



U.S. Taxation of U.S. LLCs: Concerns About ‘Hybrid’ Tax Planning

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This is the final part in a three-part series on an introduction to the cross-border tax treatment of U.S. limited liability companies. To view the first part published in the June 2018 TaxStringer, please [click here](#). To view the second part published in the July 2018 TaxStringer, please [click here](#).

An important concern in dealing with the tax treatment of U.S. LLCs in non-U.S. tax jurisdictions is the extent to which their treatment as “hybrid entities” will cause them to run afoul of a growing campaign against tax planning seeking to take advantage of the inconsistent treatment by different countries and jurisdictions of major types of income and tax offsets. Such a campaign has spurred on major international tax initiatives such as the Base Erosion and Profit Shifting (“BEPS”) project of the Organisation for Economic Cooperation and Development (the “OECD”).

It is of course important to first be clear about the meaning of the term “hybrid.” A “hybrid entity,” from the U.S. perspective, is an entity that is fiscally transparent for U.S. tax purposes but opaque for foreign tax purposes, such as a U.S. LLC that is treated as a corporation in other countries. A “reverse hybrid entity” from the U.S. perspective, on the other hand, is an entity that is a separate taxpayer or “opaque” for U.S. tax purposes but fiscally transparent for non-U.S. tax purposes, such as a foreign partnership that elects to be treated as a corporation for U.S. tax purposes under the “check-the-box” regulations.

A. U.S. 1997 Legislation: IRC section 894 and U.S. Tax Treaties

Interestingly, IRC section 894(c) was passed as part of the Tax Relief Act of 1997 (on Aug. 5, 1997) just a few months after the IRS adopted its “check-the-box” regulations. This provision was not primarily aimed at disqualifying hybrid entities from the ability to gain tax advantages as a result of inconsistent tax rules among countries and jurisdictions, but rather to ensure that the use of transparent entities did not become an opportunity for the same types of “treaty-shopping” that the “limitation of benefits” provisions of many treaties were designed to deny to corporations whose shareholders did not mainly reside in the treaty partner. IRC section 894

prohibits a foreign person from receiving, under any income tax treaty with the United States, any reduced rate of U.S. withholding tax on an item of income derived through an entity that is treated as a partnership (or is otherwise treated as fiscally transparent) “if (A) such item is not treated for purposes of the taxation law of such foreign country as an item of income of such person, (B) the treaty does not contain a provision addressing the applicability of the treaty in the case of an item of income derived through a partnership, and (C) the foreign country does not impose tax on a distribution of such item of income from such entity to such person.”

The United States has achieved amendments to U.S. income tax treaties or entered into Competent Authority Agreements that follow the principle of IRC section 894(c). These largely track the United States 2016 Model Income Tax Convention, for which Article 1(6) provides: “[f]or the purposes of this Convention, an item of income, profit or gain derived by or through an entity that is treated as wholly or partly fiscally transparent under the taxation laws of either Contracting State shall be considered to be derived by a resident of a Contracting State, *but only to the extent that the item is treated for purposes of the taxation laws of such Contracting State as the income, profit or gain of a resident*” (emphasis added). Article 3(1)(c) also expressly defines the terms “enterprise of a Contracting State” and “enterprise of the other Contracting State” to also include “an enterprise carried on by a resident of a Contracting State through an entity that is treated as fiscally transparent in that Contracting State.”

It is very important to note that the recent amendments to U.S. tax treaties and certain “competent authority” agreements that track the requirements of IRC section 894(c) do not compel the foreign jurisdiction to treat the U.S. LLC as a pass-through entity under its own legislation. They may still tax the U.S. LLC as a corporation under their own rules. Thus, the risk of unexpected adverse tax results resulting from the inconsistencies between U.S. rules and non-U.S. rules about the taxation of U.S. LLCs still remains.

B. BEPS Action Plan No. 2

The OECD has invested major resources into efforts to rationalize and harmonize international tax rules through its “Base Erosion and Profit Shifting” (“BEPS”) Project. Action 2 of the BEPS Project is intended to develop “model treaty provisions and recommendations regarding the design of domestic rules to neutralize the tax effects of hybrid instruments and entities” (e.g., double non-taxation, double deduction, long term deferral). (See paragraph 3 in the “Introduction to Part I” of the OECD/G20 BEPS Project’s “Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2 – 2015 Final Report.”) The BEPS Project essentially assumes that the world has a “single tax system” and that tax credits or deductions conferred by one country should always correspond to tax imposition or inclusion in another country. It therefore seeks to decrease the incidence of “mismatches” in tax outcomes that arise in respect of payments made under a hybrid financial instrument or payments made to or by a hybrid entity.

Action 2 proposes a “Primary Rule” and a “Secondary Rule” for hybrid transactions and entities. Under the Primary Rule, a country should deny a taxpayer’s deduction for a payment to the extent that it is not included in the taxable income of the recipient in the counterparty jurisdiction (so-called deduction/no inclusion” or “D/NI Outcome”) or it is also deductible in the counterparty jurisdiction (so-called double deduction or “DD Outcome”). Under the Secondary

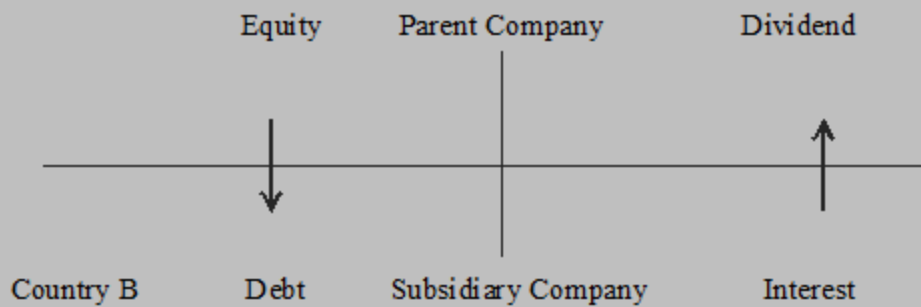
or “Defensive” Rule,” if the Primary Rule is not applied, then the counterparty jurisdiction should require the deductible payment to be included in income or deny the duplicate deduction.

Thus, in the example below, the Parent Company in Country A transfers funds to its Subsidiary Company in Country B. Country A considers the transfer to be a contribution by the Parent Company to the Subsidiary Corporation while Country B considers the transfer to be a loan. Payments made by the Subsidiary Company to the Parent Company are treated by Country A as a dividend eligible for a participation exemption in Country A and therefore not subject to Country A tax. Country B considers the payments to be deductible interest payments. Under the Primary Rule, Country B should deny the interest deduction for the payments by the Subsidiary Company to the Parent Company and, failing that, Country A should deny the exemption and tax the payments.

Example*:

Debt/Equity Hybrid

Country A

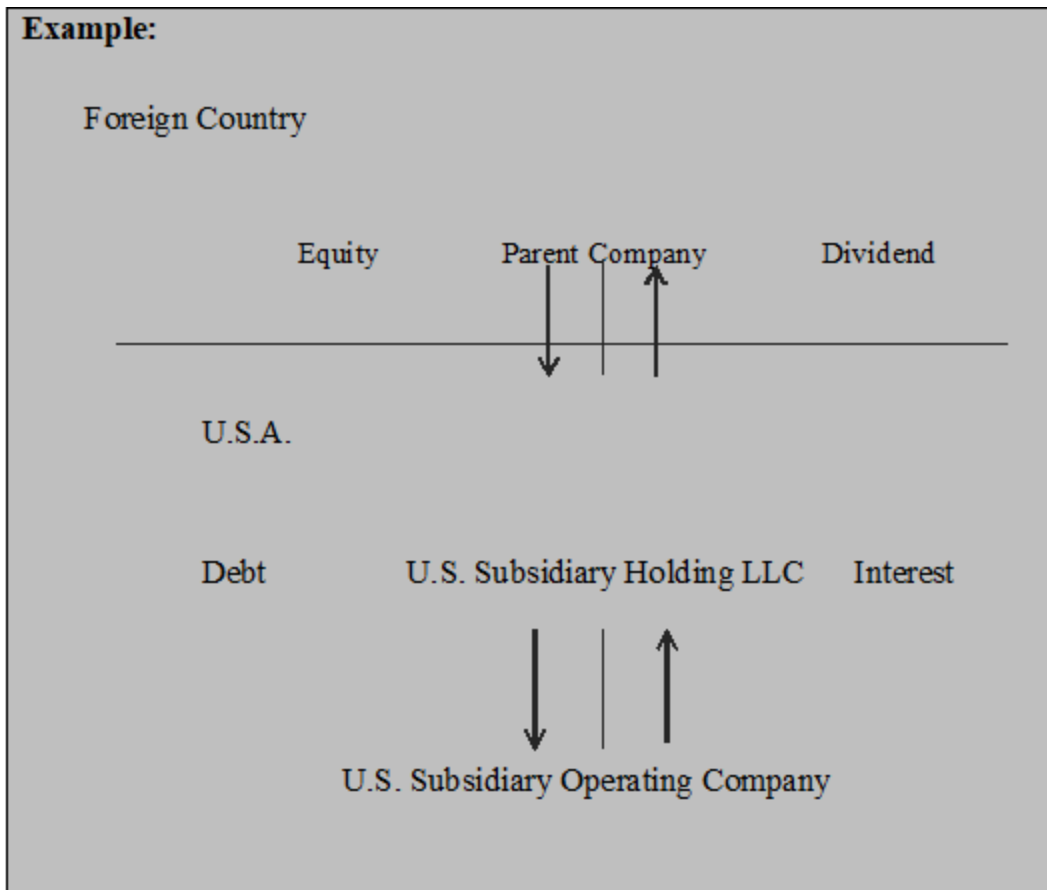


Country A considers a transfer of funds from Parent to Subsidiary as an equity investment but Country B considers it as a loan.

*Adapted from Example 1.1 of the BEPS' "Action 2: 2015 Final Report."

C. U.S. 2017 Tax Legislation – Introduction of New IRC section 267A

IRC section 267A is a new provision enacted as part of the 2017 Tax Reform Act, which is clearly inspired by BEPS Action Plan No. 2. This provision eliminates U.S. deductions for interest and royalty payments made to any foreign related party (including foreign hybrid entities) in a hybrid transaction, where the payments are not included in the income of the foreign recipient of the payment. It does not apply to payments taxed to a U.S. shareholder of a controlled foreign corporation. It applies to reverse hybrids" as well as to "hybrids" but does not appear to address payments made by foreign related parties to U.S. persons or entities not subject to U.S. taxation. Here is an example:



Suppose (1) a Foreign Parent Company contributes capital to a U.S. Subsidiary Holding LLC and (2) the U.S. Subsidiary Holding LLC in turn lends the same funds to its U.S. Subsidiary Operating Company. The U.S. Subsidiary Holding LLC is a hybrid entity because it is disregarded in the United States, even though the foreign country may consider it as a separate or “opaque” entity. From the U.S. tax perspective, the interest payments made by the U.S. Subsidiary Operating Company are treated as if they were made directly to the Foreign Parent Company and would, at least prior to the enactment of new IRC section 267A, be considered deductible. Assume, from the Foreign Parent Company’s perspective, that the interest payments are treated as dividend payments from the U.S. Subsidiary Holding LLC to the Foreign Parent Company that are eligible for a participation exemption and therefore not subject to tax in the Foreign Parent Company’s jurisdiction. Assume also that there is no U.S. withholding tax on interest payments by the U.S. Subsidiary Operating Company effectively to the Foreign Parent Company because of an exemption provision in the income tax treaty between the United States and the Foreign Parent’s jurisdiction. Any deduction by the U.S. Subsidiary Operating Company for interest payments made effectively to the Foreign Parent Company should be denied pursuant to new IRC section 267A, because neither the U.S. Subsidiary Holding LLC nor the Foreign Parent Company are paying tax on these payments. (Even if the Foreign Parent Company were also to consider the U.S. Subsidiary Holding LLC as a pass-through, a deduction should still be

denied if the foreign country treats the interest payments as dividends eligible for a participation exemption.)

Conclusion

The use of U.S. LLCs for cross-border business and investment requires careful attention to the way foreign jurisdictions classify U.S. LLCs for tax purposes and tax them to avoid double taxation, denial of deductions, and other adverse tax results, especially in an international environment in which “tax arbitrage” based on inconsistent tax treatment among different countries and jurisdictions is increasingly coming under attack.

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