "The determination of which person is treated as deriving such item of income shall be made under the principles of Treas. Reg. §1.894-1(d)(1)."

2. Affirmative Use of the Proposed Regulations. While the preamble to the Proposed Regulations states that taxpayers may not affirmatively use the rules of the Proposed Regulations if a principal purpose is tax avoidance, there does not appear to be any provision in the text of the Proposed Regulations to implement this principle.

3. Scope of the Special Rule. The Special Rule does not appear to apply where interest is paid by the domestic reverse hybrid entity prior to its receipt of dividends from its U.S. subsidiary. In addition, as noted earlier, the rule does not address

interest paid by a domestic reverse hybrid on third-party debt (*e.g.*, bank debt or debt securities issued to public or private investors) guaranteed by the domestic reverse hybrid's foreign parent. Finally, it does not address the situation in which there is no U.S. corporate subsidiary and the earnings-generating U.S. operations are owned and operated either directly by the domestic reverse hybrid entity or indirectly through a limited liability company or other subsidiary entity that is disregarded for U.S. federal income tax purposes. Each of these situations presents an opportunity for avoidance of the Special Rule.[26] As noted above, however, attempting to address each of these factual situations is likely to complicate the Special Rule significantly; for that and the other reasons discussed above, we believe that adoption of the Special Rule is not the best solution to the problems presented by the DRH Structure and other similar structures.

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[26] We recognize that certain of these situations might be addressed by invocation of the anti-abuse rule provided by Proposed Regulations §1.894-1(d)(2)(ii)(C). If this is intended, further guidance would be helpful.