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**Hybrid Entities**

# U.S. APPROACH TO APPLICATION OF INCOME TAX TREATIES TO PAYMENTS THROUGH HYBRID ENTITIES

**Note by Mr. Henry Louie**

Introduction:

A number of issues of tax treaty application arise when payments are made through an entity that the two Contracting States characterize differently (for example an entity, such as a limited liability company, that one Contracting State may view as a company and the other Contracting State may view as fiscally transparent. For this purpose, an entity is treated as fiscally transparent if the character, source and timing of taxation of an item of income are unchanged when the item of income flows through the entity. Certain unintended consequences may arise then applying a tax treaty to such payments including:

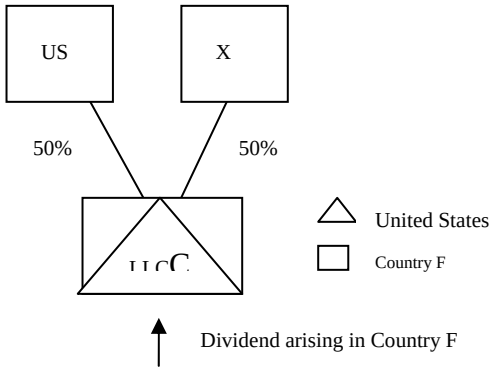
- double-taxation from the inappropriate denial of treaty benefits;
- non-taxation from the granting of treaty benefits in unintended cases, such as to third-country residents; or
- the granting of treaty benefits at the inappropriate level (as an example, the granting of the lower withholding rate on dividends paid to companies when such dividends are derived by an individual shareholder).

The principles of the OECD Partnership Report seek to avoid these unintended results. However, it has not proven to be the case that all countries, when applying their tax treaties, implicitly recognize the principles of the Partnership Report. To the contrary, the position of many countries is that the outcomes of the Partnership Report cannot be obtained absent provisions in a tax treaty explicitly providing for such results.

The following examples are intended to demonstrate the possible tax treaty issues that could

arise in the context of payments made through a hybrid entity.

Example 1: Payment arising in Country F (treaty partner) to LLC, a U.S. entity that is treated by the United States as fiscally transparent.

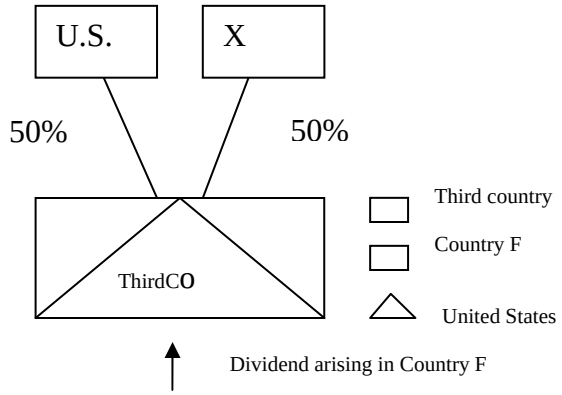



A limited liability company (LLC) organized in the United States and that is treated as fiscally transparent for U.S. tax purposes receives a dividend arising in the treaty partner, Country F. Country F treats LLC as a corporation under its domestic law. LLC is equally owned by two corporate members, one resident in the United States and the other resident in Country X. Because of the U.S. treatment of LLC, the U.S. member is taxed currently by the United States on its 50% share of the Country F dividend. This is the case even though Country F treats LLC as a corporation under its domestic law. It should follow that the U.S. member should be entitled to the benefits of the U.S.-F tax treaty (assuming that it satisfies any and all requirements set forth in the treaty). It should also follow that the portion of the dividend that flows through to the Country X member should not be entitled to the benefits of the U.S.-F tax treaty. However, as a policy matter, if Country X views LLC as fiscally transparent, the dividend should be entitled to the benefits of the tax treaty between Country F and XCo's state of residence.

While these desired outcomes are consistent with the principles of the Partnership Report, countries may not apply their tax treaties in a manner that would reach these results absent an explicit treaty provision. Countries may argue, for instance, that since LLC is not taxed by the United States as a company, the dividend (which they see as being paid to LLC, is not entitled to treaty benefits because it is not being paid to a person that qualifies as a resident of the United States.

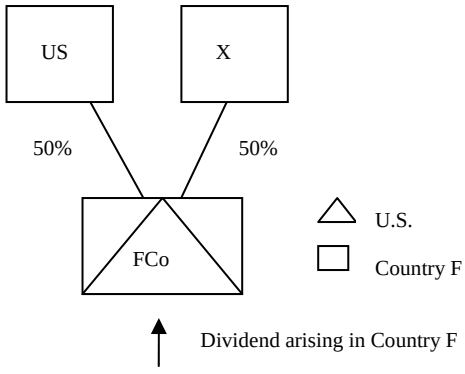
The example also raises the question of how to ensure that the appropriate level of treaty relief should be provided. For instance, if the U.S. member were an individual as opposed to a company, it would seem appropriate that Country F would apply the withholding rate available to portfolio dividends as opposed to the rate that available for direct dividends.

Example 2: Payment arising in Country F to ThirdCo, a third-country entity that is treated as fiscally transparent by the United States.




ThirdCo is an entity organized in a third country. Both Country F (the source State) and the third country view ThirdCo as a company, but the United States views ThirdCo as fiscally transparent. ThirdCo is equally owned by two corporate partners, one resident in the United States and one resident in Country X. Even though Country F and the third country view ThirdCo as a company, because the United States, as the residence State, views ThirdCo as fiscally transparent (and thus, the U.S. member is taxed currently by the United States on its 50% share of the Country F dividend), the U.S. member is treated as deriving 50% of the dividend received by ThirdCo. From a policy perspective, the same outcomes should be reached in this example as in Example 1.

Example 3: Payment arising in Country F to FCo, a Country F entity that is treated as fiscally transparent by the United States.

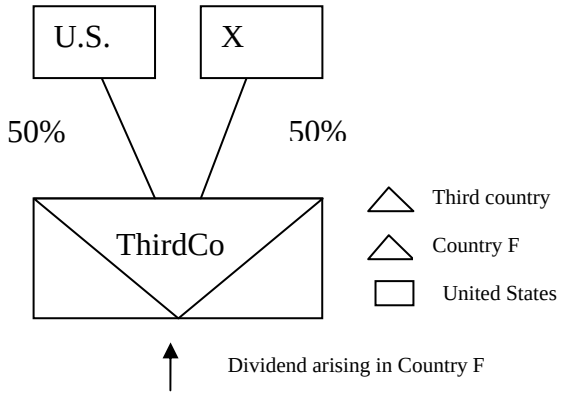



FCo, a company organized in Country F (the treaty partner) and that is treated as fiscally transparent for U.S. tax purposes receives a dividend arising in the treaty partner, Country F. Country F treats FCo as a corporation under its domestic law. FCo is equally owned by two corporate members, one resident in the United States and the other resident in Country X.

This example is distinguishable from the previous examples because from a Country F

perspective, a country F company is receiving a dividend arising in Country F. It is therefore reasonable to assume that the U.S.-F. tax treaty should not have application, and that Country F should be able to tax the dividend in accordance with its domestic law. Nevertheless, treaty benefits should be available with respect to any future dividends paid by FCo to the U.S. member.

Example 4: Payment arising in Country F to ThirdCo, a third-country entity that is treated as fiscally transparent by the third country but as a company by the United States.




ThirdCo is an entity organized in a third country. Country F and the third country view ThirdCo as fiscally transparent, but the United States views ThirdCo as a company. ThirdCo is equally owned by two corporate partners, one resident in the United States and one resident in Country X. Because the United States, as the residence State, views ThirdCo as a company, the U.S. member is not taxed on a flow-through basis by the United States on its share of the Country F dividend. It should follow that the dividend arising in Country F should not be entitled to the benefits of the U.S.-F. tax treaty.

Treaty provision:

In order to provide clarity in such situations, the Committee may wish to consider adopting a rule into the U.N. Model. The following is text for possible consideration:

> **"For the purposes of this Convention, an item of income, profit or gain derived by or through an entity that is treated as wholly or partly fiscally transparent under the taxation laws of either Contracting State shall be considered to be derived by a resident of a Contracting State, but only to the extent that the item is treated for purposes of the taxation law of such Contracting State as the income, profit or gain of a resident."**

Additional treaty provisions:

In order to achieve the desired result in Example 3 above, it would be necessary to include in the Model, in addition to the draft provision above, a provision that grants a Contracting State the authority to tax its residents as if there were no Convention. Beyond achieving the desired result

of Example 3, such a provision would also be a valuable way of ensuring that residents of a Contracting State do not use a tax treaty to reduce the tax owed to that State, by for instance, routing domestic source dividends through a company in the treaty partner.

> **"X. Except to the extent provided in paragraph Y, this Convention shall not affect the taxation by a Contracting State of its residents (as determined under Article 4 (Resident)) and its citizens. Notwithstanding the other provisions of this Convention, a former citizen or former long-term resident of a Contracting State may be taxed in accordance with the laws of that Contracting State."**

While as a general matter of policy it should be the case that a Contracting State should retain the right to tax its residents, there may be narrow instances in which a country may wish to provide certain treaty benefits to its own residents. The following provision provides a number of narrow exceptions to proposed paragraph X above:

> **Y. The provisions of paragraph 4 shall not affect:**
>
> **a) the benefits conferred by a Contracting State under paragraph 2 of Article 9 (Associated Enterprises), paragraph 7 of Article 13 (Gains), subparagraph b) of paragraph 1, paragraphs 2, 3 and 6 of Article 17 (Pensions, Social Security, Annuities, Alimony, and Child Support), paragraph 3 of Article 18 (Pension Funds), and Articles 23 (Relief From Double Taxation), 24 (Non-Discrimination), and 25 (Mutual Agreement Procedure); and**
>
> **b) the benefits conferred by a Contracting State under paragraph 1 of Article 18 (Pension Funds), Articles 19 (Government Service), 20 (Students and Trainees), and 27 (Members of Diplomatic Missions and Consular Posts), upon individuals who are neither citizens of, nor have been admitted for permanent residence in, that State.**"

ANNEX 1: U.S. Model Technical Explanation for corresponding tax treaty provisions

*Paragraph 4*

Paragraph 4 contains the traditional saving clause found in all U.S. income tax treaties. The Contracting States reserve their rights, except as provided in paragraph 5, to tax their residents and citizens as provided under their domestic laws, notwithstanding any provisions of the Convention to the contrary. For example, if a resident of the other Contracting State performs professional services in the United States and the income from the services is not attributable to a permanent establishment in the United States, Article 7 (Business Profits) would by its terms prevent the United States from taxing the income. If, however, the resident of the other Contracting State is also a citizen of the United States, the saving clause permits the United States to include the remuneration in the worldwide income of the citizen and subject it to tax under the normal Code rules (*i.e.*, without regard to Code section 894(a)). Subparagraph 5(a) of Article 1 also preserves the benefits of special foreign tax credit rules applicable to the U.S. taxation of certain U.S. income of its citizens resident in the other Contracting State. See paragraph 4 of Article 23 (Relief from Double Taxation).

For purposes of the saving clause, "residence" is determined under Article 4 (Resident). Thus, an individual who is a resident of the United States under the Code (but not a U.S. citizen) but who is determined to be a resident of the other Contracting State under the tie-breaker rules of Article 4 would be subject to U.S. tax only to the extent permitted by the Convention. The United States would not be permitted to apply its domestic law to that person to the extent that its law is inconsistent with the Convention.

However, the person would still be treated as a U.S. resident for U.S. tax purposes other than determining the individual's U.S. tax liability. For example, in determining under Code section 957 whether a foreign corporation is a controlled foreign corporation, shares in that corporation held by the individual would be considered to be held by a U.S. resident. As a result, other U.S. citizens or residents might be deemed to be United States shareholders of a controlled foreign corporation subject to current inclusion of subpart F income recognized by the corporation. *See* Treas. Reg. section 301.7701(b)-7(a)(3).

Under paragraph 4, each Contracting State also reserves its right to tax former citizens and former long-term residents in accordance with domestic law. Thus, paragraph 4 allows the United States to tax former U.S. citizens and former U.S. long-term residents in accordance with Section 877 of the Code. Section 877 generally applies to a former citizen or long-term resident of the United States who relinquishes citizenship or terminates long-term residency before June 17, 2008 if he fails to certify that he has complied with U.S. tax laws during the 5 preceding years, or if either of the following criteria exceed established thresholds: (a) the average annual net income tax of such individual for the period of 5 taxable years ending before the date of the loss of status; or (b) the net worth of such individual as of the date of the loss of status.

The United States defines "long-term resident" as an individual (other than a U.S. citizen)

who is a lawful permanent resident of the United States in at least 8 of the prior 15 taxable years. An individual is not treated as a lawful permanent resident for any taxable year in which the individual is treated as a resident of the other Contracting State under this Convention, or as a resident of any country other than the United States under the provisions of any other U.S. tax treaty, and the individual does not waive the benefits of the relevant tax treaty.

*Paragraph 5*

Paragraph 5 sets forth certain exceptions to the saving clause. The referenced provisions are intended to provide benefits to citizens and residents even if such benefits do not exist under domestic law.

Subparagraph 5(a) lists certain provisions of the Convention that are applicable to all citizens and residents of a Contracting State, despite the general saving clause rule of paragraph 4:

(1) Paragraph 2 of Article 9 (Associated Enterprises) grants the right to a correlative adjustment with respect to income tax due on profits reallocated under Article 9.

(2) Paragraph 7 of Article 13 (Gains) coordinates the tax systems of the Contracting States to avoid double taxation that could result from the imposition of an exit tax or similar regime on an individual who ceases to be treated as a resident (as determined under paragraph 1 of Article 4 (Resident)) of on Contracting State and becomes a resident of the other Contracting State.

(3) Subparagraph 1 (b), paragraphs 3 and 6 of Article 17 (Pensions, Social Security, Annuities, Alimony and Child Support) provide exemptions from source or residence State taxation for certain pension distributions, social security payments and child support.

(4) Paragraph 3 Article 18 (Pensions Funds) provides an exemption for certain investment income of pension funds located in the other Contracting State.

(5) Article 23 (Relief from Double Taxation) confirms to citizens and residents of one Contracting State the benefit of a credit for income taxes paid to the other or an exemption for income earned in the other State.

(6) Article 24 (Non-Discrimination) protects residents and nationals of one Contracting State against the adoption of certain discriminatory taxation practices in the other Contracting State.

(7) Article 25 (Mutual Agreement Procedure) confers certain benefits on citizens and residents of the Contracting States in order to reach and implement solutions to disputes between the two Contracting States. For example, the competent authorities are permitted to use a definition of a term that differs from an internal law definition.

The statute of limitations may be waived for refunds, so that the benefits of an agreement may be implemented.

Subparagraph 5(b) provides a different set of exceptions to the saving clause. The benefits referred to are all intended to be granted to temporary residents of a Contracting State (for example, in the case of the United States, holders of non-immigrant visas), but not to citizens or to persons who have acquired permanent residence in that State. If beneficiaries of these provisions travel from one of the Contracting States to the other, and remain in the other long enough to become residents under its internal law, but do not acquire permanent residence status (i.e., in the U.S. context, they do not become "green card" holders) and are not citizens of that State, the host State will continue to grant these benefits even if they conflict with the statutory rules. The benefits preserved by this paragraph are: the host country exemptions for government service salaries and pensions under Article 19 (Government Service), certain income of visiting students and trainees under Article 20 (Students and Trainees) and the income of diplomatic agents and consular officers under Article 27 (Members of Diplomatic Missions and Consular Posts); and the beneficial tax treatment of pension fund contributions under paragraph 1 of Article 18 (Pension Funds).

*Paragraph 6*

Paragraph 6 addresses special issues presented by the payment of items of income, profit or gain to entities that are either wholly or partly fiscally transparent, such as partnerships, estates and trusts. Because countries may take different views as to when an entity is wholly or partly fiscally transparent, the risk of both double taxation and double non-taxation is relatively high. The provision, and the corresponding requirements of the substantive rules of the other Articles of the Convention, should be read with two goals in mind. The intention of paragraph 6 is to eliminate a number of technical problems that could prevent investors using such entities from claiming treaty benefits, even though such investors would be subject to tax on the income derived through such entities. The provision also prevents a resident of a Contracting State from claiming treaty benefits in circumstances where the resident investing in the entity does not take into account the item of income paid to the entity because the entity is not fiscally transparent in its State of residence.

In general, the principles incorporated in this paragraph reflect the regulations under Treas. Reg. section 1.894-1(d). Treas. Reg. 1.894-1(d) (3)(iii) provides that an entity will be fiscally transparent under the laws of an interest holder's jurisdiction with respect to an item of income to the extent that the laws of that jurisdiction require the interest holder resident in that jurisdiction to separately take into account on a current basis the interest holder's respective share of the item of income paid to the entity, whether or not distributed to the interest holder, and the character and source of the item in the hands of the interest holder are determined as if such item were realized directly by the interest holder. Entities falling under this description in the United States include partnerships, corporations that have made a valid election to be taxed under Subchapter S of Chapter 1 of the Code ("S corporations"), common investment trusts under section 584, simple trusts and grantor trusts. This paragraph also applies to payments made to other entities, such as U.S. limited liability companies ("LLCs"), that may be treated as either partnerships or as disregarded entities for U.S. tax purposes. Entities falling under this

description in the other Contracting State include _____.

Under paragraph 6, an item of income, profit or gain derived by or through such a fiscally transparent entity will be considered to be derived by a resident of a Contracting State if a resident is treated under the taxation laws of that State as deriving the item of income. For example, if a company that is a resident of the other Contracting State pays interest to an entity that is treated as fiscally transparent for U.S. tax purposes, the interest will be considered derived by a resident of the United States only to the extent that the taxation laws of the United States treats one or more U.S. residents (whose status as U.S. residents is determined, for this purpose, under U.S. tax law) as deriving the interest for U.S. tax purposes. Where the entity is a partnership, the persons who are, under U.S. tax laws, treated as partners of the entity would normally be the persons whom the U.S. tax laws would treat as deriving the interest income through the partnership. Also, it follows that persons whom the United States treats as partners but who are not U.S. residents for U.S. tax purposes may not claim a benefit under the Convention for the interest paid to the partnership, because such third-country partners are not residents of the United States for purposes of claiming this benefit. If, however, the country in which the third-country partners are treated as resident for tax purposes, as determined under the laws of that country, has an income tax convention with the other Contracting State, they may be entitled to claim a benefit under that convention (these results would also follow in the case of an entity that is disregarded as a separate entity under the laws of one jurisdiction but not the other, such as a single-owner entity that is viewed as a branch for U.S. tax purposes and as a corporation for tax purposes under the laws of the other Contracting State. In contrast, where the entity is organized under U.S. laws and is classified as a corporation for U.S. tax purposes, interest paid by a company that is a resident of the other Contracting State to the U.S. corporation will be considered derived by a resident of the United States since the U.S. corporation is treated under U.S. taxation laws as a resident of the United States and as deriving the income.

The same result would be reached even if the tax laws of the other Contracting State would treat the entity differently (*e.g.*, if the entity were not treated as fiscally transparent in the source State in the first example above where the entity is treated as a partnership for U.S. tax purposes). Similarly, the characterization of the entity in a third country is also irrelevant, even if the entity is organized in that third country. The outcome would be identical regardless of where the entity is organized (*i.e.*, in the United States, in the other Contracting State or, as noted above, in a third country), subject to the saving clause of paragraph 4.

For example, income from U.S. sources received by an entity organized under the laws of the United States, which is treated for tax purposes under the laws of the other Contracting State as a corporation and is owned by a shareholder who is a resident of the other Contracting State for its 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.

These principles also apply to trusts to the extent that they are wholly or partly fiscally transparent in either Contracting State. For example, suppose that X, a resident of the other

Contracting State, creates a revocable trust in the United States and names persons resident in a third country as the beneficiaries of the trust. If, under the laws of the other Contracting State, X is treated as taking the trust's income into account for tax purposes, the trust's income would be regarded as being derived by a resident of the other Contracting State. In contrast, since the determination of deriving an item of income, profit or gain is made on an item by item basis, it is possible that, in the case of a U.S. non-grantor trust, the trust itself may be able to claim benefits with respect to certain items of income, such as capital gains, so long as it is a resident liable to tax on such gains, but not with respect to other items of income that are treated as income of the trust's interest holders.

As noted above, paragraph 6 is not an exception to the saving clause of paragraph 4. Accordingly, paragraph 6 does not prevent a Contracting State from taxing an entity that is treated as a resident of that State under its tax law. For example, if a U.S. LLC with members who are residents of the other Contracting State 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 other Contracting State views the LLC as fiscally transparent.

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