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IRS PROVIDES GUIDANCE REGARDING THE ELIGIBILITY OF CERTAIN FOREIGN INVESTMENT FUNDS AND PENSION TRUSTS FOR TAX TREATY BENEFITS

[12969] December 28, 2000 TO: INTERNATIONAL COMMITTEE No. 46-00 TAX COMMITTEE No. 50-00 RE: IRS PROVIDES GUIDANCE REGARDING THE ELIGIBILITY OF CERTAIN FOREIGN INVESTMENT FUNDS AND PENSION TRUSTS FOR TAX TREATY BENEFITS In Revenue Ruling 2000-59 the Internal Revenue Service describes three situations where a foreign investment company or a foreign pension trust will be treated as "liable to tax" under local law and, thus, eligible to assert claims for treaty benefits as a "resident" of its home country. While the discussion in the attached ruling is limited to the meaning of the term "liable to tax" for purposes of establishing residency under a relevant treaty, the ruling expressly states that to obtain treaty benefits a foreign entity also must meet any other applicable treaty requirements. For example, all treaty claimants must satisfy any applicable "limitation on benefits" provisions.1 Situations 1 and 2 In "Situation 1" the attached ruling describes a foreign investment company, Entity A, that is incorporated and taxed under the laws of Country X. Country X has an income tax treaty in effect with the United States that is identical to the 1996 United States Model Income Tax Treaty ("1996 US Model"). Entity A is taxable on income from all sources at the entity level. Similar to other domestic corporations, distributions from Entity A generally are treated as dividends and do not retain the character or source of the underlying income (with exceptions for net capital gains and tax-exempt interest). Entity A is entitled to a deduction for distributions to investors, with the result that Entity A ordinarily distributes all of its ordinary income and net capital gains to investors on a current basis and does not pay tax at the entity level. 2 Country X imposes a withholding tax on Entity A's dividend distributions to its foreign investors, regardless of the source of Entity A's underlying income. Entity A receives dividend income from the United States. 1 Treaty claimants that are "fiscally transparent" also must "derive" the item of income for which treaty benefits are sought within the meaning of Section 894 and Treas. Reg. 1.894-1(d). See Institute Memorandum to, among others, International Committee No. 27-00 and Tax Committee No. 35-00, dated August 18, 2000. 2 Although not expressly stated in the ruling, it appears that Entity A is taxed under Country X law like a US regulated investment company ("RIC"). 2In "Situation 2" the foreign investment company, Entity B, is incorporated and taxed under the laws of Country Y. The facts are the same as in Situation 1, except that Entity B eliminates tax at the entity level by qualifying for a Country Y exemption from tax for the income of investment companies. Country Y has an income tax treaty in effect with the United States that is identical to the 1996 US Model. In analyzing Situations 1 and 2, the ruling expressly states that the phrase

“liable to tax,” as used in the 1996 US Model, does not require actual taxation. The ruling refers to the 1996 US Model Technical Explanation (“1996 Model Explanation”) to Article 4(1) (Residence) which provides that “[c]ertain entities that are nominally subject to tax but that in practice rarely pay tax also would generally be treated as residents and therefore accorded treaty benefits. For example, RICs , REITs and REMICs, are all residents of the United States for purposes of the treaty.” The ruling further provides that whether a particular person will be “liable to tax” in, and thus a “resident” of, a jurisdiction for treaty purposes will depend upon the facts and circumstances. In the context of bilateral income tax treaty, however, a person will not be considered a “resident” of a jurisdiction if (1) a treaty partner has announced by public notice that such persons are not residents of that jurisdiction; (2) there is a competent authority agreement or separate specific treaty provision providing that such persons are not residents of that jurisdiction; or (3) the treaty partner would not treat similar US persons as residents of the United States, and the Internal Revenue Service has issued a public notice indicating that treaty benefits to such entities are consequently being denied. The ruling concludes that Entity A and Entity B are each “liable to tax” within the meaning of the relevant treaties. Notwithstanding that Entity A and Entity B are only nominally taxable in their home countries, the ruling emphasizes that (1) the entities may be taxed by their home countries on their worldwide income; (2) the entities would have been subject to tax like any other corporation, but for the applicable deduction or exemption regime; (3) the character and source of distributions from the entities are not determined on a pass- through basis and (4) withholding tax is imposed on distributions to foreign investors. Finally, there have been no public government notices or competent authority agreements providing that such entities are not residents for treaty purposes. Situation 3 In Situation 3, Entity C is a pension trust established and administered in Country Z. Country Z has an income tax treaty with the United States that is identical to the 1981 US Model Income Tax Treaty (“1981 US Model”). Entity C’s trustee is a resident of Country Z. Under the laws of Country Z, Entity C is treated as a resident trust taxable at the entity level. However, Country Z exempts Entity C from income tax because it is established and operated exclusively to provide pension benefits. Entity C receives dividend income from the United States. The ruling concludes that Entity C is “liable to tax” within the meaning of the US- Country Z treaty. Notwithstanding that Entity C is only nominally taxable in Country Z, the ruling emphasizes that Entity C would be taxable by Country Z at the entity level but for the applicable exemption regime. The ruling notes that the 1981 US Model, unlike the 1996 US Model, does not specifically provide that pension trusts like Entity C are “residents” for treaty 3purposes. However, the addition of a specific provision for pension trusts in the 1996 US Model merely clarified the generally accepted practice of treating these entities as residents, even though they may be entitled to a partial or complete exemption from tax. Finally, there have been no public government notices or competent authority agreements providing that such entities are not residents of Country Z. Deanna J. Flores Associate Counsel Attachment Attachment (in .pdf format)