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IRS FINAL REGULATIONS REGARDING ELIGIBILITY OF "FISCALLY TRANSPARENT" ENTITIES TO CLAIM BENEFITS UNDER US INCOME TAX TREATIES

[12496] August 18, 2000 TO: BANK AND TRUST ADVISORY COMMITTEE No. 21-00 BROKER/DEALER ADVISORY COMMITTEE No. 19-00 INTERNATIONAL COMMITTEE No. 27-00 OPERATIONS COMMITTEE No. 18-00 TAX COMMITTEE No. 35-00 TRANSFER AGENT ADVISORY COMMITTEE No. 40-00 UNIT INVESTMENT TRUST COMMITTEE No. 23-00 RE: IRS FINAL REGULATIONS REGARDING ELIGIBILITY OF “FISCALLY TRANSPARENT” ENTITIES TO CLAIM BENEFITS UNDER US INCOME TAX TREATIES The Internal Revenue Service (IRS) has released the attached final regulations (Treas. Reg. 1.894-1(d)) clarifying the availability of reduced tax withholding rates under US income tax treaties for US source investment income1 that is derived by foreign persons through “fiscally transparent” entities. For this purpose, an entity that is treated as fiscally transparent in one jurisdiction, but not another, is referred to as a “hybrid” entity.2 The regulations are intended to eliminate inappropriate and/or unintended results that may occur under US income tax treaties as a result of differing US and foreign tax classifications of hybrid entities. The regulations are of particular interest where a foreign entity (such as a partnership or trust) makes investments in US investment companies or US securities. The regulations apply to payments of US source investment income made on or after June 30, 2000. General Rule. Under the final regulations, a US income tax treaty will apply to reduce US withholding tax on US source investment income received by an entity that is “fiscally transparent” (under the laws of the United States and/or any other country) only if the income is “derived by” a resident of the applicable treaty jurisdiction. For this purpose, the term “resident” is defined in the treaty under which benefits are being claimed. The final regulations clarify that an item of income may be treated as derived by the entity, interest holders in the entity or, in certain cases, both the entity and its interest holders.3 The final regulations apply equally to US and foreign entities that are “fiscally transparent” and, unless explicitly agreed in the text of a treaty, to all US income tax treaties. Application of General Rule. The final regulations provide three specific situations in which income will be treated as “derived by” a resident of a treaty jurisdiction. First, an item of income will be treated as derived by an entity if the entity is not treated as fiscally transparent with respect to that income 1 The regulations do not apply to US source investment income that is “effectively connected” with the conduct of a US trade or business. 2 Typical types of “hybrid entities” include entities that are classified as partnerships or trusts for US tax purposes but not for foreign

tax purposes. 3 See Treas. Reg. 1.1441-6(b)(2) (describing procedures for dual rate claims under separate income tax treaties). 2under the laws of the foreign country in which the entity is organized. Second, an interest holder in the entity may be treated as deriving the item of income if that interest holder can establish under the laws of the foreign country in which the holder resides that the entity is fiscally transparent with respect to the income. For this purpose, the interest holder must not be treated as fiscally transparent under the laws of its country of residence. In both of these situations, however, the entity and/or the interest holder also must satisfy any other requirements to claim benefits under the applicable treaty, including qualification as a "resident" and "limitation on benefits" provisions. EXAMPLE: Assume that US source dividend income is paid to foreign entity Z which is organized under the laws of Country X. The United States and Country X have entered into an income tax treaty. A and B are the partners of Z. A and B each reside in a country (other than Country X) that has entered into an income tax treaty with the United States. Country X regards Z as "fiscally transparent" with respect to the dividend income. Under the final regulations, the tax treaty applicable to A and B will apply to reduce the 30 percent US tax withholding rate on the dividend income only to the extent that A and B's respective countries of residence view Z as "fiscally transparent" and do not view A or B as "fiscally transparent." In addition, A and B must satisfy any other requirements, such as "limitation on benefits" provisions, to claim benefits under the applicable treaty. Because Z is regarded as fiscally transparent by Country X, Z will not be treated as "deriving" the dividend income and, thus, will be ineligible to claim benefits under the US-Country X treaty. Third, an item of income paid to a type of entity specifically identified in a treaty as a "resident" of that treaty country will be treated as derived by a resident of that foreign country. For example, the US-France and US-Ireland income tax treaties specifically identify certain types of collective investment vehicles that will be treated as residents for purposes of those treaties.4 Even in this third situation, however, the entity must satisfy any other requirements to claim benefits under the applicable treaty, including "limitation on benefits" provisions. Definition of Fiscal Transparency. For purposes of the final regulations, an entity will be treated as fiscally transparent with respect to an item of income if the laws of a foreign country (whether that of the entity or an interest holder in the entity) require holders in the entity to include the income on a current basis (whether or not actually distributed) and the character and source of the income are the same in the hands of the entity and the interest holders. The regulations further provide that an entity may be treated as fiscally transparent where there is no requirement to separately state items of income, provided that the income tax treatment of the items (under the tax laws of the relevant foreign country) is the same whether or not such separate statement occurs. 4 See US-France Income Tax Treaty, Art. 4, para. 2(b)(iii) (identifying as residents a US regulated investment company (RIC) or real estate investment trust (REIT), and a French "SICAV" or "FCP"); US-Ireland Income Tax Treaty, Art. 4, para. 1(d) (identifying as residents a US RIC or REIT and an Irish collective investment undertaking). 3It is important to note that fiscal transparency under the final regulations is determined on an "item of income" by "item of income" basis. This means, for example, that under the laws of an applicable foreign country an entity could be fiscally transparent with respect to dividends, but not fiscally transparent with respect to other types of income, such as interest. The regulations provide additional guidance regarding the "fiscal transparency" of (1) investment vehicles, (2) complex trusts and (3) entities subject to "anti-deferral" tax regimes. First, the regulations clarify that if a foreign investment vehicle is not otherwise fiscally transparent, the vehicle will not be so treated merely because it is allowed to exclude or deduct from income amounts distributed to interest holders. Second, the regulations clarify that complex trusts will be treated as fiscally transparent to the extent that beneficiaries of the trust are required under applicable laws to take an item of the trust's income into account currently

(whether or not distributed) and the character and source of the item are the same in the hands of the trust and its beneficiaries. Finally, the regulations clarify that a foreign corporation will not be treated as fiscally transparent to the extent that its interest holders are required to include income currently under an “anti-deferral” regime, such as that found in subpart F of the US tax code. Foreign Pension Plans and Other Tax-Exempt Organizations. The final regulations clarify that foreign pension plans and other tax-exempt organizations are generally subject to the same “fiscal transparency” rules that apply to taxable foreign investors claiming treaty benefits at the investor level. Namely, investments by foreign pension plans or other tax-exempt organizations in entities that are not fiscally transparent under the laws of the foreign country in which the plan or organization is formed (such as US limited liability companies) are ineligible for tax treaty reductions in withholding tax. The preamble to the final regulations explains that “[i]n most cases, the denial of benefits . . . can be avoided by ensuring that the pension fund or tax exempt organization invests directly or through an entity treated as fiscally transparent under the laws of the jurisdiction of the fund or organization.” The preamble further explains that the United States and its treaty partners may negotiate treaties that permit pension plans and other tax-exempt organizations to invest in the United States through non-fiscally transparent entities and still obtain reduced treaty rates.5 Finally, the regulations permit the competent authorities of the United States and its treaty partners to mutually agree to depart from the “fiscal transparency” rules with respect to certain classes of entities. Domestic “Reverse Hybrid” Entities. A US corporate entity that is treated as transparent under foreign laws is called a domestic “reverse hybrid” entity. The final regulations expressly provide that where a domestic reverse hybrid entity receives a payment of US source income, US income tax treaties will not apply to reduce the entity’s tax liability or that of its foreign equity holders with respect to the US source income. The final regulations reserve on the treatment of payments by domestic reverse hybrid entities. The preamble to the regulations notes, however, that “[t]he IRS and Treasury are also aware of certain abusive structures involving domestic reverse hybrid entities,” and that they expect “to issue guidance shortly regarding payments by domestic reverse hybrid entities to their interest holders.” Deanna J. Flores Assistant Counsel Attachment Attachment (in .pdf format) 5 See US-Canada Income Tax Treaty, Art. XXI, para. 2(b). 4
