

TAX SECTION

New York State Bar Association

Report on Regulations relating to withholding on U.S. source investment
income paid to "fiscally transparent" entities

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October 2, 1997

Honorable Donald C. Lubick
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Dear Secretary Lubick and Commissioner Dolan:

I am pleased to enclose a report prepared by an ad hoc committee of the Tax Section of the New York State Bar Association commenting on the regulations issued in temporary and proposed form under section 894 of the Internal Revenue Code with respect to the application of U.S. tax treaties to U.S. source dividends, interest, royalties and other investment income derived by a foreign person through an entity that is "fiscally transparent" for U.S. and or foreign tax purposes (the "Regulations").

The Regulations address tax treaty issues resulting from the increasing use of "hybrid" entities, i.e., entities that are fiscally transparent for U.S. but not for foreign tax purposes, or vice versa. In general, the Regulations provide that (a) tax treaty benefits will not be available with respect to U.S. source income derived by a foreign person

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through a "regular hybrid" entity U.e., an entity that the United States but not the foreign person's residence country views as fiscally transparent) unless the entity is a resident of the foreign country within the meaning of the applicable treaty and therefore subject to tax in that country and (b) tax treaty benefits will be available with respect to U.S. source income derived by a foreign person through a "reverse hybrid" entity (.i.e., an entity that the foreign country, but not the United States, views as fiscally transparent), provided that the entity is not treated as a domestic corporation for U.S. tax purposes.

In general, the Committee understands the policy considerations that led to the issuance of the Regulations and concurs with their general approach. The Committee has serious concerns, however, regarding the effective date of the Regulations. In particular, the Report recommends that:

(i) the Regulations be withdrawn as temporary regulations;

(ii) the proposed Regulations be adopted only after regulations are issued providing guidance to withholding agents on the procedural aspects of the Regulations;

(iii) the effective date of the Regulations, when adopted, be no earlier than the effective date of the regulations providing guidance to withholding agents; and

(iv) the Treasury and Internal Revenue Service consider a limited transition rule that would protect income derived through domestic hybrid entities created prior to the date on which the Regulations were issued.

With regard to the substance and technical aspects of the Regulations, the principal recommendations of the Report are that:

(i) the final Regulations clarify the extent to which income derived through a regular hybrid must retain its source, timing and

character in order for the entity to be considered "fiscally transparent";

(ii) the final Regulations clarify that "fiscal transparency" of a regular hybrid is determined on an item of income-by-item basis and acknowledge that this may cause an entity (such as a simple trust) to be treated as a regular hybrid with respect to some income and as fiscally transparent or a reverse hybrid, with respect to other income;

(iii) the final Regulations provide a "stacking rule" to identify distributions by a regular hybrid entity with particular items of income;

(iv) complex trusts and estates be treated as fiscally transparent with respect to income that is distributed;

(v) in the context of regular hybrids, the drafters consider a more targeted rule that would deny treaty benefits to U.S. source income derived through a reverse hybrid entity only here the interposition of the entity defers the payment, or reduces the amount, of the foreign tax that would have been due had the income been received directly;

(vi) the final Regulations clarify that income that is treated under the laws of a foreign country as the income of a tax-exempt entity resident in that country will be considered as "subject to tax" for purposes of the Regulations, and thus will be eligible for treaty benefits;

(vii) the final Regulations provide rules for determining how a reduction in the rate of withholding on "direct investment" dividends will be applied when dividends are received by a fiscally transparent entity with more than one equity owner; and

(viii) the final Regulations be conformed in certain respects to new section 894 (c) of the Internal Revenue Code, and that regulations issued under new Code section

894(c)(1) do not affect the obligations of a withholding agent in respect of payments made before such regulations are adopted.

Please let me know if we can be of further assistance in finalizing the Regulations.

Sincerely yours,

Richard O. Loengard, Jr.
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(Enclosure)

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October 2, 1997

Report on Regulations relating to
withholding on U.S. source investment
income paid to "fiscally transparent"
entities

This report, prepared by an ad hoc committee of the Tax Section of the New York State Bar Association*, comments on the regulations issued on June 30 in temporary anti proposed form (hereafter, the "Regulations") with respect to the application of U.S. tax treaties to U.S. source dividends, interest, royalties and other investment income derived by a foreign person through an entity that is "fiscally transparent" for U.S. and/or foreign tax purposes.**

The general purpose of the Regulations is to address tax treaty issues resulting from the increasing use of "hybrid" entities -- that is, entities that are fiscally transparent for U.S. but not for foreign tax purposes or vice versa. The treatment of some "hybrid" entities (so-called "regular" hybrids, as defined below) was specifically addressed by an amendment to Section 894 of the Internal Revenue Code that was made by the Taxpayer Relief Act of 1997, and the report also addresses the need to conform the Regulations to the amendment.

Summary of the Regulations

The preamble to the Regulations distinguishes between

* Co-chaired by Emily S. McMahon and Willard B. Taylor and consisting of S. Douglas Borisky, James T. Chudy, Kevin P. Glenn, Stanley I. Katz, Richard O. Loengard and Yaron Z. Reich. Helpful comments were received from Samuel J. Dimon, Steven C. Todrys and Michael L. Schler.

** T.D. 8722, 62 FR 35673 (July 2, 1997).

"regular" hybrids, which are entities that the United States, but not the foreign country, views as "fiscally transparent"; and "reverse" hybrids, which are entities that the foreign country, but not the United States, views as fiscally transparent. We use that terminology here.

Under the Regulations, which will apply to amounts paid on or after January 1, 1998:

1. U.S. tax treaties will apply to reduce or eliminate U.S. withholding tax on U.S. source investment income derived by a foreign person through an entity that both the United States and the foreign person's country of residence treat as "fiscally transparent".

2. U.S. tax treaties will not apply to reduce or eliminate U.S. withholding tax on U.S. source investment income derived by a foreign person through a regular hybrid unless the entity is a "resident" of the foreign country within the meaning of the applicable treaty and therefore subject to tax in that country.

3. U.S. tax treaties will apply to reduce or eliminate U.S. withholding tax on U.S. source investment income derived by a foreign person through a reverse hybrid, provided that the entity is not treated as a domestic corporation for U.S. tax purposes.

The Regulations will apply equally to domestic and foreign entities that are "fiscally transparent" and, unless explicitly agreed upon in the text of a treaty, to all U.S. tax treaties. Notwithstanding the foregoing, however, a reduced withholding rate will not be available under a treaty for a

payment of U.S. source income to the extent that the treaty partner would not grant a reduced rate under the treaty to a U.S. resident in a reciprocal situation. Whether there is a lack of reciprocity will be determined by mutual agreement between the competent authorities of the United States and the treaty country, or by a public notice of the treaty country, and denial of tax treaty benefits for lack of reciprocity will be effective only on a prospective basis.

Fiscally transparent holders of equity interests in a hybrid or fiscally transparent entity are in effect looked through -- thus, if C owns E, E owns an interest in H and H owns an interest in A, treaty benefits may or may not be available with respect to C's share of U.S. source investment income paid to A, depending on whether A, H and E are or are not fiscally transparent under the laws of the relevant foreign jurisdictions.*

For purposes of the Regulations, an entity is "fiscally transparent" under foreign tax law if the foreign country requires holders of equity in the entity "to take into account separately on a current basis their respective shares of the items of income paid to the entity and to determine [for purposes of the foreign tax law] the character of such items as if such items were realized directly from the source from which realized by the entity" ** An entity that is viewed as a corporation under foreign tax law is not "fiscally transparent" even though, under foreign rules equivalent to the U.S. "subpart F" rules, a foreign owner is required to include the owner's share of its income currently.

* Cf. Example (11) of Temp. Regs. § 1.894-5T(d)(6).

** Temp. Regs. § 1.894-1T(d)(4)(ii).

Assume, for example, that U.S. source dividends are paid to a foreign entity that the United States regards as a partnership for tax purposes, that the foreign entity is not a treaty country resident (e.g., is a Cayman Islands entity) and that it has two partners, A and B, each of which is a resident of a different country with its own tax treaty with the United States. Under the Regulations, the tax treaty applicable to A or B will apply to reduce the 30% U.S. withholding tax on A or B's shares of the dividend income of the entity only to the extent that their respective countries of residence view the entity as "fiscally transparent". Thus, A's share will be subject to a reduced rate if A's country of residence treats the entity as "fiscally transparent". Otherwise withholding will be at the 30% statutory rate. The result will be the same if the entity is not foreign -- for example, is a U.S. partnership or limited liability company with foreign partners. If the entity is not fiscally transparent under foreign law, treaty benefits will be denied even though the income received by the entity is promptly distributed to the owners of the entity (and thus is subject to foreign tax as a distribution).

Amendment to Section 894

As amended by the Taxpayer Relief Act of 1997, Section 894 specifically addresses the treatment of "regular hybrids" in two ways.

First, effective on August 5, 1997, the date that the Act was enacted, Section 894 (c) (1) denies treaty reductions in withholding tax to income derived by a foreign person through an entity viewed as fiscally transparent for U.S. tax purposes if (i) the item is not treated as an item of income of the foreign person under foreign law, (ii) the foreign country

does not impose tax on a distribution of the item by the entity to the foreign person and (iii) the treaty does not contain a provision addressing the application of the treaty to income derived through partnerships. This provision is directed primarily at the use of limited liability companies by Canadian corporations to finance their U.S. subsidiaries.*

Second, Section 894(c)(2) authorizes the issuance of regulations that will specify in other cases the extent to which treaty benefits will be denied with respect to income derived by a foreign person through a "regular" hybrid -- that is, entities that the United States, but not the foreign country, treats as fiscally transparent, including partnerships, disregarded entities, grantor trusts and common trust funds.

Comments on the Regulations

We have the following comments on the Regulations:

1. Withdrawal of the Temporary Regulations and Coordination with Proposed Withholding Tax Regulations

While we understand the policy considerations that led to the issuance of the Regulations, we recommend that (i) the Regulations be withdrawn as temporary regulations, (ii) the proposed Regulations be adopted only after regulations are issued providing guidance to withholding agents on the procedural aspects of the Regulations, and (iii) the effective date of the

* This part of the amendment originated as Section 1175 of the House Bill, H.R. 2014, 105th Cong. 1st Sess. (1997), and its purpose is set out in the Ways and Means Committee Report, H.R. 105-148, 105th Cong. 1st Sess. (1997) at 549-51. Apart from Canada, only the Netherlands and Japanese treaties include no mention of partnerships.

Regulations, when adopted, be no earlier than the effective date of the regulations providing guidance to withholding agents.

As set forth below, we make this recommendation primarily because the Internal Revenue Service has so far not provided adequate guidance to withholding agents regarding implementation of the Regulations, but also because the Regulations will have to be revised to reflect the enactment of Section 894 (c) and any comments that are requested on the Regulations. We think it is entirely reasonable to request that the Regulations be revised prior (to their effective date to reflect the enactment of Section 894 (c), comments on the Regulations and the need for guidance to withholding agents.

If this recommendation is not accepted, however, the Treasury and Internal Revenue Service might consider alternative solutions that would address, at least in part, our procedural concerns. For example, the Regulations could be made effective in 1998 only with respect to payments made to affiliated entities and in other situations involving private transactions where it is more likely that a withholding agent would have or could reasonably obtain sufficient information to make the judgments necessary to apply the Regulations. With respect to other transactions, I the Regulations would be effective only in conjunction with new withholding regulations, as described in the text.

To determine its withholding obligations under the Regulations with respect to any payment to an entity, other than a domestic corporation, a U.S. withholding agent must have a basis for determining whether the payee is fiscally transparent under foreign law, whether interest holders in the entity are fiscally transparent, and the treaty residence

(or lack of treaty residence) of the ultimate owners of the income. This is an issue whether the entity is foreign or domestic (and, of course, is particularly acute if the holders of interests in the entity are fiscally transparent). We do not see how a withholding agent can be expected to meet its obligations under either Section 894(c)(1) or the Regulations without regulations that provide guidance as to how it is to determine fiscal transparency.* In addition, guidance is needed as to the level of diligence required of a withholding agent and the types of information that a withholding agent may rely upon in this regard in order to avoid penalties for failure to collect any withholding tax due under the Regulations.

By way of illustration, consider Example (3) of Temp. Regs. § 1.894-1T(d)(6), in which U.S. source royalties paid to a Country X entity are treated as covered in part by the U.S. treaty with Country X and in part by its treaty with Country Y, or Example (11) in which U.S. source royalties are paid to a non-treaty country entity but are ultimately covered in part, one or two tiers down, by U.S. treaties with Countries X and Z. How are withholding agents to apply these rules?

We recognize that the burden of making a determination as to eligibility for treaty benefits under the Regulations is placed initially upon the foreign person seeking to claim those benefits. In this connection, under the existing withholding tax regulations, a withholding agent is entitled to rely on the "address rule" in the case of dividends and on Form 1001 in respect of other treaty income, unless the withholding agent has actual knowledge to the contrary. It is not clear, however,

* Nonetheless, the Regulations plainly contemplate that withholding agents will, in the case of payments made after the end of 1997, apply the Regulations. See, e.g., Examples (5) and (6) of Temp. Regs. § 1.894-1T(d)(6) ("A must withhold...under Section 1442").

in what circumstances withholding agents may be considered to have knowledge that a foreign person presenting a Form 1001 is not entitled to treaty benefits under the Regulations.

Further, the withholding tax regulations proposed in April of 1996 would eliminate the "address rule" and would permit a withholding agent to rely upon a new Form W-8 (expanded to incorporate the existing Form 1001) only where the withholding agent does not have actual knowledge or reason to know that the beneficial owner of an item of income is not entitled to treaty benefits. Withholding agents will need guidance under these proposed regulations, both in determining when they are considered to have actual knowledge or reason to know that a foreign person is not entitled to treaty benefits under the Regulations, and in determining when they may have a duty to inquire as to the circumstances of a foreign person who presents a claim of treaty benefits and what information to collect.

The proposed withholding tax regulations will clearly have to be revised to address these questions, and Service personnel have stated publicly that the revised version of the proposed withholding tax regulations will not be effective for payments before 1999.*

2. Solicitation of New Forms 1001.

Related to the foregoing, the preamble to the Regulations states that withholding agents should consider whether they need to obtain new withholding certificates in order to reconfirm claims of treaty benefits made prior to the

* See comments of Michael Danilack, Associate Chief Counsel (International) at the annual meeting of the American Bar Association, reported in the Daily Tax Report. August 6, 1997.

effective date of the Regulations. The text of the Regulations does not, however, impose any affirmative obligation on withholding agents to solicit new Forms 1001 with respect to existing payee relationships and does not indicate that previously-solicited Forms 1001 will cease to be effective after December 31, 1997. Thus, it is not clear whether the statement in the preamble is intended to suggest that withholding agents must solicit new Forms 1001 in respect of all claims for treaty benefits prior to the effective date of the Regulations.

Any such general requirement would be inappropriate for several reasons. First, Form 1001 has not been revised to reflect the Regulations. Thus, a Form 1001 solicited after the issuance of the Regulations would include the same information as the corresponding Form currently held by a withholding agent; the Regulations do not indicate whether any information in addition to that provided on Form 1001 must be obtained. Moreover, the proposed withholding tax regulations would eliminate Form 1001 and replace it with an expanded Form W-8. As noted above, the Service has recently indicated that those proposed regulations will be finalized later this year and will be effective beginning in 1999. Thus, to require that withholding agents solicit revised Forms 1001 from their customers for purposes of payments made in 1998, and then re-solicit entirely new forms under the new withholding tax regulations for payments made in 1999 and thereafter,* would impose a significant burden on withholding

* The proposed withholding tax regulations generally provide that Forms valid on the effective date of those regulations will continue to be valid until they expire in accordance with their terms. Under this rule, if adopted, Forms 1001 solicited for 1998 would be valid for 1999 and 2000 as well. Nevertheless, withholding agents could be placed in the position later this year of having to implement new procedures and collect new forms (which will already have become obsolete) under the Regulations with respect to claims of treaty benefits for 1998, while at the same time beginning to implement the broader new withholding tax procedures and forms that ultimately will supersede any procedures used to accommodate the Regulations for 1998.

on withholding agents. Finally, to the extent that the Service does intend to require withholding agents to solicit new Forms 1001 from their customers, this requirement should be stated clearly in the text of the Regulations.

3. Authority -- Regular Hybrids

The Regulations are generally consistent with the proposed withholding tax regulations issued in April of 1996 with respect to payments derived through regular hybrids that are foreign entities* and with subsequent indications from the Treasury Department that the principles of those proposed regulations would be extended to payments derived through domestic entities classified as partnerships for U.S. tax purposes.

In our report on those regulations,** we expressed support for the tax policy considerations that justified denying treaty benefits to foreign partners in a partnership that was a regular hybrid, but we questioned whether there was statutory authority to issue regulations to that effect. It seemed to us that, if the entity was a partnership for U.S. tax purposes, the availability of treaty benefits followed from Section 702(b) of the Internal Revenue Code. While we did not in our report on the withholding tax regulations address the issue of treaty benefits in the case of a grantor trust, a simple trust or a common trust fund, we would have the same concerns about the authority to issue regulations denying treaty benefits in the absence of the amendment to Section 894 of the Internal Revenue

* Prop. Regs. § 1.1441-6(b)(4).

** NYSBA, Tax Section, Report on Proposed Withholding Tax Regulations (September 27, 1996).

Code.^{***}

The amendment of Section 894 of the Internal Revenue Code by the Taxpayer Relief Act of 1997 specifically authorizes such regulations (in Section 894 (c) (2)) and thus eliminates our concern about authority.* We note also that the United States Model Income Tax Convention (September 20, 1996) would limit treaty benefits for income derived through a hybrid to cases where the entity is fiscally transparent under the tax laws of the country of the person so deriving the income.**

4. Authority -- Reverse Hybrids

Amended Section 894(c)(2) does not address reverse hybrids -- that is, entities that are not fiscally transparent for U.S. tax purposes but are for foreign tax purposes. As noted, under the Regulations, U.S. tax treaties will apply to reduce or eliminate U.S. withholding tax on U.S. source investment income derived by a foreign person through a reverse hybrid but only if it is not a U.S. corporation and in a reciprocal situation the foreign country would extend such treatment to income derived by a U.S. person from that country through a fiscally transparent

^{***} In the case of a regular hybrid that was a grantor trust, the availability of tax treaty benefits would follow from Section 671 (a); in the case of a simple trust, from Section 652(b); and in the case of a common trust fund from Section 584(c).

^{*} We express no view as to whether the Regulations and/or Section 894(c)(1) may be viewed as overriding U.S. tax treaty obligations.

^{**} Article 4(1)(d). This does not, of course, address the question of whether there is statutory authority to deny treaty benefits to regular hybrids.

entity.***

For the reasons set out in our report on the proposed withholding tax regulations, we question the statutory authority for treating reverse hybrids as fiscally transparent for tax treaty purposes. The conference report to the Taxpayer Relief Act of 1997 states that the Regulations are consistent with amended Section 894 (c)*, but there is nothing in the language of that provision which addresses "reverse" hybrids and no support elsewhere in the Internal Revenue Code for that result. The United States has historically used its classification rules in applying tax treaties with respect to U.S. source income**, and deferring to foreign tax law seems to us to be inconsistent with the "plain language" construction of tax treaties adopted in Maximov v. United States.*** Further, while the United States Model Income Tax Convention (September 20, 1996) would extend treaty benefits to treaty country residents deriving income through reverse hybrids, no treaty currently in force contains such a provision.**** Thus, it seems clear that a foreign equity holder

*** It is our understanding that the United Kingdom and the Netherlands have each announced that they will extend treaty benefits to income derived by U.S. residents through limited liability companies that are fiscally transparent for U.S. tax purposes but not for United Kingdom or Dutch tax purposes, respectively.

* H. Rept. 105-220, 105th Cong. 1st Sess. 575 (1997) ("The conferees believe that these regulations are consistent with the provision in the Conference Agreement.")

** See the preamble to the Regulations ("The United States generally applies its tax rules to determine the classification of both domestic and foreign entities.")

*** 373 U.S. 49 (1963), involving the application of the exemption under the U.S.-U.K. tax treaty then in effect of capital gains in a case where the capital gains were recognized by a U.S. trust with U.K. beneficiaries.

**** Article 4(1)(d) of the Model Convention. The treaty recently signed with South Africa, but not yet ratified, contains a provision that is similar in substance.

of a foreign entity that is classified as a corporation for U.S. tax purposes and is itself not covered by the typical existing U.S. tax treaty could not, but for the Regulations, successfully assert that the shareholder's share of the income of the entity was covered by the U.S. tax treaty with the shareholder's country of residence.* Since the effect of this part of the Regulations is to extend (i.e., not cut back on) treaty benefits provided by the United States, however, it is difficult to see why any foreign taxpayer will ever complain.

5. Non-Hybrids

Although the focus of the Regulations is on hybrid entities, the preamble states clearly, and the Regulations acknowledge**, that U.S. tax treaty benefits are available in respect of income derived by a foreign person through an entity, wherever organized, that both the United States and the foreign person's country of residence regard as fiscally transparent. We think this is correct and that it would be useful to have a clearer statement of this rule in the text of the Regulations.

6. Treatment of Regular Hybrids

As described in the preamble, the purpose of the Regulations is to ensure that treaty benefits are extended only where, consistent with the general purpose of income tax treaties, double taxation would otherwise arise, and not where such benefits would permit an avoidance of any tax. We understand and support this objective. We are concerned, however,

* But see Example (11) of Temp. Regs. § 1.894-1T(d)(6).

** See, e.g., Temp. Regs. § 1.894-1T(d)(6), Examples (4) and (11).

that the approach adopted in the Regulations may be overly broad and mechanical, and thus may lead to situations in which treaty benefits are denied even where the result is double taxation or is otherwise inconsistent with the intent of a particular treaty.*

In the case of regular hybrids, the Regulations will deny treaty benefits to income derived by a foreign person through a regular hybrid unless the entity is a resident of a treaty country. Fiscal transparency requires that the income of the entity flow through to the equity owners with the same character and source as if received directly.** In our report on the April 1996 withholding tax regulations, we questioned whether there should always be a denial of tax treaty benefits to a regular hybrid that was not itself a treaty country resident, and specifically whether it was appropriate to deny treaty benefits in cases where (i) the U.S. source income was promptly distributed to the owners of the entity or (ii) the U.S. source income is taxed to the owners of the entity, notwithstanding the absence of a distribution, under principles similar to subpart F. The Regulations resolve these points by denying tax treaty

* In this regard, we note that the Commentary to the OECD Model Income Tax Convention contemplates that instances of "improper use of the convention" will generally be addressed through bilateral negotiations for the reason that no single set of anti-abuse provisions can adequately address all of the considerations that may arise in the context of any particular treaty. See Commentary on Article 1 of the OECD Model Income Tax Convention.

** The rule with respect to regular hybrids is to some degree inconsistent with the rules that apply to regulated investment companies. As a practical matter, a regulated investment company is a regular hybrid, assuming that it is treated as a corporation under foreign law, since it is not subject to U.S. tax so long as its income is distributed to shareholders. Nonetheless, U.S. tax treaties do apply to reduce the U.S. withholding tax on dividends to 15% in the case of foreign shareholders of regulated investment companies, even if the foreign country does not treat the regulated investment company as fiscally transparent. See Article 10(2)(b) and Article 10(3) of the United States Model Income Tax Treaty (September 20, 1996).

benefits* and, in fact, go further and deny treaty benefits in any case in which the interposition of the entity changes the character of the income, regardless of whether or not this helps or hurts the tax position of the foreign person.

We have several comments on this approach.

First, we think the definition of fiscal transparency -- that the holder must be required to take the income into account currently and "to determine the character of [items of income] as if such items were realized directly from the source from which realized by the entity" -- may be overtechnical. Specifically, should it make any difference whether income is taken into account as ordinary income (or its equivalent under foreign law) or as dividend, interest or royalty income so long as this does not affect the basis on which the income is taxed under foreign law? ** We are concerned that the language of the definition will be the source of uncertainty and may exclude income in cases where this is inappropriate. The formulation in the Regulations goes beyond the United States Model Income Tax Convention (September 20, 1996), which simply requires that the "item of income... [be] treated for purposes of the taxation law of [the foreign country] as the income...of a resident".* The Regulations similarly go beyond the specific statutory rule adopted by Congress in Section 894 (c)(1).

* Temp. Regs. § 1.894-1T(d)(6), Example (7) (immediate distribution) and Example (8) (principles similar to subpart F).

** It seems overly technical to us to conclude that the availability of treaty benefits should turn on whether the item has the same character (e.g., as a royalty) under foreign law as under U.S. law.

* Article 4(1)(d). Nothing more is required by the Treasury Department's Technical Explanation of the Model Treaty.

Second, it should be clarified that the requirement of fiscal transparency does not apply to all "items of income paid to the entity" (as the Regulations state), but just to the particular item of U.S. source investment income on which treaty relief is sought. This would seem to follow from the fact that the Regulations specifically treat "simple trusts" as fiscally transparent^{**}, even though simple trusts are "fiscally transparent" only with respect to the income that is required to be distributed and income for this purpose is determined under applicable local law (and so, for example, would generally not include capital gains).^{***} An item-by-item approach would also be consistent with Section 894(c)(1) and with Article 4 (1) (d) of the United States Model Income Tax Convention (September 20, 1996). If fiscal transparency is determined on an item-by-item basis, as we have recommended and Section 894(c) (1) and the Model Treaty seem to contemplate, it is possible that an entity (such as a simple trust) will be a regular hybrid with respect to some items of income and fiscally transparent or a reverse hybrid with respect to others. This should be acknowledged in the Regulations, and reflected in the revisions to the proposed withholding tax regulations.^{***}

Third, the Regulations will require a "stacking" rule -- that is, a rule that identifies distributions by the hybrid with particular items of income. Such a rule is required because of the possibility that a hybrid may be both a regular and a reverse hybrid, as discussed above, and also because a hybrid may have other items of income (e.g., foreign source investment income) --

^{**} Temp. Regs. § 1.894-1T(d)(4)(ii).

^{***} Section 651(a) and Regs. § 1.651(a)-2.

^{***} A similar issue arises in connection with the application of the different treaty withholding rates for portfolio and direct investment dividends. See discussion on pages 20-21.

if the hybrid is the withholding agent, it will need to know which items have been paid out. In our report on the April 1996 withholding tax regulations, in dealing with distributions by trusts and estates, we suggested by analogy to Sections 652(b), 661(b) and 662(b), that distributions consist of a pro rata portion of each class of income, absent a specific allocation under the governing instrument. We repeat that suggestion here.

Fourth, it is not clear to us why, if simple trusts are fiscally transparent for U.S. tax purposes, complex trusts and estates are not also fiscally transparent with respect to income that is distributed. As noted, a simple trust is a trust that is required to distribute the income that it has under governing non-tax law, and such income is currently taxable to the beneficiary, whether or not distributed, and has the same character as in the hands of the trust. *Complex trusts and estates may or may not distribute income, but if they do, it also has the same character as in the hands of the trust or estate.** Apart from consistency with the rules that apply to simple trusts, there is a question of authority -- specifically, the absence of any apparent basis for overriding the source and character rules in Section 662(b).

Finally, we wonder whether a more targeted rule would not be sufficient to deal with the abuse that the Regulations are directed at. As the preamble to the Regulations notes, the interposition of a hybrid entity may defer or change the basis of taxation, even if the income is deemed to be distributed or in fact is promptly distributed. However, this concern, which we share, could be dealt with by a rule that was more targeted

* Sections 652(a) and (b).

** Section 661(b).

than a complete denial of treaty benefits -- for example, the Regulations could provide that tax treaty benefits are denied with respect to U.S. source income derived through a regular hybrid only where the interposition of the entity defers the payment, or reduces the amount, of the foreign tax that would have been due had the income been received directly.*

We recognize that there are competing arguments -- for example, providing treaty benefits to income that is taxed when distributed would logically lead to extending treaty benefits to shareholders of an entity that both the U.S. and the foreign country treat as a corporation. In addition, such a rule may be more difficult to administer than the rule in the Regulations.

7. Tax-Exempt Entities

The Regulations provide generally that treaty benefits are available only with respect to income (whether derived directly or through an entity) that is "treated as derived by a resident of an applicable treaty jurisdiction", and they further provide that this will be so "to the extent the payment [of the income] is subject to tax in the hands of a resident of such jurisdiction".* This language is confusing and arguably could be construed as denying tax treaty benefits to income derived, either directly or indirectly, by pension plans and other tax-exempt organizations or by other residents of a treaty jurisdiction who, for whatever reason, are not taxed on the

* Even where the interposition of a hybrid entity defers taxation of an item of income, we believe it would be reasonable to permit the beneficial owner of the income to file for a refund of U.S. withholding tax once the foreign tax has been paid, at least when such tax is paid within the period of the statute of limitations for seeking a refund of overpayments of tax.

* Temp. Regs. § 1.894-1T(d)(1).

particular item of income.

We do not believe that the drafters of the Regulations intended to conclude in such a case that tax treaty benefits are unavailable, and we can see no justifiable policy reason for reaching such a conclusion. We recommend, therefore, that this point be clarified in the final Regulations. For example, the final Regulations could provide that income that is treated under the laws of a foreign jurisdiction as the income of a tax-exempt entity resident in that jurisdiction will be considered "subject to tax" in that jurisdiction for purposes of the Regulations.**

8. Conformity to Section 894 (c)

The denial of treaty benefits in Section 894(c)(1) is generally consistent with the Regulations' denial of treaty benefits to income derived through regular hybrids. In addition to a difference in effective dates, discussed below under Effective Date, however, there are two differences that could usefully be addressed.

First, the Regulations provide that tax treaty benefits will be available to a regular hybrid entity if the entity is

** Such an approach would be consistent with the position taken by the Treasury Department in the United States Model Income Tax Convention (September 20, 1996). Article 4(1)(b) of the Model Convention explicitly provides that tax-exempt entities that are organized for religious, charitable, educational, scientific or similar purposes, as well as tax-exempt pension funds, are treated as residents of the Contracting States. The Treasury Department's Technical Explanation of the Model Convention describes this provision as adopting "the generally accepted practice of treating an entity that would be liable for tax as a resident under the internal law of a state but for a specific exemption from tax (either complete or partial) as a resident of that state...."

itself a treaty resident.* Thus, for example, the benefits of the U.S.-Country X tax treaty will be available to be regular hybrid that is a Country X resident, even though it is in part owned by nonresidents of X who are not covered by any U.S. tax treaty.** By its terms, however, Section 894(c) addresses only the availability of treaty benefits to the owners of a regular hybrid entity and does not address the availability of treaty benefits to the regular hybrid itself. We do not believe that the legislative intent of Section 894 (c) was to preclude a claim of treaty benefits by the regular hybrid, and so we do not view the Regulations as inconsistent with Section 894 (c).*** To avoid confusion, however, it may be useful to confirm this point explicitly in the final Regulations.

Second, in the case of a tax treaty that does not address the applicability of the treaty to income derived through a partnership, Section 894(c)(1) denies treaty benefits with respect to income derived by a foreign person through a regular hybrid where the item of income is not treated by the treaty country as income of the hybrid entity and "the foreign country does not impose tax on a distribution of...[the] item of income from...[the] entity to such person". We understand the quoted language to be directed at foreign countries that have adopted an exemption or territorial tax system under which certain types of foreign source income are excluded from taxation. By its terms, however, this language might also be construed to deny treaty

* Regs. § 1.894-1T(d)(2)(i).

** Example (1) of Temp. Regs. § 1.894-1T(d)(6). The limitation on benefits provision of a particular treaty may, however, limit the availability of treaty benefits for such an entity.

*** For example, we do not believe that Section 894 (c) (1) should be interpreted to deny the benefits of the U.S.-Canadian tax treaty to U.S. source investment income paid to a Canadian entity that is classified as a Canadian company for Canadian tax purposes but (under a check-the-box election) is for U.S. tax purposes fiscally transparent.

benefits to income derived by a foreign pension plan or other tax-exempt investor through a regular hybrid. Consistent with our comment above (see "7. Tax-exempt entities"), we do not think that this was the intent of the statutory language, and we recommend that the final Regulations make this clear.

9. Treatment of Reverse Hybrids

While we have doubts about the authority for the part of the Regulations relating to reverse hybrids, we believe that the policy of providing tax treaty benefits to holders of equity interests in reverse hybrids is generally sound. It might usefully be clarified, however, that the exclusion of any "entity that is treated as a domestic corporation for U.S. tax purposes" encompasses unincorporated entities that are so treated (including regulated investment companies and real estate investment trusts, however organized).

In addition, as noted above, some entities (such as simple trusts with respect to amounts not required to be distributed that are not distributed) may be treated as both regular and reverse hybrids as to different items of income. It would be useful for this point to be acknowledged in the Regulations and addressed in the revised withholding tax regulations.

10. Beneficial Ownership

The Regulations distinguish, appropriately, between the concept of beneficial ownership and the application of tax treaty benefits to income derived through fiscally transparent

entities,* but it is not clear from the preamble whether the anti-conduit regulations issued under the authority of Section 7701(1) are regarded separately from "beneficial ownership". The anti-conduit regulations do not as such determine beneficial ownership. As we understand the rules, there are three hurdles in the case of a fiscally transparent entity -- beneficial ownership, the non-application of the anti-conduit rules and satisfaction of the Regulations. This might be clarified.

11. Rate of Withholding on Dividends

Most U.S. tax treaties provide for a reduction in the rate of withholding on dividends received by a corporation of the other country if the foreign corporation owns a specified percentage of the voting power of the voting stock of the U.S. corporation that pays the dividends. These treaties may provide, for example, that the reduction applies to dividends "if the beneficial owner [of the dividends] is a company that owns directly at least 10 percent of the voting stock" of the payor.** In our prior report, we recommended that, if adopted, the Regulations set out how this reduction will be applied where dividends are received by a fiscally transparent entity with more than one equity owner*** - will a look through rule be applied for this purpose, so that the 5% rate will be available to a foreign person whose indirect interest in the entity satisfies the 10% ownership requirement? This would be consistent with Rev. Rul.

* Id.

** Article 10(2)(a) of the United States Model Income Tax Convention (September 20, 1996)

*** An example in the Regulations seems to imply that the 5% rate will apply to an entity that is disregarded under Regs. § 301.7701-3(c). Temp. Regs. § 1.894-1T(d)(6), Example (12).

71-141, 1971-1 C.B. 211, and the apparent intent of the Section 902 regulations.

12. Scope of the Regulations.

As drafted, the Regulations address only the availability of treaty benefits with respect to U.S. source income derived through hybrid entities. The same tax avoidance possibilities that gave rise to the concerns underlying the Regulations, however, would seem to exist outside the treaty context in connection with the use of a domestic hybrid entity by a foreign taxpayer to earn non-U.S. source income that escapes both foreign and U.S. taxation under the laws of both countries. For example, a resident of Country A may organize a domestic limited liability company in order to earn investment income from Country B, and thereby escape taxation in both Country A and the United States. We make no recommendation, but simply note that the concerns expressed in the preamble to the Regulations may also apply to the use of domestic hybrids to avoid foreign tax on foreign source income. However, we recognize that the U.S. interest in, and ability to tax, the foreign source income of foreign taxpayers is limited.

13. Effective Date Issues.

The Regulations will apply to payments made on or after January 1, 1998. We have several comments on this:

First, we have recommended that the Regulations be withdrawn as temporary Regulations and that the proposed regulations be adopted as final regulations only when there are coordinating withholding tax regulations setting forth procedural standards on which withholding agents can rely.

Second, Section 894(c)(1), is effective on August 5, 1997, the date of enactment of the Taxpayer Relief Act of 1997. The Regulations do not as such construe that Section but we assume that any subsequent Regulations thereunder will be effective, in the narrow case covered by Section 894(c)(1), on the date of enactment. We would recommend, however, that regulations under that Section do not affect the obligations of a withholding agent in respect of payments made before such regulations are adopted.

Third, the question of when a payment is made for purposes of the effective date should be clarified. For example, in the case of a domestic partnership, withholding on U.S. source investment income that is subject to withholding is due on the earlier of the date of distribution or the date on which Schedule K-1s must be provided to partners.* For purposes of the effective date rules, will income subject to withholding be regarded as paid when paid to the partnership, when distributed by the partnership or when withholding would be due if the income was not distributed? We suggest that the final Regulations clarify that income derived through an entity will be treated as paid for purposes of the effective date rules at the time that it is paid to the entity.

Finally, we suggest that consideration be given to including in the final Regulations a transition rule that would protect income derived through certain hybrid entities created prior to date on which the Regulations were issued. We believe that there are a significant number of cases where entities,

* Rev. Rul. 89-33, 1989-1 C.B. 269; Prop. Regs. 1.1441- 5(a). As we noted in our report on the withholding tax regulations that were proposed in April of 1996, there is under current law no rule that identifies partnership distributions with particular items of 1 partnership income.

especially domestic entities, were set up to hold U.S. investments in the belief that these entities, such as partnerships, limited liability companies, and complex domestic trusts, were transparent for U.S. tax purposes and would not affect the amount of U.S. tax on their income from investments (especially on their distributed income). In many instances, the investors were institutions which were tax-exempt in their country of residence, and little or no thought was given to whether the entity was or was not fiscally transparent under foreign law. We are concerned that the tax consequences of the Regulations could not have been anticipated by these taxpayers, which may have chosen to organize the investment entities in a form that would not have been chosen had the Regulations been foreseen, and that it may not be feasible, or it may be unduly expensive, for the foreign investors to now seek to restructure the form of the investment entity in light of the changes in U.S. law. We therefore recommend that the final Regulations provide a transition rule that would grandfather pre-existing domestic entities or, at a minimum, delay application of the Regulations to such entities for a sufficient period to permit taxpayers to reorganize their affairs (with appropriate safeguards against entities into which additional assets are infused after the effective date of the Regulations).