(3) In the evaluation of proposals and the ranking/selection of a consultant;

(4) In negotiation of the reimbursement to be paid to the selected consultant;

(5) In monitoring the consultant's work and in preparing a consultant's performance evaluation when completed; and

(6) In determining the extent to which the consultant, who is responsible for the professional quality, technical accuracy, and coordination of services, may be reasonably liable for costs resulting from errors or deficiencies in design furnished under its contract.

(b) *Contracts.* Contracts and contract settlements involving design services for projects that have not been delegated to the State under 23 U.S.C. 106(c), that do not fall under the small purchase procedures in § 172.5(a)(2), shall be subject to the prior approval by FHWA, unless an alternate approval procedure has been approved by FHWA.

(c) *Major projects.* Any contract, revision of a contract or settlement of a contract for design services for a project that is expected to fall under 23 U.S.C. 106(h) shall be submitted to the FHWA for approval.

(d) *Consultant services in management roles.* When Federal-aid highway funds participate in the contract, the contracting agency shall receive approval from the FHWA before hiring a consultant to act in a management role for the contracting agency.

[FR Doc. 02–14751 Filed 6–11–02; 8:45 am]

BILLING CODE 4910–22–P

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[TD 8999]

RIN 1545–AY13

Treaty Guidance Regarding Payments With Respect to Domestic Reverse Hybrid Entities

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations under section 894 relating to the eligibility for treaty benefits of items of income paid by domestic entities that are not fiscally transparent under U.S. law but are fiscally transparent under the laws of the jurisdiction of the person claiming treaty benefits (domestic reverse hybrid entities). The regulations affect the determination of tax treaty benefits with respect to U.S. source income of foreign persons.

DATES: *Effective Date:* These regulations are effective June 12, 2002.

Applicability Date: These regulations are applicable 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.

FOR FURTHER INFORMATION CONTACT: Elizabeth U. Karzon at (202) 622–3880 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

On February 27, 2001, the IRS and Treasury published a notice of proposed rulemaking (REG–107101–00) in the **Federal Register** (66 FR 12445) under section 894 relating to whether payments made by domestic reverse hybrid entities to their interest holders are eligible for benefits under income tax treaties. A limited number of comments responding to the notice of proposed rulemaking were received. After consideration of these comments, the proposed regulations are adopted as final regulations as revised by this Treasury decision.

Explanation of Provisions

I. General

These final section 894 regulations clarify the availability of treaty benefits on payments made by a domestic reverse hybrid entity (DRH) to its interest holders. A DRH is a U.S. entity that the United States treats as non-fiscally transparent (e.g., as a corporation), but the interest holder's country treats as fiscally transparent (e.g., as a partnership or branch). These regulations are the final piece of guidance associated with section 894 regulations finalized on July 3, 2000 (TD 8889; 65 FR 40993) (the ''2000 regulations''), that generally address the availability of treaty benefits on items of U.S. source income paid to hybrid entities (i.e., entities treated as fiscally transparent by one jurisdiction but non-fiscally transparent by another).

The preamble to the 2000 regulations noted that the IRS and Treasury had learned that non-U.S. multinationals were establishing DRH structures in the United States to manipulate the U.S. tax treaty network to obtain tax-advantaged financing. The IRS and Treasury notified the public in that preamble that they intended to issue regulations to address this situation.

Proposed regulations were issued on February 27, 2001. The proposed regulations provided guidance with respect to two distinct issues involving domestic reverse hybrid entities. First, to resolve a technical question raised by commentators regarding the application of the 2000 regulations, the proposed regulations clarified that a payment by a domestic reverse hybrid entity to a foreign interest holder may be eligible for treaty benefits. No comments were received on this portion of the proposed regulations, and the rule in the proposed regulations is accordingly adopted without change in these final regulations.

The proposed regulations also addressed certain structures involving domestic reverse hybrid entities that Treasury and the IRS believed represented the use of such entities to obtain inappropriate treaty benefits. The comments received in response to this portion of the proposed regulations generally confirmed the need for regulations to address the use of DRH structures by non-U.S. companies. One commentator wrote in its comment that ''regulations addressing the DRH structure are appropriate.'' The commentator noted that DRH structures are ''relatively uncommon'' with the exception of their use by highly sophisticated non-U.S. multinational groups to procure acquisition financing at a tax-advantaged rate vis-a-vis their U.S. competitors.

Several commentators expressed concern that the approach taken in the proposed DRH regulations might erode the simplicity achieved by the section 7701 entity classification rules, known as the Check-the-Box (CTB) regulations. The IRS and Treasury have carefully considered this comment, but continue to believe that the approach in these final regulations is appropriate. The regulations only apply to a DRH structure established by a group of taxpayers related to each other by 80% common ownership. This high ownership requirement minimizes the possibility that a taxpayer might inadvertently establish such a structure. In addition, the comments confirm that DRH structures remain ''relatively uncommon.'' Thus, any loss of the simplification benefits of the CTB regulations also will be relatively uncommon.

One commentator suggested that, rather than adopt the approach in the regulations, the IRS and Treasury should pursue an approach under section 1503(d) to directly address structures similar to, and potentially including, the DRH that rely on hybrid entity structures to deduct the same

interest expense in two jurisdictions (commonly called a ''double dip'' of interest deductions) to achieve tax-advantaged financing. The commentator expressed the view that the real concern of the IRS and Treasury should be this double dip on deductions, rather than the tax treaty manipulation present in DRH structures.

Treasury and the IRS agree that a re-examination of the rules of section 1503(d) and the policies underlying those rules may be appropriate. Such a re-examination will require substantial and careful analysis with respect to the interaction of U.S. and foreign law in a variety of contexts and is therefore beyond the scope of these regulations, which, as noted above, focus on the use of DRH structures to obtain inappropriate treaty benefits.

In this regard, the commentator misconstrues the concern of the IRS and Treasury with respect to the issues associated with the use of DRH structures. Treasury and the IRS are concerned that DRH structures are being 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. 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. The legislative history of section 894(c) supports this analysis. Congress specifically expressed its concern about the use of income tax treaties to manipulate the inconsistencies between U.S. and foreign tax laws to obtain similar benefits. See H.R. Conf. Rep. No 220, 105th Cong., 1st Sess. 573 (1997); Joint Committee on Taxation, 105th Cong., 1st Sess., General Explanation of Tax Legislation Enacted in 1997 (JCS–23–97), at 249 (December 17, 1997). The approach adopted by these regulations also is consistent with the U.S. view that contracting states to an income tax treaty may adopt provisions in their domestic laws to prevent inappropriate use of the treaty. See, *e.g.,* the Treasury Department Technical Explanation to Article 22 (Limitation on Benefits) of the 1996 United States Model Income Tax Convention. See also Commentaries to Article 1 of the 2000 OECD Model Tax Convention on Income and Capital; S. Rep. No. 445, 100th Cong. 2d Sess. 322–23 (1988).

Another commentator questioned Treasury's authority for issuing the regulations, arguing that the recharacterization of an interest payment as a dividend payment may contravene the definition of interest contained in various U.S. treaties. The IRS and Treasury have concluded that the regulations are consistent with U.S. law, including U.S. treaties. These final regulations are issued under the authority of sections 894(a), 894(c), 7805 and 7701(l). Further, as noted above, contracting states to an income tax treaty may adopt provisions in their domestic laws to counter inappropriate uses of the treaty. Id.

II. Comments and Changes to § 1.894–1(d)(2)(ii)(B)(1): Payment Made to Related Foreign Interest Holder

Section 1.894–1(d)(2)(ii)(B)(*1*) of the proposed regulations provided a special rule that was generally targeted at payments made by a domestic reverse hybrid entity to a foreign parent of the domestic reverse hybrid entity. This rule would apply if: (1) A domestic subsidiary made a payment to a domestic reverse hybrid entity, the payment was considered to be a dividend either under the laws of the United States or under the laws of the jurisdiction of the foreign parent of the domestic reverse hybrid entity, and the domestic reverse hybrid entity was treated as a fiscally transparent, or ''pass-through,'' entity under the foreign parent's laws; and (2) the domestic reverse hybrid entity made a deductible payment to the foreign parent that otherwise would qualify for a treaty-based reduction in U.S. withholding tax. Under these circumstances, the proposed regulations provided that the payment by the domestic reverse hybrid entity would be treated as a dividend for all purposes of the Internal Revenue Code and the applicable income tax treaty, but only to the extent of the foreign parent's proportionate share of the prior dividend payments made to the domestic reverse hybrid entity by the domestic subsidiary.

Commentators recommended the inclusion of a tax avoidance purpose test in the final regulations. As part of this approach, commentators suggested consideration of several factors, including the ability of the domestic reverse hybrid entity to satisfy the debt independent of dividends or payments from the domestic entity, and the amount of time between the time the related foreign interest holder, the domestic reverse hybrid entity, and the domestic entity became related persons and the incurrence of the inter-company debt. This recommendation was not adopted. These regulations are intended to provide objective rules regarding eligibility for treaty benefits on certain items of U.S. source income paid by domestic reverse hybrid entities.

Commentators requested clarification that paragraph (d)(2)(ii)(B) does not apply to payments made by a domestic reverse hybrid entity that would not be subject to withholding tax without regard to a treaty. Commentators are correct in reading the regulations to provide that paragraph (d)(2)(ii)(B) will not apply if the payment made by the domestic reverse hybrid entity is exempt from withholding tax under the Internal Revenue Code. Commentators also requested clarification that the regulations apply only to payments received by the domestic reverse hybrid entity while it is related to both the domestic entity and the related foreign interest holder, and to payments made by the domestic reverse hybrid entity while it is related to the related foreign interest holder. The text of these regulations also confirms this result. Accordingly, no changes to the regulations were considered necessary on either of these points.

As a general matter, commentators questioned whether paragraph (d)(2)(ii)(B)(*1*) of the regulations applies to a situation in which the dividend withholding rate under the applicable income tax treaty is lower than the withholding rate for interest under the treaty. The regulations do not make the recharacterization of the deductible payment dependent on the withholding rates in the applicable income tax treaty. Therefore, if the requirements of the regulations are met, the regulations will apply regardless of whether the dividend withholding rate is higher than the withholding rate for interest or other deductible payments in the applicable income tax treaty. An example to this effect has been added to the final regulations.

III. Comments and Changes to § 1.894–1(d)(2)(ii)(B)(3): Definition of Related

Paragraph (d)(2)(ii)(B)(*3*) of the proposed regulations defined the term *related* for purposes of determining whether a domestic entity made a dividend payment to a related domestic reverse hybrid entity, and for purposes of determining whether a domestic reverse hybrid entity made a payment to a related foreign interest holder. The ownership requirements set forth in section 267(b) or 707(b)(1), the

constructive ownership rules of sections 318, and attribution rules of section 267(c) were used solely to determine whether an entity was ''related'' for purposes of paragraph (d)(2)(ii)(B); and not to determine if the entity was an interest holder.

Commentators consequently have questioned whether corporations that do not own any stock directly in the domestic reverse hybrid entity, but are related to the domestic reverse hybrid entity within the meaning of paragraph (d)(2)(ii)(B)(*3*), can be interest holders, and, therefore, related foreign interest holders for purposes of paragraph (d)(2)(ii)(B). For example, commentators questioned whether the regulations apply if a domestic reverse hybrid entity, which has received a dividend payment from a related domestic entity, makes an interest payment to a foreign sister corporation of the domestic reverse hybrid entity which is not itself a shareholder in the domestic reverse hybrid entity. Commentators believe that the application of the regulations to a foreign sister corporation should depend on whether that corporation is part of a ''consolidated group'' under the laws of the jurisdiction of the foreign parent.

The IRS and Treasury generally agree with this position. Paragraph (d)(2)(ii)(B)(*ii*) of the final regulations provides that a payment to a person, wherever organized, the income and losses of which are available, under the laws of the jurisdiction of the related foreign interest holder, to offset the income and losses of a related foreign interest holder, will be treated as a payment to a related foreign interest holder, and the regulations will apply. Examples have been added to the final regulations illustrating these principles.

Paragraph (d)(2)(ii)(B)(*3*) of the proposed regulations also contained a special rule that would treat certain accommodation parties as related foreign interest holders. Pursuant to the rule in the proposed regulations, if a person entered into a transaction with a domestic reverse hybrid entity, its related interest holder, or other related entity, and the effect of the transaction was to avoid the principles of these regulations, then that person would be treated as related to the domestic reverse hybrid entity for purposes of this section. Commentators expressed concern that this language could encompass legitimate dealings with unrelated third parties. For example, an unrelated foreign bank that makes a loan to a domestic reverse hybrid entity and receives interest payments under the loan could be treated as related to the domestic reverse hybrid entity under paragraph (d)(2)(ii)(B)(*3*). In recognition of the fact that the special rule in paragraph (d)(2)(ii)(B)(*3*) was potentially overbroad and created uncertainty as to its application, the rule was deleted.

IV. Comments and Changes to § 1.894–1(d)(2)(ii)(C): Commissioner's discretion.

Paragraph (d)(2)(ii)(C) of the proposed regulations provided the Commissioner with the authority to 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 was to avoid the principles of paragraph (d)(2)(ii)(B). Commentators also questioned the scope of this provision and requested the inclusion of examples of situations in which the Commissioner would not exercise his discretion and situations in which the Commissioner may exercise his discretion. Commentators were concerned that this provision would allow the Commissioner to apply the regulations to legitimate, non-abusive transactions involving domestic reverse hybrid entities.

In response to these comments, and in recognition of the potentially overbroad reach of the proposed provision, paragraph (d)(2)(ii)(C) has been modified in the final regulations to narrow its scope and clarify the circumstances under which the provision will apply. Thus, under paragraph (d)(2)(ii)(C)(*1*) of the final regulations (which applies to transactions involving related parties), the Commissioner has authority to recharacterize a transaction only if the following conditions are met: (1) A deductible payment is made to a person who is related, as that term is defined in paragraph (d)(2)(ii)(B)(*3*), to the domestic reverse hybrid entity (but is not otherwise described in paragraph (d)(2)(ii)(B)(*1*)(*ii*)); and (2) that payment is made in connection with one or more transactions the effect of which is to avoid the application of paragraph (d)(2)(ii)(B). If paragraph (d)(2)(ii)(C)(*1*) applies, the Commissioner is authorized to treat the deductible payment as if it were received directly by the related foreign interest holder in the domestic reverse hybrid entity.

In addition, paragraph (d)(2)(ii)(C)(*2*) of the final regulations (which applies to transactions involving an unrelated ''middleman'') provides that the Commissioner may treat a deductible payment made by a domestic reverse hybrid entity to an unrelated person as being made directly to a related foreign interest holder if: (1) The unrelated person (or other person (whether related or not) which receives a payment in a series of transactions that includes a transaction involving such unrelated person) makes a payment to the related foreign interest holder (or other person described in paragraph (d)(2)(ii)(B)(*1*)(*ii*)); (2) the payment to the unrelated person and the payment to the related foreign interest holder are made in connection with a series of transactions which constitute a financing arrangement, as defined in § 1.881–3(a)(2)(i); and (3) the transactions have the effect of avoiding the application of paragraph (d)(2)(ii)(B) of this section. An example has been added to illustrate the principles contained in this revised paragraph (d)(2)(ii)(C)(*2*).

To the extent the Commissioner recharacterizes a deductible payment as a distribution within the meaning of section 301(a) under this paragraph (d)(2)(ii)(C), the payment will be treated as such for all purposes of the Internal Revenue Code and the applicable income tax treaty.

Special Analysis

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations and, because these regulations do not impose a collection of information requirement on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, the notice of proposed rulemaking preceding these regulations was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Drafting Information

The principal author of these regulations is Karen A. Rennie-Quarrie of the Office of the Associate Chief Counsel (International). However, other personnel from the IRS and Treasury Department participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2. In § 1.894–1, paragraphs (d)(2)(ii), and (d)(2)(iii) are added and paragraph (d)(6) is revised to read as follows:

§ 1.894–1 Income affected by treaty.

* * * * *

(d) * * *

(2) * * *

(ii) *Payments by domestic reverse hybrid entities—(A) General rule.* Except as otherwise provided in paragraph (d)(2)(ii)(B) of this section, an item of income paid by a domestic reverse hybrid entity to an interest holder in such entity shall have the character of such item of income under U.S. law and shall be considered to be derived by the interest holder, provided the interest holder is not fiscally transparent in its jurisdiction, as defined in paragraph (d)(3)(iii) of this section, with respect to the item of income. In determining whether the interest holder is fiscally transparent with respect to the item of income under this paragraph (d)(2)(ii)(A), the determination under paragraph (d)(3)(ii) of this section shall be made based on the treatment that would have resulted had the item of income been paid by an entity that is not fiscally transparent under the laws of the interest holder's jurisdiction with respect to any item of income.

(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, 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; 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 jurisdiction 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; then

(*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)(1) 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 the principles of paragraph (d)(2)(ii)(A) of this section.

(2) Determining amount to be recharacterized under paragraph (d)(2)(ii)(B)(1)(iii). For purposes of determining the amount to be recharacterized under paragraph (d)(2)(ii)(B)(*1*)(*iii*) of this section, 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 shall be increased by the portion of the payment derived by any other person described in paragraph (d)(2)(ii)(B)(*1*)(*ii*), and shall be reduced by the amount of any prior section 301(c) distributions made by the domestic reverse hybrid entity to the related foreign interest holder or any other person described in paragraph (d)(2)(ii)(B)(*1*)(*ii*) and by the amount of any payments from the domestic reverse hybrid entity previously recharacterized under paragraph (d)(2)(ii)(B)(*1*)(*iii*) of this section.

(3) Tiered entities. The principles of this paragraph (d)(2)(ii)(B) also shall apply to payments referred to in this paragraph (d)(2)(ii)(B) made among related entities when there is more than one domestic reverse hybrid entity or other fiscally transparent entity involved.

(4) Definition of related. For purposes of this section, a person shall be treated as related to a domestic reverse hybrid entity if it is related by reason of the ownership requirements of section 267(b) or 707(b)(1), except that the language ''at least 80 percent'' applies instead of ''more than 50 percent,'' where applicable. For purposes of determining whether a person is related by reason of the ownership requirements of section 267(b) or 707(b)(1), the constructive ownership rules of section 318 shall apply, and the attribution rules of section 267(c) also shall apply to the extent they attribute ownership to persons to whom section 318 does not attribute ownership.

(C) *Payments to persons not described in paragraph (d)(2)(ii)(B)(1)(ii)—(1) Related persons.* The Commissioner may treat a payment by a domestic reverse hybrid entity to a related person (who is neither the related foreign interest holder nor otherwise described in paragraph (d)(2)(ii)(B)(*1*)(*ii*) of this section), in whole or in part, as being made to a related foreign interest holder for purposes of applying paragraph (d)(2)(ii)(B) of this section, if—

(i) The payment to the related person is of a type that is deductible by the domestic reverse hybrid entity; and

(*ii*) The payment is made in connection with one or more transactions the effect of which is to avoid the application of paragraph (d)(2)(ii)(B) of this section.

(*2*) *Unrelated persons.* The Commissioner may treat a payment by a domestic reverse hybrid entity to an unrelated person, in whole or in part, as being made to a related foreign interest holder for purposes of applying paragraph (d)(2)(ii)(B) of this section, if—

(*i*) The payment to the unrelated person is of a type that is deductible by the domestic reverse hybrid entity;

(*ii*) The unrelated person (or other person (whether related or not) which receives a payment in a series of transactions that includes a transaction involving such unrelated person) makes a payment to the related foreign interest holder (or other person described in paragraph (d)(2)(ii)(B)(*1*)(*ii*));

(*iii*) The foregoing payments are made in connection with a series of transactions which constitute a financing arrangement, as defined in § 1.881–3(a)(2)(i); and

(*iv*) The transactions have the effect of avoiding the application of paragraph (d)(2)(ii)(B) of this section.

(iii) *Examples.* The rules of this paragraph (d)(2) are illustrated by the following examples:

Example 1. Dividend paid by unrelated entity to domestic reverse hybrid entity. (i) *Facts.* Entity A is a domestic reverse hybrid entity, as defined in paragraph (d)(2)(i) of this section, with respect to the U.S. source dividends it receives from B, a domestic corporation to which A is not related within the meaning of paragraph (d)(2)(ii)(B)(*4*) of

this section. A's 85-percent shareholder, FC, is a corporation organized under the laws of Country X, which has an income tax treaty in effect with the United States. A's remaining 15-percent shareholder is an unrelated domestic corporation. Under Country X law, FC is not fiscally transparent with respect to the dividend, as defined in paragraph (d)(3)(ii) of this section. In year 1, A receives $100 of dividend income from B. Under Country X law, FC is treated as deriving $85 of the $100 dividend payment received by A. The applicable rate of tax on dividends under the U.S.-Country X income tax treaty is 5 percent with respect to a 10-percent or more corporate shareholder.

(ii) *Analysis.* Under paragraph (d)(2)(i) of this section, the U.S.-Country X income tax treaty does not apply to the dividend income received by A because the payment is made by B, a domestic corporation, to A, another domestic corporation. A remains fully taxable under the U.S. tax laws as a domestic corporation with regard to that item of income. Further, pursuant to paragraph (d)(2)(i) of this section, notwithstanding the fact that A is treated as fiscally transparent with respect to the dividend income under the laws of Country X, FC may not claim a reduced rate of taxation on its share of the U.S. source dividend income received by A.

Example 2. Interest paid by domestic reverse hybrid entity to related foreign interest holder where dividend is paid by unrelated entity. (i) *Facts.* The facts are the same as in *Example 1.* Both the United States and Country X characterize the payment by B in year 1 as a dividend. In addition, in year 2, A makes a payment of $25 to FC that is characterized under the Internal Revenue Code as interest on a loan from FC to A. Under the U.S.-Country X income tax treaty, the rate of tax on interest is zero. Under Country X laws, had the interest been paid by an entity that is not fiscally transparent under Country X's laws with respect to any item of income, FC would not be fiscally transparent as defined in paragraph (d)(2)(ii) of this section with respect to the interest.

(ii) *Analysis.* The analysis is the same as in Example 1 with respect to the $100 payment from B to A. With respect to the $25 payment from A to FC, paragraph (d)(2)(ii)(B) of this section will not apply because, although FC is a related foreign interest holder in A, A is not related to B, the payor of the dividend income it received. Under paragraph (d)(2)(ii)(A) of this section, the $25 of interest paid by A to FC in year 2 is characterized under U.S. law as interest. Accordingly, in year 2, A is entitled to an interest deduction with respect to the $25 interest payment from A to FC, and FC is entitled to the reduced rate of withholding applicable to interest under the U.S.-Country X income tax treaty, assuming all other requirements for claiming treaty benefits are met.

Example 3. Interest paid by domestic reverse hybrid entity to related foreign interest holder where dividend is paid by a related entity. (i) *Facts.* The facts are the same as in Example 2, except the $100 dividend income received by A in year 1 is from A's wholly-owned subsidiary, S.

(ii) *Analysis.* The analysis is the same as in Example 1 with respect to the $100 dividend payment from S to A. However, the $25 interest payment in year 2 by A to FC will be treated as a dividend for all purposes of the Internal Revenue Code and the U.S.-Country X income tax treaty because $25 does not exceed FC's share of the $100 dividend payment made by S to A ($85). Since FC is not fiscally transparent with respect to the payment as determined under paragraph (d)(2)(ii)(A) of this section, FC is entitled to the reduced rate applicable to dividends under the U.S.-Country X income tax treaty with respect to the $25 payment. Because the $25 payment in year 2 is recharacterized as a dividend for all purposes of the Internal Revenue Code and the U.S.-Country X income tax treaty, A is not entitled to an interest deduction with respect to that payment and FC is not entitled to claim the reduced rate of withholding applicable to interest.

Example 4. Definition of related foreign interest holder. (i) *Facts.* The facts are the same as in *Example 3,* except that A has two 50-percent shareholders, FC1 and FC2. In year 2, A makes an interest payment of $25 to both FC1 and FC2. FC1 is a corporation organized under the laws of Country X, which has an income tax treaty in effect with the United States. FC2 is a corporation organized under the laws of Country Y, which also has an income tax treaty in effect with the United States. FP owns 100-percent of both FC1 and FC2, and is organized under the laws of Country X. Under Country X law, FC1 is not fiscally transparent with respect to the dividend, as defined in paragraph (d)(3)(ii) of this section. Under Country X law, FC1 is treated as deriving $50 of the $100 dividend payment received by A because A is fiscally transparent under the laws of Country X, as determined under paragraph (d)(3)(iii) of this section. The applicable rate of tax on dividends under the U.S.-Country X income tax treaty is 5-percent with respect to a 10-percent or more corporate shareholder. Under Country Y law, FC2 is not treated as deriving any of the $100 dividend payment received by A because, under the laws of Country Y, A is not a fiscally transparent entity.

(ii) *Analysis.* The analysis is the same as in *Example 1* with respect to the $100 dividend payment from S to A. With respect to the $25 payment in year 2 by A to FC1, the payment will be treated as a dividend for all purposes of the Internal Revenue Code and the U.S.-Country X income tax treaty because FC1 is a related foreign interest holder as determined under paragraph (d)(2)(ii)(B)(*4*) of this section, and because $25 does not exceed FC1's share of the dividend payment made by S to A ($50). FC1 is a related foreign interest holder because FC1 is treated as owning the stock of A owned by FC2 under section 267(b)(3). Since FC1 is not fiscally transparent with respect to the payment as determined under paragraph (d)(2)(ii)(A) of this section, FC1 is entitled to the 5-percent reduced rate applicable to dividends under the U.S.-Country X income tax treaty with respect to the $25 payment. Because the $25 payment in year 2 is recharacterized as a dividend for all purposes of the Internal Revenue Code and the U.S.-Country X income tax treaty, A is not entitled to an interest deduction with respect to that payment. Even though FC2 is also a related foreign interest holder, the $25 interest payment by A to FC2 in year 2 is not recharacterized because A is not fiscally transparent under the laws of Country Y, and FC2 is not treated as deriving any of the $100 dividend payment received by A. Thus, the U.S.-Country Y income tax treaty is not implicated.

Example 5. Higher treaty withholding rate on dividends. (i) *Facts.* The facts are the same as in *Example 3,* except that under the U.S.-Country X income tax treaty, the rate of tax on interest is 10-percent and the rate of tax on dividends is 5-percent.

(ii) *Analysis.* The analysis is the same as in *Example 1* with respect to the $100 dividend payment from S to A. The analysis is the same as in *Example 3* with respect to the $25 interest payment in year 2 from A to FC.

Example 6. Foreign sister corporation the income and losses of which may offset the income and losses of related foreign interest holder. (i) *Facts.* The facts are the same as *Example 3,* except that in year 2, A makes the interest payment of $25 to FS, a subsidiary of FC also organized in Country X. Under the laws of Country X, FS is not fiscally transparent with respect to the interest payment, and the income and losses of FS may be used to offset the income and losses of FC.

(ii) *Analysis.* The analysis is the same as in *Example 1* with respect to the $100 dividend payment from S to A. With respect to the $25 interest payment from A to FS in year 2, FS is a person described in paragraph (d)(2)(ii)(B)(*1*)(ii) of this section because the income and losses of FS may be used under the laws of Country X to offset the income and losses of FC, the related foreign interest holder that derived its proportionate share of the payment from S to A. Therefore, paragraph (d)(2)(ii)(B) of this section applies, and the $25 interest payment in year 2 by A to FS is treated as a dividend for all purposes of the Internal Revenue Code and the U.S.-Country X income tax treaty because the $25 payment does not exceed FC's share of the $100 dividend payment made by S to A ($85). Since FS is not fiscally transparent with respect to the payment as determined under paragraph (d)(2)(ii)(A) of this section, FS is entitled to obtain the rate applicable to dividends under the U.S.-Country X income tax treaty with respect to the $25 payment. Because the $25 payment in year 2 is recharacterized as a dividend for all purposes of the Internal Revenue Code and the U.S.-Country X income tax treaty, A is not entitled to an interest deduction with respect to the payment and FS is not entitled to claim the reduced rate of withholding applicable to interest under the U.S.-Country X income tax treaty.

Example 7. Interest paid by domestic reverse hybrid entity to unrelated foreign bank. (i) *Facts.* The facts are the same as in *Example 3,* except that in year 2, A makes the interest payment of $25 to FB, a Country Y unrelated foreign bank, on a loan from FB to A.

(ii) *Analysis.* The analysis is the same as in *Example 1* with respect to the $100

dividend payment from S to A. With respect to the payment from A to FB, paragraph (d)(2)(ii)(B) of this section will not apply because, although A is related to S, the payor of the dividend income it received, A is not related to FB under paragraph (d)(2)(ii)(B)(*4*) of this section. Under paragraph (d)(2)(ii)(A) of this section, the $25 interest payment made from A to FB in year 2 is characterized as interest under the Internal Revenue Code.

Example 8. Interest paid by domestic reverse hybrid to an unrelated entity pursuant to a financing arrangement. (i) *Facts.* The facts are the same as in *Example 7,* except that in year 3, FB makes an interest payment of $25 to FC on a deposit made by FC with FB.

(ii) *Analysis.* The analysis is the same as in *Example 1* with respect to the $100 dividend payment from S to A. With respect to the $25 payment from A to FB in year 2, because the payment is made in connection with a transaction that consititutes a financing arrangement within the meaning of paragraph (d)(2)(ii)(C)(*2*) of this section, the payment may be treated by the Commissioner as being made directly to FC. If the Commissioner disregards FB, then the analysis is the same as in *Example 3* with respect to the $25 interest payment in year 2 from A to FC.

Example 9. Royalty paid by related entity to domestic reverse hybrid entity. (i) *Facts.* The facts are the same as in *Example 3,* except the $100 income received by A from S in year 1 is a royalty payment under both the laws of the United States and the laws of Country X. The royalty rate under the treaty is 10 percent and the interest rate is 0 percent.

(ii) *Analysis.* The analysis as to the royalty payment from S to A is the same as in *Example 1* with respect to the $100 dividend payment from S to A. With respect to the $25 payment from A to FC, paragraph (d)(2)(ii)(B) of this section will not apply because the payment from S to A is not treated as a dividend under the Internal Revenue Code or the laws of Country X. Under paragraph (d)(2)(ii)(A) of this section, the $25 of interest paid by A to FC in year 2 is characterized as interest under the Internal Revenue Code. Accordingly, in year 2, FC may obtain the reduced rate of withholding applicable to interest under the U.S.-Country X income tax treaty, assuming all other requirements for claiming treaty benefits are met.

(6) *Effective dates.* This paragraph (d) applies to items of income paid on or after June 30, 2000, except paragraphs (d)(2)(ii) and (d)(2)(iii) of this section 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.

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Robert E. Wenzel,

Deputy Commissioner of Internal Revenue.

Approved: June 3, 2002.

Pamela F. Olson,

Assistant Secretary of the Treasury (Tax Policy).

[FR Doc. 02–14506 Filed 6–11–02; 8:45 am]

BILLING CODE 4830–01–P

DEPARTMENT OF TRANSPORTATION

Coast Guard

33 CFR Part 165

[COTP Pittsburgh–02–005]

RIN 2115–AA97

Security Zone; Ohio River Mile 34.6 to 35.1, Shippingport, PA

AGENCY: Coast Guard, DOT.

ACTION: Final rule.

SUMMARY: The Coast Guard is establishing a security zone encompassing all waters extending 200 feet from the shoreline of the left descending bank on the Ohio River, beginning from mile marker 34.6 and ending at mile marker 35.1. This security zone is necessary to protect the First Energy Nuclear Power Plant in Shippingport, Pennsylvania, from any and all subversive actions from any groups or individuals whose objective it is to cause disruption to the daily operations of the First Energy Nuclear Power Plant. Entry of persons and vessels into this security zone is prohibited unless authorized by the Coast Guard Captain of the Port Pittsburgh or his designated representative.

DATES: This rule is effective June 15, 2002.

ADDRESSES: Comments and material received from the public, as well as documents indicated in this preamble as being available in the docket, are part of [COTP Pittsburgh-02–005] and are available for inspection or copying at Marine Safety Office Pittsburgh, Suite 1150 Kossman Bldg., 100 Forbes Ave., Pittsburgh, PA, 15222–1371, between 7:30 a.m. 4 p.m., Monday through Friday, except Federal holidays.

FOR FURTHER INFORMATION CONTACT: Chief Petty Officer Brian Smith, Marine Safety Office Pittsburgh at (412) 644–5808 ext. 112.

SUPPLEMENTARY INFORMATION:

Regulatory Information

On March 18, 2002, the Coast Guard published a notice of proposed rule making (NPRM) entitled ''Security Zone; Ohio River Mile 34.6 to 35.1, Shippingport, Pennsylvania'', in the **Federal Register** (67 FR 11963). We received no comments on the proposed rule. No public hearing was requested, and none was held.

Under 5 U.S.C. 553 (d)(3), good cause exists for making this rule effective less than 30 days after publication in the **Federal Register**. This final rule maintains the status quo for the security zone. We received no comments on either the temporary final rule or the NPRM. Delaying its effective date would be contrary to public interest since immediate action is needed to respond to the security risks associated with nuclear power plants.

Background and Purpose

On September 11, 2001, both towers of the World Trade Center and the Pentagon were attacked by terrorists. National security and intelligence officials have warned that future terrorist attacks against civilian targets are anticipated. In response to these terrorist acts, heightened awareness and security of our ports and harbors is necessary. To immediately enhance that security, the Captain of the Port, Pittsburgh established a temporary security zone on the Ohio River in the vicinity of the First Energy Nuclear Power Plant, in Shippingport, PA. The temporary final rule was published March 4, 2002 in the **Federal Register** (67 FR 9589) and remains in effect until 8 a.m. on June 15, 2002.

Because the generalized high-level threat environment continues, the Captain of the Port, Pittsburgh has determined that there is a need for this security zone to remain in effect indefinitely. This security zone will reduce the risk of a terrorist incident in this generalized high-level threat environment. It reduces the potential of a waterborne attack on the facility, enhancing public health, safety, defense and security, at this location and surrounding areas.

The location of this security zone limits access to only the waters immediately adjacent to the facility and permits vessels to safely navigate around the facility.

Discussion of Comments and Changes

We received no comments on the proposed rule. Therefore, we have made no substantive changes to the provisions of the proposed rule. The words ''and vessels'' were added to paragraph (b)(2)