

MEMO# 9056

July 9, 1997

TREASURY DEPARTMENT GUIDANCE ON TAX TREATY ISSUES

1 These rules apply, for example, to portfolio investments (except in the unusual situation where the investments are "effectively connected with the conduct of a US trade or business"). 2 As discussed in Example 6 of Treas. Reg. section 1.894-1T(d)(6), the principles of the regulation apply as well to so-called "dual organized entities," i.e., entities organized under the laws of both a foreign country and the US (pursuant to a state domestication statute). July 9, 1997 TO: TAX MEMBERS No. 26-97 INTERNATIONAL MEMBERS No. 11-97 OPERATIONS COMMITTEE No. 23-97 TRANSFER AGENT ADVISORY COMMITTEE No. 33-97 RE: TREASURY DEPARTMENT GUIDANCE ON TAX TREATY ISSUES

The Internal Revenue Service has released guidance on tax treaty issues involving (1) the inapplicability of the US income tax treaty with the People's Republic of China to investments in Hong Kong and (2) the application of income tax treaties to "fiscally transparent" entities. Notice on Inapplicability of US-China Treaty to Hong Kong The IRS has announced (in Notice 97-40, attached) that the People's Republic of China and Hong Kong will continue to be treated as separate countries for tax purposes. Consequently, transactions involving residents of Hong Kong will not be eligible for benefits under the US income tax treaty with China. Regulations on Treaty Benefit Eligibility For Payments to Fiscally Transparent Entities The IRS also has released the attached temporary regulations (Treas. Reg. section 1.894- 1T) regarding the availability of tax treaty rate reductions for certain US source income¹ that is received by a "fiscally transparent" entity, including a "hybrid entity" that is treated as fiscally transparent in either (but not both) the US or the jurisdiction of residence of the person seeking to claim treaty benefits (the "applicable treaty jurisdiction"). These regulations are of particular interest where investments are made either (1) in a US investment company (including a master fund organized in the US) by a non-US entity (whether the entity has multiple owners or a single owner) or (2) in a US security by a master fund organized outside the US.² Fiscal Transparency. An entity is treated as fiscally transparent by a jurisdiction only if each interest holder in the entity is required by the jurisdiction to take into account currently his or her share of the entity's various items of income and to determine the character of such items of income as if they were realized directly (rather than through the entity). Thus, an entity would be treated as fiscally transparent if it were subject to rules analogous to the 3 See Institute Memorandum to Tax Members No. 19-96, Operations Members No. 18-96 and Transfer Agent Advisory Committee No. 22-96, dated April 25, 1996. 4 The final nonresident alien withholding regulations, expected to be issued soon, may provide additional guidance regarding requirements for claiming treaty benefits.

- 2 - US tax rules applicable to partnerships. Other entities that are treated as fiscally transparent for US tax purposes include common trust funds, simple trusts, grantor trusts and certain other entities that are treated as partnerships or as disregarded entities for US

tax purposes. **Fiscally Transparent Entities.** Under the regulations, payments of certain US source income to an entity that is treated as fiscally transparent under the laws of both the US and the country whose resident is claiming benefits under the treaty between the two countries shall be eligible for reduced tax rates under the treaty only to the extent that the interest holders of the entity are residents of the applicable treaty jurisdiction. **Regular Hybrid Entities.** If the entity is treated as fiscally transparent for US tax purposes but not for purposes of the applicable treaty jurisdiction (a "regular hybrid entity"), payments of certain US source income would be eligible for reduced tax rates pursuant to the treaty between the two countries only if the entity itself is treated as a resident of the applicable treaty jurisdiction. **Reverse Hybrid Entities.** If the entity is treated as fiscally transparent for purposes of the applicable treaty jurisdiction but not for US tax purposes (a "reverse hybrid entity"), payments of certain US source income would be eligible for reduced tax rates pursuant to the treaty between the two countries only to the extent that the interest holders of the entity are residents of the applicable treaty jurisdiction. Treaty benefits will not be available if the entity is a reverse hybrid organized in the United States, however, because the US will treat the entity as a corporation liable to tax at the entity level. **Three-Country Situations.** The regulations apply regardless of where the entity is organized and where the owners are resident. For example, if the US (the source country) and "Country B" (the country in which the owners of an entity organized in a third country reside) both treat the entity as fiscally transparent, both countries can ignore the entity for purposes of granting treaty benefits under the treaty between the US and Country B. In a three-country situation, there may also be simultaneous application of two treaties to the same flow of income: the treaty with the country where the entity is organized and the treaty with the country where the entity's owners are resident. Various three-country situations are illustrated in the examples to the regulations. **Requirement of Reciprocal Treatment.** Because these regulations are intended to be applied in a reciprocal manner by US tax treaty partners, the regulations include a special rule providing that, irrespective of any other aspect of the regulations, treaty-reduced rates will not be available to the extent that the applicable treaty partner does not grant a reduced rate under the tax treaty to a US resident under similar circumstances (as evidenced by either a mutual agreement between the treaty partners or a public notice of the treaty partner). Denial of benefits under this special rule would be effective only prospectively, following an announcement by the Internal Revenue Service. **Use of the Term "Beneficial Ownership".** The explanation to the regulations provides that, while the principles relied upon in these temporary regulations are consistent with the proposed nonresident alien withholding regulations³ regarding claims of treaty-reduced withholding rates for US source payments through foreign entities, the temporary regulations do not utilize the same terminology as the proposed withholding tax regulations. Under the proposed withholding tax regulations, the term "beneficial owner" functions as a surrogate for the principle that a person is eligible for tax treaty benefits only if the person is a resident (generally liable to tax) with respect to such payment. Because tax treaties use the "beneficial owner" concept to address situations involving persons acting as conduits or nominees (who do not have the strongest economic nexus to, and therefore "ownership" of, the income), the temporary regulations condition eligibility for treaty-reduced tax rates on, among other things, a determination that the income is "treated as derived by a resident" of the applicable treaty jurisdiction. **Effective Date.** The regulations apply to amounts paid on or after January 1, 1998. The explanation to the regulations encourages withholding agents to consider the effect of these regulations on their withholding obligations, including the need to obtain a new withholding certificate to confirm claims of treaty benefits for payments made on or after the effective date.⁴ **Comments and Public Hearing.** The IRS has requested that all comments on the regulations (which also have been released in proposed form) and any requests to testify at a public

hearing scheduled for September 24, 1997, be submitted to the IRS by September 3, 1997. If you have comments on the regulations that you would like the Institute to submit, please contact the undersigned at 202-326-5832 by August 8, 1997. * * * We will keep you informed of developments. Keith D. Lawson Associate Counsel - Tax Attachments Note: Not all recipients of this memo will receive attachments. If you wish to obtain copies of the attachments referred to in this memo, please call the Institute's Information Resource Center at (202)326-8304, and ask for this memo's attachment number: 9056.

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