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ARTICLES

Application of U.S. Treaties to Hybrid Entities*

by Peter J. Connors, Partner
Orrick, Herrington & Sutcliffe LLP
New York, N.Y.
and Rocco V. Femia, Member
Miller & Chevalier Chartered
Washington, D.C.

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I. OVERVIEW

Hybrid entities (i.e., entities that are treated as fiscally transparent by one treaty country but not by the other) play a significant role in international tax planning. The application of income tax treaties to hybrid entities raises substantial technical and policy issues. These issues drew considerable attention from practitioners and policymakers in the 1990's, leading to significant developments in the United States and internationally.

This article revisits those developments as background for a review of recent guidance relating to the application of tax treaties to hybrid entities. The United States recently has entered into new treaties and agreements with significant treaty partners that address hybrid entity issues at an increasing level of specificity. Although the primary issue of availability of reduced rates of withholding tax for income earned through a hybrid entity has been addressed at some length, secondary issues such as the treatment of ownership through hybrid entities, foreign tax credit issues, and issues arising from the so-called saving clause merit increasing attention.

The article begins with a look back at significant developments of the 1990's, including the relevant provisions of the 1996 U.S. Model Income Tax Treaty, the Commentaries to the OECD Model Income Tax Treaty, and U.S. Treasury regulations issued under Code §894(c).[1] Next, we review the recent relevant guidance relating to the U.S. income tax treaties with the United Kingdom, the Netherlands, Japan and Mexico. Finally, we introduce tax treaty issues raised by hybrid entities beyond the basic issue of entitlement to treaty rates of withholding tax.

II. DEVELOPMENTS IN THE 1990'S

A. Introduction

The 1990's saw an emerging consensus in the United States and internationally on the appropriate application of income tax treaties to hybrid entities. As discussed below, this consensus is reflected in the 1996 U.S. Model Income Tax Treaty, the Commentaries to the OECD Model Income Tax Treaty, U.S. regulations, and recent U.S. income tax treaties. The general principles underlying the international consensus on these issues can be stated as follows: (1) the source country should allow treaty benefits for income earned through a hybrid entity to the extent the income is subject to tax by the residence country as the income of a resident, and (2) the source country need not allow treaty benefits for income earned through a hybrid entity to the extent the income is not subject to tax by the residence country as the income of a resident or if the hybrid entity is treated as not fiscally transparent (and taxed as a resident) by the source country. Although much of the commentary on these principles has focused on their role as anti-abuse rules, it is worth noting that they also clarify the circumstances under which treaty benefits should be allowed for payments through hybrid entities notwithstanding technical arguments to the contrary under some older treaties.

The focus on the view of the residence country is peculiar in the treaty context and is a departure from the general rule, under which terms are defined with reference to the tax law of the source country.[2] A related, but entirely different topic, is whether payments ''by'' (rather than through) a fiscally-transparent entity are subject to withholding tax.

B. 1996 U.S. Model Income Tax Treaty

Prior to the 1996 U.S. Model Income Tax Treaty, U.S. model tax treaties did not contain any special provision directed at hybrid entities. However, each of the 1976, 1977, and 1981 U.S. Model Income Tax Treaties included partnerships in the definition of ''person'' (Art. 3(1)(a)) and ''resident'' (Art. 4(1)(b)), and provided for treaty benefits with respect to income earned through a partnership to the extent that income was subject to tax by the residence country.[3]

The 1996 U.S. Model Income Tax Treaty introduced several provisions directed at hybrid entities. These new provisions were necessitated by the combination of a rapidly increasing number of limited liability company (''LLC'') statutes among the states of the United States and the adoption of revised entity classification regulations for tax purposes at the federal level. While the entity classification regulations permit elective classification of LLCs as either companies or pass-through entities for U.S. tax purposes,

[1] All section references herein are to the Internal Revenue Code of 1986, as amended, (''the Code''), and the regulations thereunder, unless otherwise stated.

[2] *See, e.g.,* 1996 U.S. Model Income Tax Treaty, Art. 3(2).

[3] *See, e.g.,* 1981 U.S. Model Income Tax Treaty, Art. 4(1)(b) (''[I]n the case of income derived or paid by a partnership . . . [the term ''resident of a Contracting State''] applies only to the extent that the income derived by such partnership . . . is subject to tax as the income of a resident of the Contracting State, either in its hands or in the hands of its partners . . . .'').

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most other jurisdictions will regard them as companies for local tax purposes. Further, the entity classification regulations permit elective classification of most foreign entities as either companies or pass-through entities for U.S. tax purposes without regard to the treatment of such entities for foreign tax purposes.[4]

The 1996 U.S. Model Income Tax Treaty introduced the term ''fiscally transparent'' and provides rules consistent with the general principles articulated above. In particular, Article 4(1)(d) provides that ''An item of income, profit or gain derived through an entity that is fiscally transparent under the laws of either Contracting State shall be considered to be derived by a resident of a State to the extent that the item is treated for purposes of the tax law of such Contracting State as the income, profit or gain of a resident.'' [5] Further, the model treaty provides that the activities conducted by a resident of one country through an entity treated as fiscally transparent by that country is treated as conducted directly by the resident.[6]

The Technical Explanation to the 1996 U.S. Model Income Tax Treaty expands upon the meaning of the provisions.[7] The first issue addressed is the meaning of the term ''fiscally transparent,'' which the model treaty does not define. The Technical Explanation to the U.S. Model states that entities falling under this description in the United States would include partnerships, common investment trusts under §584, grantor trusts and U.S. LLCs that are treated as partnerships for U.S. tax purposes. Consistent with the §894(c) regulations described below, the determination of whether an entity is treated as fiscally transparent appears to depend on whether the income of the entity is recognized by its owners for tax purposes as if earned directly by the owners.

The Technical Explanation then goes on to address how to determine whether the recipient is entitled to treaty benefits. An item of income derived through a fiscally transparent entity will be considered to be derived by a resident of a country if the recipient is treated under the tax laws of that country as a resident and as deriving the item of income. If a U.S. corporation distributes a dividend to an entity that is treated as fiscally transparent in another country, for example, the dividend will be considered to be derived by a resident of that country to the extent that the tax law of that country treats the owners of the entity as deriving the income as residents for tax purposes. In the case of a partnership, this normally would include the partners of the entity that are residents of that country.[8]

The Technical Explanation further provides that the tax laws of a country may be considered to treat an item of income as income of a resident of that country even if the resident is not subject to tax on that particular item of income. If a country has a participation exemption for certain foreign-source dividends and capital gains, for example, such income or gains would be regarded as income or gain of a resident of that country who otherwise derived the income or gain, despite the fact that the resident could be exempt from tax in that country on the income or gain.

Income is ''derived through'' a fiscally transparent entity if the entity's participation in the transaction giving rise to the income in question is respected after application of any source country anti-abuse principles based on substance over form and similar analyses. If a partnership with U.S. partners receives income arising in another treaty country, that income will be considered to be derived through the partnership by its partners as long as the partnership's participation in the transaction is not disregarded for lack of economic substance. In such a case, the partners would be considered to be the beneficial owners of the income.

Where income is derived through an entity organized in a third country that has owners resident in one of the treaty countries, the characterization of the entity in that third country is irrelevant for purposes of determining whether the resident is entitled to treaty benefits with respect to income derived by the entity. The focus is on the treatment of the entity and the owner for tax purposes by the country in which the owner is resident.

This rule also applies to trusts to the extent that they are fiscally transparent in their beneficial owner's state of residence. If X, a resident of a treaty country, creates a revocable trust and names persons resident in a third country as the beneficiaries of the trust, X would be treated as the beneficial owner of income

[4] See Regs. §301.7701-3 (generally permitting taxpayers to elect the U.S. tax classification of entities, other than specified per se corporations, as pass-through entities or taxable entities).

[5] 1996 U.S. Model Income Tax Treaty, Art. 4(1)(d).

[6] *See* 1996 U.S. Model Income Tax Treaty, Art. 3(1)(c) (''[T]he terms 'enterprise of a Contracting State' and 'enterprise of the other Contracting State' . . . 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 . . . .'').

[7] Explanation for 1996 U.S. Model Income Tax Treaty, Art. 4(1)(d).

[8] In CCA 200019042, the Office of the Associate Chief Counsel (International) issued a technical assistance memorandum regarding the certification for U.S. treaty purposes of a single member LLC that is disregarded for U.S. federal income tax purposes. Relying on the definition of resident contained in the 1996 Model, the memorandum concluded that a single-member LLC is not a resident for treaty purposes because it does not constitute a person and is not liable for federal income tax within the meaning of treaties. However, the IRS Service Center could certify that the single owner of the disregarded LLC is a resident of the United States.

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derived from the United States under the Code's rules. If the treaty country had no rules comparable to those in §§671 through 679 (the grantor trust rules) then it is possible that under the laws of that country neither X nor the trust would be taxed on the income derived from the United States. In these cases, the trust's income would be regarded as being derived by a resident of the treaty country only to the extent that the laws of that country treat residents of that country as deriving the income for tax purposes.

C. OECD Model Income Tax Treaty and Commentaries

The OECD model income tax treaties (including the 2005 version) do not contain a general fiscally transparent entity provision comparable to Article 4(1)(d) of the 1996 U.S. Model Income Tax Treaty. The OECD generally has left open the issue to be determined by individual countries in negotiating their bilateral tax treaties.[9] However, the accompanying Commentary to the OECD Model (herein the ''Commentary'') incorporates various conclusions expressed in a 1999 report prepared by the OECD Committee on Fiscal Affairs entitled ''The Application of the OECD Model Tax Convention to Partnerships'' (the ''OECD Partnership Report''), which provided a comprehensive analysis of treaty issues relating to partnerships.[10] These conclusions should be considered as authority with respect to bilateral treaties between OECD countries modeled after the OECD model treaty that do not contain specific contrary provisions, to the extent the parties have not placed observations or reservations on the language. This is particularly the case with respect to treaties negotiated following the adoption of the Commentary language.[11]

The OECD Partnership Report takes the position that the source country should extend treaty benefits to any beneficial owner of a fiscally transparent entity if the residence country taxes the owner currently on the same income for which the owner claims the benefits.[12] The owner in such a case would be entitled to treaty benefits as if it had earned the income directly. The OECD Partnership Report also takes the position that the source country should not extend treaty benefits to any beneficial owner of what it considers to be a fiscally transparent entity unless the residence country taxes the owner currently on the same income for which the owner claims the benefits.[13] Thus, in general, the OECD Partnership Report and the Commentary each reach the same result as the 1996 U.S. model. However, the OECD Partnership Report by its terms applies only to partnerships and not (for example) to income earned through trusts or LLCs.

To clarify application of the OECD model to partnerships, the Commentary to Article 3 was revised to provide that ''partnerships'' will be considered ''persons'' either because they fall within the definition of ''company'' or, where this is not the case, because they constitute other bodies of persons.[14] Thus, a partnership that is taxed as an entity by its country of residence is entitled to treaty benefits without regard to its treatment by the country of source.

The OECD Partnership Report, in addition to addressing treaty eligibility, also addresses double taxation and double nontaxation issues. The OECD Partnership Report also contains an extensive analysis of entity characterization rules in the OECD member countries.[15]

D. Section 894 Regulations

1. Background

Treasury regulations issued under §894 generally follow the approach taken in the 1996 U.S. Model Income Tax Treaty with respect to hybrid entities, albeit with certain significant differences. Regulations were first issued in 1997 as temporary and proposed regulations[16] and applied to all treaties to which the United States was a party. Subsequently, Congress effectively approved of these regulations through the grant of regulatory authority pursuant to §894(c)(2). At the same time, Congress also enacted a similar (albeit narrower) set of statutory provisions,[17] primarily directed at the Canadian/U.S. LLC transaction discussed below. In 2000, the Treasury issued final regulations under §894 that replaced the 1997 temporary and proposed regulations.[18] The regulations are limited in application to withholding taxes, but the preamble states that the IRS and Treasury may issue ad-

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[9] Before the addition of relevant provisions of the Commentaries in 2003, there had been some concern whether a partnership qualified as a ''person'' under treaties based on the OECD model treaties.

[10] *See* OECD Commentary on Art. 1, ¶¶2 through 6.

[11] *See, e.g., National Westminster Bank, PLC v. U.S.*, 44 Fed. Cl. (1999) (holding the Commentaries in existence at the time a treaty is being negotiated to be persuasive authority).

[12] See discussion in OECD Partnership Report at ¶¶35 and 56. This position is set out in the OECD Commentary to Art. 1, ¶3, and the OECD Commentary to Art. 4, ¶8.2.

[13] See discussion in OECD Partnership Report at ¶35. This position is set out in the OECD Commentary, Art. 1, ¶5.

[14] See discussion in OECD Partnership Report at ¶30. This position is set out in the OECD Commentary on Art. 3, ¶2.

[15] For an overview of the OECD Partnership Report, see Sasseville, ''OECD Releases Report on Application of Model Treaty to Partnerships,'' 1999 *WTD* 157-2 (Aug. 16, 1999).

[16] Regs. §1.894-1T(d).

[17] §894(c)(1).

[18] Regs. §1.894-1(d).

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ditional regulations addressing the availability of other tax treaty benefits, such as the application of business profits provisions, with respect to the income of fiscally transparent entities, particularly where a conflict in entity classification exists.

The preamble to the final regulations states that the approach adopted in the final regulations is ''consistent with the evolving multilateral consensus among the member countries of the [OECD] on the appropriate method for source countries to follow to determine if they should provide treaty benefits on items of income paid to fiscally transparent entities, particularly when an entity classification conflict exists between the source and residence states.'' The preamble further notes that this evolving multilateral consensus is described in the OECD Partnership Report, stating that the report ''generally provides that a source state is required to grant treaty benefits on income paid to an entity only if the income is considered to be derived by a resident of a treaty partner for purposes of the treaty partner's tax laws.'' The preamble further states that the IRS and Treasury ''will continue to coordinate these issues with U.S. tax treaty partners both bilaterally and multilaterally to resolve substantive issues arising from application of the principles set forth in the Code Section 894 regulations and the OECD Partnership Report.''

In 2002, Treasury finalized proposed amendments addressing payments made by domestic reverse hybrid entities, as discussed further below.

2. The Canadian/U.S. LLC Transaction

Section 894(c)(1) and the §894 regulations, while in part an attempt to incorporate into current treaties aspects of the hybrid entity provisions contained in the 1996 U.S. Model Income Tax Treaty, were also a direct attack on a structure popular at the time for funding U.S. operations of a Canadian parent. This structure involved the use of an intermediate U.S. LLC which was fiscally transparent for U.S. tax purposes but not for Canadian tax purposes.

> *Example*. A Canadian parent corporation contributes equity to a wholly owned U.S. LLC, and the U.S. LLC in turn lends funds to its U.S. corporate subsidiary. The U.S. LLC receives interest income from its U.S. subsidiary and pays dividends to its Canadian parent. The U.S. LLC is treated as a fiscally transparent disregarded entity for U.S. tax purposes, and a company for Canadian tax purposes. Thus, for U.S. tax purposes, the U.S. subsidiary is viewed as paying interest directly to the Canadian parent, and the Canadian parent is viewed as the beneficial owner of the interest income. Thus, the parties would claim that the reduced withholding tax rate on interest (10%) under the Canada-U.S. income tax treaty applied (instead of the 30% statutory rate). For Canadian tax purposes, interest payments from the U.S. subsidiary to the U.S. LLC were not subject to Canadian tax because they were viewed as being made from one U.S. corporation to another U.S. corporation. Further, dividends paid to the Canadian parent from the U.S. LLC were potentially exempt from Canadian tax as ''exempt surplus.'' Thus, in the absence of §894(c) and the related Treasury regulations, such income would only be subject to a worldwide effective tax rate of 10%.

3. General Provisions of 2000 §894 Regulations

The final §894 regulations provide that tax on income received by an entity, wherever organized, that is fiscally transparent under U.S. laws and/or any other jurisdiction will be eligible for reduction under a U.S. treaty only if the income is ''derived by a resident of the applicable treaty jurisdiction.''

For this purpose, an item of income may be derived by either the entity receiving the item of income or by the interest holders in the entity or, in certain circumstances, both an item of income paid to an entity shall be considered to be derived by the entity only if the entity is not fiscally transparent under the laws of the entity's jurisdiction with respect to the item of income, and an item of income paid to an entity shall be considered to be derived by the interest holder in the entity only if the interest holder is not fiscally transparent in its jurisdiction with respect to the item of income and if the entity is considered to be fiscally transparent under the laws of the interest holder's jurisdiction with respect to the item of income. However, an item of income paid directly to a type of entity specifically identified in a treaty as a resident of a treaty jurisdiction shall be treated as derived by a resident of that treaty jurisdiction.

Twelve examples are provided that illustrate the operation of the rules with respect to a variety of entities including partnerships, grantor trusts, complex trusts, controlled foreign corporations, collective investment funds, investment companies, charitable organizations and pension trusts.[19]

4. Domestic Reverse Hybrids

The final regulations issued in 2000 contain special rules for both payments received by, and made by, domestic reverse hybrid entities. A domestic reverse hybrid entity is a domestic entity that is treated as not fiscally transparent for U.S. tax purposes and as fis-

[19] Regs. §1.894-1(d)(5) *Exs. (1)-(12)*.

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cally transparent under the laws of the interest holder's jurisdiction, with respect to the item of income received by the domestic entity.[20] Before the adoption in 2002 of final amendments to the §894 regulations (first proposed in 2001), the treatment of payments made *by* domestic reverse hybrid entities had been reserved.[21] Similar to §894(c)(1), the amendments to the regulations addressing payments made by domestic reverse hybrid entities were in response to a particular planning structure perceived as abusive. This time, the transaction involved the funding of U.S. operations of a foreign parent, using an intermediate U.S. limited partnership ("LP") that was fiscally transparent for foreign tax purposes but not for U.S. tax purposes.

> *Example*. A Canadian parent corporation owns a U.S. LP, which in turn owns a U.S. corporate subsidiary. The U.S. LP checks the box to be treated as a corporation for U.S. tax purposes, but is fiscally transparent for Canadian tax purposes. The Canadian parent lends funds to the U.S. LP, and the U.S. LP in turn makes a capital contribution to the U.S. subsidiary. The U.S. LP receives dividend income from its U.S. subsidiary and pays interest to its Canadian parent. In the absence of the domestic reverse hybrid rules, the U.S. LP would be entitled to a deduction for the interest it pays to its Canadian parent, and the Canadian parent would be entitled to the reduced rate of withholding applicable to interest under the U.S.-Canada Income Tax Treaty. For Canadian tax purposes, the interest payment from the U.S. LP would generally not be subject to Canadian tax because it is viewed as a direct dividend from the U.S. subsidiary.

Under the regulations, interest paid by the U.S. LP to the Canadian parent would be treated as a dividend for U.S. tax and treaty purposes. As a result, the U.S. LP would not be entitled to an interest deduction with respect to its payment to the Canadian parent, and the Canadian parent would be entitled to the treaty rate of tax on dividends, not interest.[22] This would be the case even if the treaty rate of tax on interest is *higher* than the treaty rate of tax on dividends.[23] Nine examples are provided that illustrate the operation of the domestic reverse hybrid entity rules.[24]

[20] Regs. §1.894-1(d)(2)(i).

[21] *See* former Regs. §1.894-1(d)(2)(ii) (2000).

[22] Regs. §1.894-1(d)(2)(ii).

[23] Regs. §1.894-1(d)(2)(iii) *Ex. (5)*.

[24] Regs. §1.894-1(d)(2)(iii) *Exs. (1)-(9)*.

III. RECENT TREATIES, PROTOCOLS AND OTHER GUIDANCE

A. Introduction

Beginning with the income tax treaty with Luxembourg signed in 1996, treaties that the U.S. has entered into or renegotiated following the adoption of the fiscally transparent entity provisions in the 1996 U.S. Model Income Tax Treaty have included provisions addressing fiscally transparent entities consistent with the general principles set out above. Several of the more recent treaties are reviewed below.

B. 2001 U.S.-U.K. Income Tax Treaty

1. In General

The 2001 U.S.-U.K. Income Tax Treaty adopts a fiscally transparent entity provision substantially identical to the one set out in the 1996 U.S. Model Income Tax Treaty, as discussed above.[25]

> An item of income, profit or gain derived through a person that is fiscally transparent under the laws of either Contracting State shall be considered to be derived by a resident of a Contracting State to the extent that the item is treated for the purposes of the taxation laws of such Contracting State as the income, profit or gain of a resident.

Much of the discussion and examples in the U.S. Treasury Department's Technical Explanation of the U.S.-U.K. Income Tax Treaty regarding fiscally transparent entities are substantially similar to those contained in the Technical Explanation of the 1996 U.S. Model Income Tax Treaty, as noted above. The Technical Explanation of the U.S.-U.K. Income Tax Treaty also includes additional language elaborating on the general principles described by the Technical Explanation of the 1996 U.S. Model Treaty. For example, the Technical Explanation of the U.S.-U.K. treaty clarifies that a resident of a third country that owns an entity that is organized in the United States and treated as fiscally transparent for purposes of U.S. tax law is not entitled to treaty benefits under the U.S.-U.K. treaty with respect to income from the United Kingdom. Such a person, however, may be entitled to the benefits of a treaty between the United Kingdom and their country of residence. The Technical Explanation of the U.S.-U.K. treaty also emphasizes that the characterization of an entity by the source country or by a third country generally is irrelevant.

[25] *See* 2001 U.S.-U.K. Income Tax Treaty, Art. 1(8).

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The Technical Explanation of the U.S.-U.K. treaty also provides that, except in the case of the application of the saving clause described below, the fiscally transparent entity rules operate in the same manner without regard to where the entity is organized (i.e., in the United States, in the United Kingdom, or, as noted above, in a third country). This leads to interesting results in the case of a U.S. hybrid entity with U.K. owners. Income from U.S. sources received by an entity organized under the laws of the United States, which is treated for U.K. tax purposes as a corporation and is owned by a U.K. shareholder who is a U.K. resident for U.K. tax purposes, is not considered derived by the shareholder of that corporation even if, under the tax laws of the United States, the entity is treated as fiscally transparent. Rather, for purposes of the treaty, the income is treated as derived by the U.S. entity. For example, a payment received by a U.S. LLC is treated as being made to a U.S. entity for purposes of the treaty even though the entity might be treated as a partnership or disregarded entity for U.S. tax purposes. This also raises the question of whether the U.S. LLC would be eligible for other treaty benefits such as the business profits article.

2. The Saving Clause

The technical explanation of the U.S.-U.K. treaty clarifies that the treatment of fiscally transparent entities is not an exception to the saving clause.[26] Therefore, the fiscally transparent entity provision does not prevent a treaty country from taxing an entity that is treated as a resident of that country under its tax laws. For example, if a U.S. LLC with U.K. members elects to be taxed as a corporation for U.S. tax purposes, the United States will tax that LLC on its worldwide income on a net basis, without regard to whether the United Kingdom views the LLC as fiscally transparent.

3. Relief of Double Taxation

The diplomatic notes allow each country significant latitude in dealing with cases of double taxation where both countries attempt to tax on a residence basis the same income earned through a fiscally transparent entity as income earned by a resident.[27] These provisions, however, have been interpreted by some commentators to suggest that the countries may independently determine more generally for both domestic tax and treaty purposes (i) whether an entity is fiscally transparent and (ii) whether the entity's income should be treated for treaty purposes as income of a resident of the other country.[28] In the view of the authors, the language of the diplomatic notes should be limited in application to the issue of double taxation and should not be interpreted in a manner to deny treaty benefits where that result would clearly contradict the language of the treaty itself.

The Technical Explanation of the U.S.-U.K. Income Tax Treaty (Article 24) provides the following example:

> [A] U.K. company pays interest to a U.K. unlimited liability company ("ULC") with U.S. resident partners. The ULC has elected to be treated for U.S. tax purposes as a partnership [such that the partners are subject to U.S. tax on that income]. . . . [T]he U.S. partners claim an exemption from U.K. withholding tax with respect to that interest. However, because the United Kingdom treats the ULC as a company resident in the United Kingdom for U.K. tax purposes, the saving clause . . . ensures that the United Kingdom may continue to tax the company as a U.K. resident. Pursuant to the notes, the United States will treat the tax paid by the ULC as having been paid by the partners for purposes of providing a foreign tax credit to the U.S. partners with respect to the interest income.

4. Deferred Subscription Agreements

While largely mooted by the new U.K. Finance Legislation, a question was raised whether income that was not taxable in one jurisdiction was nonetheless eligible for benefits of the treaty on the theory that such income was not subject to the tax laws of the other jurisdiction. Under a typical deferred subscription transaction, which is commonly analyzed as a repo for U.S. tax purposes, interest for the purchase of shares is paid but not considered taxable in the United Kingdom. As noted above, however, the Technical Explanation to the 1996 U.S. Model Income Tax Treaty provides that the residence country need not actually tax the item of income, provided that the recipient of the income is generally subject to tax with respect to income earned through the fiscally transparent entity. In this regard, it is difficult to distinguish

[26] 2001 U.S.-U.K. Income Tax Treaty, Art. 1(4).

[27] The diplomatic notes state with reference to Article 24 (Relief from Double Taxation):

> it is understood that, under paragraph 4 or 8 of Article 1 (General Scope), the provisions of the Convention may permit the Contracting State of which a person is a resident (or, in the case of the United States, a citizen), to tax an item of income, profit or gain derived through another person (the entity) which is fiscally transparent under the laws of either Contracting State, and may permit the other Contracting State to tax a) the same person; b) the entity; or c) a third person with respect to that item.

[28] Berner and May, "The New U.S.-U.K. Income Tax Treaty Revisited," 32 *Tax Mgmt. Int'l J.* 395 (8/8/03).

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nontaxation of an item of income by a residence country pursuant to a participation exemption, for example, from nontaxation of an item of income by a residence country pursuant to a rule that provides an exemption for amounts paid to the issuing company with respect to its stock.

5. "Owned Directly"

The U.S.-U.K. Income Tax Treaty contains an exemption from withholding tax for dividends received where stock representing 80% or more of the voting power of the company paying the dividends for a 12-month period ending on the date the dividend is declared and certain other requirements are satisfied. The Technical Explanation of Article 10(3)(a) clarifies that such shares must have been "owned directly." In PLR 200522006, the IRS held that the requirements were met despite ownership through a disregarded entity before actual ownership by the U.K. parent where the 12-month holding period would not have been met based purely on the parent's ownership. The IRS stated that defining the term "direct ownership" to include stock directly owned by the taxpayer's disregarded entity is not contrary to the purpose of Article 10(3)(a)—the elimination of the withholding tax on direct investment—and does not cause a result that was not intended by the Contracting Parties. Accordingly, it was not necessary to require "direct ownership" to be defined in a manner that differs from domestic law.

C. 2004 U.S.-Netherlands Protocol

1. In General

The 2004 protocol to the U.S.-Netherlands Income Tax Treaty adopts a fiscally transparent entity provision substantially identical to the one set out in the 1996 U.S. Model Income Tax Treaty and the 2001 U.S.-U.K. Income Tax Treaty, as discussed above.[29]

The U.S. Treasury Department's Technical Explanation of the 2004 Protocol contains discussion and examples substantially similar to those provided in the Technical Explanation of the 2001 U.S.-U.K. Income Tax Treaty.

2. Reverse Hybrids — U.S. and Dutch Perspectives

As with the other treaties discussed above, the Technical Explanation to the 2004 U.S.-Netherlands Protocol states that the treatment of fiscally transparent entities is not an exception to the saving clause.[30] Therefore, the fiscally transparent entity provision does not prevent a treaty country from taxing an entity that is treated as a resident of that country under its tax laws.

The Technical Explanation illustrates this with the case of a reverse hybrid:

> For example, if a U.S. LLC with Netherlands members elects to be taxed as a corporation for U.S. tax purposes, the United States will tax that LLC on its worldwide income on a net basis, and will impose withholding tax, at the rate provided in Article 10, on dividends paid by the LLC, without regard to whether the Netherlands views the LLC as fiscally transparent.

On July 6, 2005, the State Secretary of Finance of the Netherlands issued a decree that provides that the hybrid entity provision in the Protocol will not apply to a dividend paid to a fiscally transparent entity under Dutch law that is treated as a corporation under U.S. law provided the Dutch company that pays the dividend is engaged in "real" activities in the Netherlands. A company will be considered to be engaged in "real" activities in the Netherlands if: it has directors who are residents of the Netherlands, they make their decisions in the Netherlands and they have sufficient professional qualifications; it maintains accounts in the Netherlands including its main bank account; and it has sufficient equity and it is engaged in reasonable economic activity. The decree applies to dividend distributions made by Dutch companies as of January 1, 2006. U.S. participants in CV/BV structures that existed on January 1, 2005, can invoke a 12-month grandfather clause to obtain the benefits of the treaty before its amendment.

The decree will effectively permit the commonly used CV/BV structure in which an "open" CV is treated as a pass-through for Dutch purposes, but as a company for U.S. tax purposes, when it receives interest or dividends from an operating subsidiary. As a result, the withholding rate on dividend payments will be zero percent, rather than the 25% rate that would otherwise have applied under the Protocol. Before amendment, the rate of withholding under the treaty would have been 5%.

3. Tax Exempt Entities

The diplomatic notes also state that the competent authority of a treaty country may grant the benefits of the treaty to a resident of the other treaty country with

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[29] *See* Art. 6(e) of the 2004 U.S.-Netherlands Protocol, amending the 1992 U.S.-Netherlands Income Tax Treaty to include a new Article 24(4).

[30] Art. 24(1) of the U.S.-Netherlands Income Tax Treaty, as amended by the 2004 Protocol.

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respect to an item of income, even though it is not treated as income of the resident under the laws of the other treaty country, in cases where the income would have been exempt from tax if it had been treated as the income of that resident.

The 2004 Memorandum of Understanding Regarding the U.S.-Netherlands Income Tax Treaty discusses the following example:

> Z is an exempt pension trust within the meaning of Article 35 (Exempt Pension Trusts) that is a resident of the Netherlands for purposes of the Convention. Z is a member of Y, a U.S. limited liability company that has elected to be treated as fiscally transparent for U.S. tax purposes. Because of certain characteristics, Y is non-transparent under Netherlands law. Y owns shares in a number of U.S. companies that pay dividends currently. Under the general rule . . ., Z would not be entitled to the benefits of [the dividend article of the Convention] because the income derived by Y is not treated by the Netherlands as the income of Z. However, the U.S. competent authority may determine that Z is entitled to benefits because Z would be exempt from tax on the income even if it were treated as having derived the income.

Although this provision is novel, conceptually it is consistent with the language in the Technical Explanation to the 1996 U.S. Model Income Tax Treaty that provides that a dividend may be treated as the income of a resident for purposes of the tax laws of the residence country notwithstanding the application of a participation exemption.

D. 2003 U.S.-Japan Income Tax Treaty and Protocol

1. In General

The 2003 U.S-Japan Income Tax Treaty contains the most detailed variation of the fiscally transparent entity provision agreed to date. In general, the provisions are consistent with the principles articulated by the 1996 U.S. Model Income Tax Treaty and the §894(c) regulations. However, unlike the §894(c) regulations, they are not limited to withholding taxes, but instead applies to all taxes covered by the treaty. Article 4 (6) sets out five specific fact patterns and provides results with respect to each. In addition, the Protocol provides specific guidance regarding *Tokumei Kumiai*, and the U.S. Treasury Department's Technical Explanation of the U.S.-Japan Income Tax Treaty elaborates on the treatment of hybrid entities in additional contexts.

2. Article 4(6)

Article 4(6) enumerates five specific fact patterns, each of which is discussed below, and provides results with respect to each. Each of the results is consistent with the general rules set out in the 1996 U.S. Model Income Tax Treaty and in other recent U.S. income tax treaties such as the treaty with the United Kingdom.

a. Fiscally Transparent Entity Organized in Recipient's Location

An item of income derived from the source country through an entity that is organized in the residence country and treated as the income of the owners of that entity under the tax laws of that residence country is eligible for the treaty benefits that would be granted if the income were directly derived by a resident of that residence country without regard to whether the income is treated as the income of such owners under the tax laws of the source country.[31]

The Technical Explanation of the U.S.-Japan treaty illustrates this rule with the following example:

> [I]f a Japanese company pays interest to a U.S. LLC that is treated as a partnership for U.S. tax purposes, the interest income will be eligible for the benefits of the Convention to the extent it is treated under the taxation laws of the United States as the income of one or more U.S. residents that satisfy any other conditions specified for eligibility for the benefits of the Convention.

b. Fiscally Nontransparent Entity Organized in Recipient's Location

An item of income derived from the source country through an entity that is organized in the residence country and treated as the income of that entity under the tax laws of that residence country is eligible for the treaty benefits that would be granted to a resident of that residence country without regard to whether the income is treated as the income of the entity under the tax laws of the source country.[32]

The technical explanation illustrates this rule with the following example:

> [I]f a Japanese company pays interest to a U.S. contractual joint venture that elects to be treated as a corporation for U.S. tax purposes, the interest income will be eligible for the benefits of the Convention if the joint venture is a U.S. resident and it satisfies any other conditions for the benefits specified in the Convention. That result obtains even if the

[31] 2003 U.S.-Japan Income Tax Treaty, Art. 4(6)(a).

[32] 2003 U.S.-Japan Income Tax Treaty, Art. 4(6)(b).

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> U.S. contractual joint venture were viewed differently under the tax laws of Japan (e.g., not as an entity but rather as an aggregate of its owners). Thus, that result obtains without regard to whether the income is treated as the income of the U.S. contractual joint venture under the tax laws of Japan.

c. Fiscally Transparent Entity Organized in Third Country Location

An item of income derived from the source country through an entity that is organized in a third country and treated as the income of the owners of that entity under the tax laws of the residence country is eligible for the treaty benefits that would be granted if the income were directly derived by an owner of that entity who is a resident of that residence country without regard to whether the income is treated as the income of such owners under the tax laws of the source country or the third country.[33]

The Technical Explanation illustrates this rule with the following example:

> [I]f a Japanese company pays interest to an Australian proprietary company that is treated as a partnership for U.S. tax purposes, the interest income will be eligible for the benefits of the Convention to the extent it is treated under the taxation laws of the United States as the income of one or more U.S. residents that satisfy any other conditions specified for eligibility for the benefits of the Convention.

d. Fiscally Nontransparent Entity Organized in Third Country Location

An item of income derived from the source country through an entity that is organized in a third country and treated as the income of that entity under the tax laws of the residence country is not eligible for treaty benefits.[34]

The Technical Explanation illustrates this rule with the following example:

> [I]f a U.S. company pays interest to an Australian proprietary company that is treated as a corporation for Japanese tax purposes, the interest income will not be eligible for the benefits of the Convention. That result obtains even if the Australian proprietary company were viewed differently under the tax laws of the United States (e.g., if it elects to be treated as a partnership for U.S. tax purposes). Thus, the same result obtains without regard to whether the income is treated as the income of the partners or members of the Australian proprietary company under the tax laws of United States. Similarly, the characterization of the entity in the country of organization is also irrelevant. Thus, the same result obtains in the example above without regard to whether the income is treated as the income of the Australian proprietary company under the tax laws of Australia.

e. Fiscally Nontransparent Entity Organized in the Jurisdiction of the Payor

An item of income derived from the source country through an entity that is organized in that source country and treated as the income of that entity under the tax laws of the residence country is not eligible for treaty benefits.[35]

The Technical Explanation illustrates this rule with the following example:

> [I]f a U.S. company pays interest to a U.S. LLC that is treated as a corporation for Japanese tax purposes, the interest income will not be eligible for the benefits of the Convention. That result obtains even if the U.S. LLC were viewed differently under the tax laws of the United States (e.g., if it is treated as a partnership for U.S. tax purposes). Thus, the same result obtains without regard to whether the income is treated as the income of the partners or members of the U.S. LLC under the tax laws of United States.

This view is adopted because Japan views the U.S. LLC as an entity that is formed in the United States. Thus, from a planning perspective, it may be necessary to treat such entities as corporations for U.S. tax purposes so as to be subject to U.S. tax on a net income basis as opposed to a gross withholding tax basis. This also raises the possibility that a U.S. LLC through which Japanese members operate would not be eligible for the business profits article because the treaty is not limited to amounts subject to withholding.

3. The Saving Clause

The Technical Explanation states that the fiscally transparent provisions are not an exception to the saving clause.[36] Thus, a country may tax an entity that is treated as a resident of that country under its tax law. For example, if a U.S. LLC with Japanese members elects to be taxed as a corporation for U.S. tax purposes, the United States may tax that U.S. LLC on its

[33] 2003 U.S.-Japan Income Tax Treaty, Art. 4(6)(c).

[34] 2003 U.S.-Japan Income Tax Treaty, Art. 4(6)(d).

[35] 2003 U.S.-Japan Income Tax Treaty, Art. 4(6)(e).

[36] *See* 2003 U.S.-Japan Income Tax Treaty, Art. 1(4).

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worldwide income on a net basis, without regard to whether Japan views the LLC as fiscally transparent. Thus, if a U.S. company pays interest to a U.S. LLC that elects to be treated as a corporation for U.S. tax purposes, the interest income will not be eligible for the benefits of the Convention. In the case of income derived in the United States, this result is consistent with the result in Regs. §1.894-1(d)(2)(ii) (providing rules for the eligibility for treaty benefits of items of income paid *by* U.S. 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).

If, however, the entity is not liable to tax under the tax laws of the Contracting State in which it is organized, then income derived through the entity is treated as the income of the owners of that entity under the tax laws of both Contracting States. In such a case, the saving clause generally is not relevant to the taxation of income derived through the entity by the Contracting State in which it is organized. Further, according to the Technical Explanation of the U.S.-Japan Income Tax Treaty the source country should provide treaty benefits in such a case even though this case is not explicitly described in Article 4(6). This result is consistent with the result under the more general provisions such as in the U.K. treaty or Netherlands protocol.

4. Tokumei Kumiai

Paragraph 13 of the Protocol to the 2003 U.S.-Japan Income Tax Treaty provides special rules regarding the application of the treaty to an arrangement created by a *Tokumei Kumiai* (or "TK") contract. In general, these rules allow the United States and Japan to apply their respective domestic tax laws to income derived subject to such an arrangement and to distributions made pursuant to the arrangement.

A TK contract is a contractual relationship that is often referred to as a sleeping partnership. It has been used by U.S. corporations to finance Japanese operations because of the lack of Japanese withholding tax on distributions under the prior treaty and continues to be used in cross-border planning into Japan. Subparagraph 13(a) of the Protocol provides that the United States may treat an arrangement created by a TK contract or similar contract as not a resident of Japan and may treat income derived subject to the arrangement as not derived by any participant in the arrangement. In that event, neither the arrangement nor any of the participants in the arrangement will be entitled to benefits of the Convention with respect to income derived subject to the arrangement.

The Technical Explanation illustrates this rule with the following example:

> [I]f a U.S. corporation pays interest income to an arrangement created by a [TK] contract, then the United States will not grant the benefits of the Convention to that interest income even if the operator and investor in the arrangement are Japanese residents.

Subparagraph 13(b) provides that Japan may impose tax at source in accordance with its domestic law on distributions that a person makes pursuant to a TK contract or similar contract and that are deductible in computing the taxable income in Japan of that person.

The Technical Explanation illustrates this rule with the following example:

> [I]f a Japanese person acting as the operator in the arrangement makes a distribution pursuant to the arrangement to another person that is deductible in computing the taxable income in Japan of the Japanese person, then Japan may impose tax at source on the distribution even if the investor is a U.S. resident.

Thus, distributions from an arrangement created by a TK contract are not covered by the business profits, other income or interest articles.

5. Treatment of Hybrid Entities in Other Contexts

The Technical Explanation of the U.S.-Japan treaty addresses the issue of the treatment of hybrid entities in two other contexts.

First, the Technical Explanation provides that income earned through a fiscally transparent entity and eligible for treaty benefits is eligible for the benefits that would be granted if it were received directly by the owners of the entity. Thus, for example, if interest income is received from a Japanese payor by a U.S. LLC treated as fiscally transparent in the United States and owned by U.S. residents, the interest income would be entitled to the benefits that would be granted if it were received directly by the LLC's members. If the members of the U.S. LLC are all banks that are U.S. residents and satisfy all other conditions specified in the treaty, the interest income would be exempt from source-basis taxation in Japan under the special rule applicable to interest derived by banks, irrespective of whether the U.S. LLC is a bank.

The Technical Explanation also provides that, for purposes of the dividend article, stock owned by a company through a fiscally transparent entity is treated as owned directly by the company if the entity is treated as fiscally transparent by BOTH Contracting States. The ownership of stock is relevant for purposes of whether the recipient of a dividend owned (directly or indirectly through a resident at either Contracting State) more than 50% of the voting stock of the issuer for the requisite 12-month period, thereby satisfying a key component of the test for determining

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whether the dividend is exempt from withholding tax under the treaty. The Technical Explanation does not provide guidance regarding the appropriate treatment of ownership through a hybrid entity where the source country or the residence country, but not both, treats the entity as fiscally transparent for purposes of its tax laws.

E. 2005 U.S.-Mexico Competent Authority Mutual Agreement

This agreement implements a provision in the 1992 Protocol to the U.S.-Mexico Income Tax Treaty. Paragraph 2(b) of the 1992 Protocol provides that "a partnership, estate, or trust is a resident of a Contracting State only to the extent that the income it derives is subject to tax in that State as the income of a resident, either in the hands of the partnership, estate or trust, or in the hands of its partners or beneficiaries. . . ."

The 2005 Competent Authority Mutual Agreement (as revised December 22, 2005) provides that in applying paragraph 2(b) of the 1992 Protocol:

> [I]t is understood that income from sources within one of the Contracting States received by an entity that is organized in either of the Contracting States, or a third state with which Mexico has in force a comprehensive exchange of information agreement, and that is treated as fiscally transparent under the laws of either Contracting State will be treated as income derived by a resident of the other Contracting State to the extent that such income is subject to tax as the income of a resident of the other Contracting State.

The 2005 Competent Authority Mutual Agreement provides the following example:

> For Mexican tax purposes, a fiscally transparent entity organized in the United States, such as a U.S. limited liability company (LLC) that has elected to be treated as a partnership for federal tax purposes, will be treated as a U.S. resident for purposes of paragraph 2(b) of the Protocol, and entitled to claim treaty benefits, to the extent that the income it derives is subject to tax as the income of a U.S. resident in the hands of its members, owners, partners or beneficiaries. Similar rules will apply to a U.S. subchapter S Corporation, an LLC that is disregarded as an entity separate from its owner, or a U.S. grantor trust.

As noted previously, Mexico agrees to apply the agreement with respect to amounts paid to an entity created and subject to the laws of a third state or jurisdiction only where such third state or jurisdiction has in force a comprehensive exchange of information agreement as provided in Mexican tax provisions and such information is effectively exchanged.

IV. SELECTED ISSUES

A. Introduction

While there has been considerable attention to the basic issue of applicability of the lower treaty rates, there are other issues that will arise in applying hybrid entities. These include secondary requirements for the application of a treaty rate reduction—such as the requirement in some treaties that stock be "directly owned" to be eligible for a lower dividend withholding rate, as described above in connection with the exemption from dividend withholding tax for subsidiaries. In addition, while the technical explanations to the 1996 U.S. Model Income Tax Treaty and other U.S. income tax treaties focus on withholding taxation, other taxes may be relevant.

B. Income Earned by Second-Tier Foreign Hybrid

As an example, take the case of income earned by a second-tier foreign entity that is distributed through a hybrid entity. Assume a dividend is distributed from a Japanese entity (e.g., a *Yugen Kaisha* or "YK") to an entity that is a hybrid entity for U.S. law purposes (say a third country entity) and is thereafter distributed to its U.S. parent. Assume both entities are treated as fiscally transparent for U.S. tax law purposes, but as taxable entities in Japan. For treaty benefits to be available, the item must be subject to taxation at the entity level in the country of residence or the interest holder's country of residence.

Is the income subject to tax in the United States for these purposes? Even though there has been no dividend for U.S. tax purposes, there has been one for Japanese tax purposes. No treaty benefits appear to be available by virtue of payment to the first entity (which itself is a pass-through). There is no taxable dividend for U.S. tax law purposes, even though the interest holder, the U.S. parent, is eligible for treaty benefits and has been taxed directly on the income earned by the Japanese YK. Arguably this case is similar to that of a dividend payment to a company located in a country with a participation exemption; although the United States does not tax the dividend (which it views as a branch remittance), the U.S. parent is generally subject to tax on income earned through the first-tier (and second-tier) fiscally transparent entity. The technical language of the U.S.-

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Japan treaty (as well as the U.S.-U.K. and U.S.-Netherlands treaties), however, would have to be considered in arriving at the conclusion that the treaty rate of withholding is applicable.

C. Ownership Through Hybrid Entities

Another issue is ownership ''through'' the hybrid entity. Consider the example posed by the dividends paid to the U.K. entity that was held through an LLC in PLR 200522006. The entity was a disregarded entity for U.S. tax purposes, but it was a taxable entity for U.K. tax purposes.

The question is whether the dividend is entitled to the lowest rate, which under the U.S.-U.K. treaty is reserved for dividends paid to direct corporate owners. One approach would be for the source country to apply its rules to determine whether the dividend is paid to a corporation that directly owns the dividend payor. Under such an analysis, if the source country treats the hybrid entity as a corporation rather than a flow through, arguably the dividend can't be entitled to the lowest rate. In PLR 200522006, the IRS took the position that it was the view of the source country that matters.

The other approach is to cede to residence country law, in which case treatment by the source country would not matter and the lowest rate would be secure. This arguably is the approach of ¶6.6 of the OECD Commentary to Article 1 of the OECD Model Income Tax Treaty. Finally, consider the approach of the Technical Explanation to the 2003 U.S.-Japan Income Tax Treaty, which considers the view of both the residence country and the source country.

As a second example, consider the case where a dividend is paid by a U.S. corporation to a Dutch partnership that is owned by Dutch corporate investors. Assume the entity is a partnership for U.S and Dutch tax purposes. Is the direct dividend withholding rate available even though the stock of the U.S. corporation is owned through a partnership and not ''directly'' as required by the literal language of the treaty?

D. Hybrid Entities and Branch Taxes

A further issue is the application of the branch level profits and interest taxes that are imposed on foreign corporations, where not prohibited by treaties.[37] The examples in the 1996 U.S. Model Income Tax Treaty and other technical explanations seem limited to withholding taxes. However, it could be the case that other taxes (e.g., the branch level interest or the branch level profits taxes) might apply to an entity which is fiscally transparent for U.S. tax purposes, but not fiscally transparent for foreign tax purposes.

The branch profits tax is a U.S. tax on U.S. branch operations of foreign entities treated as corporations for U.S. tax purposes. The branch level interest tax also is a U.S. tax on such operations. Each have their own detailed treaty qualification requirements that say nothing with respect to partnerships or other fiscally transparent entities. For treaty application, is the residence country required to recognize the interest holder or entity itself as subject to tax?

As an example, assume the case of a U.K. corporation that owns an LLC through which it conducts business in the United States. For U.K. purposes, the LLC is a corporation. For U.S. purposes, the LLC is a disregarded entity. Because neither of the branch related taxes is a withholding tax, the restriction in the Technical Explanation of the U.S.-U.K. Income Tax Treaty should not prevent treaty benefits from applying. As noted earlier, the preamble to the final §894 Regulations on hybrids notes that the IRS is considering whether to issue rules outside of the withholding tax area.

On the other hand, the fiscally transparent entity provision in the U.S.-Japan treaty is not limited to withholding taxes. Thus, it could apply to limit treaty benefits with respect to the branch level taxes, although such a reading seems awkward and inconsistent with the underlying position.

What if the entity is a reverse hybrid? A reverse hybrid is an entity that is formed as a partnership, but treated as corporation for U.S. tax purposes by feature of an election under the entity classification rules.[38] Reverse hybrids can be domestic entities or foreign entities, and when they are treated for U.S. tax purposes as foreign corporations, the branch profits tax should apply, in the absence of a treaty limitation.

What if the owners of the reverse hybrid are individuals which would not otherwise be subject to the branch related taxes? For example, consider a reverse hybrid U.K. partnership, as to which the individual owners have checked the box so that it is treated as a corporation for U.S. tax purposes.

As a corporation, a foreign reverse hybrid entity also could incur the branch profits tax. The reverse hybrid entity would not qualify for the rate reduction because, not being liable to tax in its home country, it is not a resident within the meaning of the treaty. If individual partners are entitled to treaty benefits, however, they may be able to claim the rate reduction un-

[37] *See* §884(e)(1) and (2).

[38] Regs. §301.7701-3(a).

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der an interpretation of the treaty's branch profits tax provision or nondiscrimination article.[39]

[39] *See, e.g.,* 2001 U.S.-U.K. Income Tax Treaty, Arts. 3(1)(c) (defining "enterprise"), (d) (defining "business") & (e) (defining "enterprise of a Contracting State"), 4(1) (defining "resident"), 10(8) (the branch profits tax shall be a rate not "in excess of the rate specified" for corporate direct investors owning 10% or more of the voting power of the company paying the dividends), and 25(2) (the taxation of a permanent establishment of an enterprise shall not be less favorable than the taxation of other enterprises of that other state carrying on the same activities).

V. CONCLUSION

An analysis of recent guidance in the treatment of fiscally transparent entities, particularly hybrid entities, under U.S. income tax treaties reveals issues beyond the basic issue of entitlement to treaty rates of withholding tax. These issues are highly complex and require careful consideration, on a treaty-by-treaty basis, as these entities continue to be used as a basic component of international tax planning.

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