Report No. 1373

New York State Bar Association

Tax Section

Report on the Application of Section 894 to Effectively Connected Income of Hybrid Entities

June 13, 2017

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This report[1] comments on the appropriate application of treaty limitations to source country taxation of non-FDAP income (as defined below) and the branch profits tax ("**BPT**") when the underlying income is earned by or through an entity that is fiscally transparent under the laws of one treaty partner but fiscally opaque under the other treaty partner's laws (a "**hybrid entity**").[2] This is not our first report on this subject. We have previously commented on this issue in both our report on the 2006 Model Treaty (the "**2007 Report**") and our 2010 report seeking guidance on treaty issues (the "**2010 Report**").[3] This report is intended to provide a more detailed discussion of the issues.

Part I summarizes our conclusions and recommendations. **Part II** provides background of the current law and policy considerations of the hybrid entity rules applicable to FDAP income under Section 894(c) and the Treasury Regulations thereunder (the "**Hybrid Entity Rules**"). **Part III** discusses the potential expansion, from both technical and policy perspectives, of the application of the Hybrid Entity Rules to business profits earned by a resident of a treaty partner through a hybrid entity that are not attributable to a permanent establishment in the source country. This Part also identifies and considers a number of collateral consequences of such an expansion. **Part IV** discusses application of the Hybrid Entity Rules to the BPT if the rules were to be extended to business profits.

I. Summary of Conclusions

- Business Profits. We believe that, as a matter of policy, the Derived By Rule (as defined below) should be extended to apply to business profits.
    - o Applying the Derived By Rule to business profits earned through certain types of hybrid entities, such as domestic hybrid entities, should be relatively straightforward and would reduce substantial taxpayer uncertainty as well as limit the potential for government whipsaw.
    - o Applying the Derived By Rule to business profits earned through other structures, such as foreign reverse hybrid entities, raises a number of practical and administrative

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[2] A "hybrid entity" refers to an entity treated as transparent for U.S. federal income tax purposes and as non-transparent, or opaque, under the laws of the relevant foreign jurisdiction. A hybrid entity can be either domestic or foreign. A "reverse hybrid entity" refers to an entity treated as a corporation for U.S. federal income tax purposes, and as transparent under the laws of the relevant foreign jurisdiction. A reverse hybrid entity can be domestic or foreign.

[3] NYSBA, TAX SEC., *Report on Guidance under U.S. Income Tax Treaties* (Rep. No. 1214, May 28, 2010), 9-11; NYSBA, TAX SEC., *Report on the Model Income Tax Convention Released by the Treasury on November 15, 2006* (Rep. No. 1127, Apr. 11, 2007), 21.

questions. Instead of recommending a specific approach, we have identified reasons for and against extending the Derived By Rule to these scenarios. If Treasury were to extend the Derived By Rule to these scenarios, even limited guidance would help reduce uncertainty.

- Tax-Exempt Income. We recommend, as we have previously, that the Derived By Rule be clarified to allow treaty benefits for income (whether FDAP or business profits) of a hybrid entity that would have been exempt from tax in the country of the investor's residence, had it been earned directly (and had the same character as the underlying income).

- Branch Profits Tax.

    - In general, we believe that the Derived By Rule should be applied without modification to the BPT. This approach would deny treaty benefits for the BPT imposed on business profits earned through a domestic or foreign hybrid entity, and would allow treaty benefits in the case of business profits earned through a foreign reverse hybrid.

    - We also identify an alternative approach that would favor a modification to the Derived By Rule as it applies to the BPT on business profits earned through a domestic hybrid entity. Under this approach, the Derived By Rule would be applied to the BPT only if treaty benefits would have been available to the taxpayer under the Derived By Rule with respect to the dividends withholding tax had the business profits been earned through a domestic subsidiary and repatriated as dividends to the taxpayer.

    - In the case of the BPT imposed on a foreign corporation with respect to business profits earned through a foreign hybrid entity, we believe that the foreign hybrid should be permitted to claim its own treaty benefits with respect to the BPT imposed on its corporate interest holder.

    - Finally, we review a number of additional considerations and alternative approaches in circumstances in which the BPT is imposed on a foreign reverse hybrid entity with treaty-eligible individual interest holders. While we identify more than one approach, we recommend an approach that would allow the individual interest holders to claim treaty benefits as a result of their status as individuals only if their portion of the ECI earned by the foreign reverse hybrid is subject to tax at individual tax rates.

II. Background

A. History and Policy of Hybrid Entity Rules

Nonresident aliens and foreign corporations that derive dividends, interest, rents, royalties and other fixed, determinable, annual or periodic income ("**FDAP**") from U.S. sources are generally subject to a 30 percent withholding tax imposed on the gross payments of such items of income.[4] Other jurisdictions also impose similar taxes on payments to nonresidents of income derived from within their borders. By imposing withholding taxes on such payments, a jurisdiction asserts the primary taxing jurisdiction over income derived from sources within that jurisdiction. While such payments may also be taxed by the recipient's jurisdiction of residence, it is generally accepted that the source country is entitled to the first bite of the apple.[5]

Withholding taxes are often reduced substantially by income tax treaties. From the perspective of the United States, the reduced treaty withholding rates reflect the agreement by the United States to cede part or all of its primary taxing jurisdiction on U.S.-source FDAP to its treaty partner. In doing so, the United States assumes that the treaty partner will exercise its taxing jurisdiction over the income by either imposing, or choosing not to impose, tax on the income.[6] However, income earned by or through a hybrid entity does not fit neatly within these parameters.[7] By routing items of income through a hybrid entity, a taxpayer may be able to exploit the differences between the tax regimes of two countries to avoid, reduce or defer taxation of the income.

In the legislative history to Section 894(c), Congress noted its understanding that the interaction of the domestic tax laws and the applicable tax treaty may have provided a business structuring opportunity that would allow Canadian corporations with U.S. subsidiaries to avoid both U.S. and Canadian income taxes for U.S. operations conducted through a U.S. limited liability company that is treated as a partnership for U.S. tax purposes but as a corporation for Canadian tax purposes.[8] More specifically, prior to the enactment of Section 894(c), a typical hybrid structure often involved the use of foreign and U.S. hybrid entities (*e.g.,* a U.S. limited liability company) as illustrated below.[9]

[4] Sections 871(a), 881(a), 1441 and 1442. All references to "Sections" are to the Internal Revenue Code of 1986, as amended (the "**Code**").

[5] *See, e.g.*, League of Nations, Technical Experts to the Economic and Financial Committee, Double Taxation and Tax Evasion Report and Resolutions submitted by the Technical Experts to the Financial Committee, Document F.19, Part III, Section 1 (1925) (available at http://setis.library.usyd.edu.au/pubotbin/toccer-new?id=brulegi.sgml&images=acdp/gifs&data=/usr/ot&tag=law&part=1&division=div1).

[6] TD 8889, 65 Fed. Reg. 40993 (July 3, 2000).

[7] The term "fiscally transparent" means that the income derived by the entity is treated as the income of the persons holding interests in the entity for income tax purposes in the applicable jurisdiction.

[8] H.R. Rep. No. 105-148, 105th Cong. 1st Sess., at 550 (1997).

[9] For a thoughtful discussion, see Carol Doran Klein and Diane L. Renfroe, *Section 894: Payments to Flow-Through Entities*, 26 TAX MGMT. INT'L J. 547 (1997).

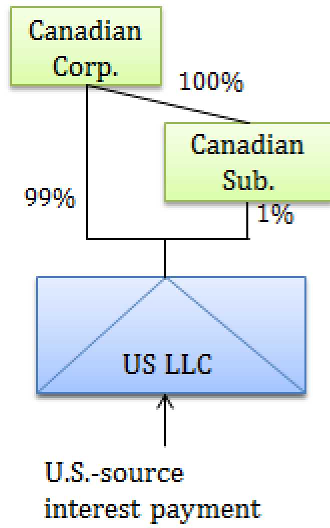

Figure 1

In Figure 1, one Canadian corporation owns 99% of a domestic limited liability company ("**US LLC**") directly and 1% indirectly. US LLC is treated as a corporation for Canadian tax purposes and a flow-through entity (partnership) for U.S. tax purposes. The interest payment to US LLC is currently deductible to the U.S. payor but is not currently taxable in Canada because from a Canadian perspective, the interest is treated as income of a U.S. corporation. Further, under then-applicable Canadian tax law, the income was also not subject to tax in Canada when US LLC made a distribution to its Canadian members. Taxpayers took the position that the interest payment qualified for reduced U.S. withholding rates under the treaty because, under U.S. law, the Canadian members were subject to tax on the income of US LLC and were therefore entitled to treaty benefits.[10] The allowance of treaty benefits seemed improper as a matter of policy because there was no current tax in Canada on the interest, and when US LLC later transferred funds to the Canadian parent, the transfers were characterized as dividends and excludable from income for Canadian tax purposes.[11]

[10] The applicable treaty withholding rate was 15% for 1995 and earlier years and 10% for 1996 and later years. *See* Article XI of the U.S.-Canada treaty and Article VI(1) of the 1995 protocol.

[11] *See* H.R. Rep. 105-148, 105th Cong. 1st Sess., at 550 (1997).

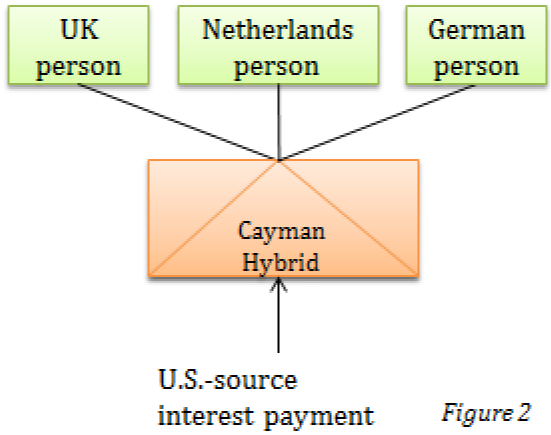

Figure 2

Figure 2 illustrates another common structure then in use in which a foreign hybrid entity is organized in a tax haven jurisdiction and owned by partners in treaty jurisdictions. In this example, a Cayman limited company is owned by residents of the United Kingdom, The Netherlands and Germany. The Cayman limited company makes loans to a U.S. corporation and the interest is not otherwise eligible for the portfolio interest exemption. The Cayman limited company is classified as a partnership for U.S. tax purposes but as a corporation in each of its members' jurisdictions. None of the partners is subject to tax in its home jurisdiction on either the receipt by the Cayman limited company of the interest payments from the U.S. corporation (because the Cayman limited company is a corporation under the applicable home jurisdiction law) or on the repatriation of the funds from the Cayman limited company to the partners (under an applicable participation exemption regime). Nevertheless, taxpayers took the position that the interest payments to the Cayman limited company qualified for reduced treaty withholding rates because the Cayman limited company was a pass-through for U.S. income tax purposes.

To reduce this type of tax planning, the Treasury Department issued temporary and proposed regulations under Section 894 on June 30, 1997, limiting the extent to which payments to flow-through entities would be entitled to a reduced rate of tax under an income tax treaty.[12] Shortly thereafter, on August 5, 1997, the Taxpayer Relief Act of 1997[13] added Section 894(c) to the Code.

Section 894(c)(1) denies treaty benefits on payments to a foreign person with respect to an item of income derived through a partnership (or other fiscally transparent entity) if (i) the item is not treated by the foreign country as an item of income of such person, (ii) the treaty does not address the treatment of income derived through partnerships and (iii) the foreign country does not tax the distribution of the income from the partnership to the foreign person.

In addition, Section 894(c)(2) authorizes the Secretary of the Treasury to prescribe regulations as may be necessary or appropriate to determine whether a taxpayer to which Section

[12] TD 8722, 62 Fed. Reg. 35673 (June 30, 1997).

[13] P.L. 105-34, § 1054(a).

894(c)(1) does not apply should not be entitled to benefits under any income tax treaty with respect to any payment received by, or income attributable to any activities of, an entity that is treated as a partnership or is otherwise treated as fiscally transparent for U.S. federal income tax purposes and is treated as fiscally non-transparent for purposes of the tax laws of the jurisdiction of residence of the taxpayer. The statutory authority for regulations addressing the treatment of income earned through a hybrid entity is not limited to FDAP, and addressing the treatment of business profits would clearly be within the scope of the regulatory authority granted.

The 1997 proposed regulations were finalized in July 2000.[14] Notwithstanding the statutory grant of authority for regulations covering "income attributable to any activities of" a fiscally transparent entity, the Hybrid Entity Rules address eligibility for income tax treaty relief only in respect of the taxes imposed by Sections 871(a), 881(a), 1443,[15] 1461 and 4948(a)[16] of the Code. Thus, the Hybrid Entity Rules do not apply, for example, to business profits derived by or through a fiscally transparent entity. The Preambles to the 1997 proposed regulations and to the 2000 final regulations similarly state that the Hybrid Entity Rules "address only the treatment of U.S.-source income that is not effectively connected with the conduct of a U.S. trade or business," and they go on to state that "[t]he IRS and Treasury may issue additional regulations addressing the availability of other tax treaty benefits, such as the application of business profits provisions, with respect to the income of fiscally transparent entities, particularly where a conflict in entity classification exists."[17]

B. The Hybrid Entity Rules: Basic Principles

The Hybrid Entity Rules are premised on a basic principle: When the entity classification laws of the United States and a foreign treaty jurisdiction conflict, treaty benefits are determined based on the treaty eligibility of the income in the hands of the person treated as deriving the income in that person's home country (the "**Derived By Rule**").

The purpose of the Derived By Rule is often articulated as avoiding both double taxation and double non-taxation.[18] As discussed in **Part III** of this report, notwithstanding this

[14] TD 8889, 65 Fed. Reg. 40993 (July 3, 2000). The final regulations were subsequently revised in 2002 by T.D. 8999 (June 11, 2002).

[15] Section 1443 relates to certain income of a foreign tax-exempt organization.

[16] Section 4948 relates to investment income of a foreign private foundation.

[17] TD 8889 (Preamble), 65 Fed. Reg. at 40994 (July 3, 2000); TD 8722 (Preamble), 62 Fed. Reg. at 35673 (June 30, 1997). Since 1996, the U.S. Model Income Tax Treaty includes a provision in its Residence article reflecting the general principle of the regulations but, as discussed in Part III.B., *infra*, appears to extend the concept to all income items, including business profits. In addition (and also as discussed below), certain income tax treaties in force, including Article IV(6) of the U.S.-Canada treaty, similarly extend the concept to business profits.

[18] *See, e.g.*, OECD (1999), Issues in International Taxation Report No. 6, *The Application of the OECD Model Tax Convention to Partnerships*, OECD Publishing (Jan. 20, 1999) (the "**OECD Partnership Report**"); *see also* OECD (2014), *Neutralising the Effects of Hybrid Mismatch Arrangements*, OECD/G20 Base Erosion and Profit Shifting Project Action 2, OECD Publishing (2014), Chapter 9 (proposing a new provision in the OECD Model to
(continued...)

nomenclature, the fundamental policy consideration reflected in the Derived By Rule is not whether the item of income is subject to actual double taxation or actual double non-taxation.[19] Rather, the question is whether the item of income is "seen" by one or more taxing jurisdictions and included in the "notional" tax base of those jurisdictions.[20]

More specifically, Treasury regulation section 1.894-1(d)(1) provides that an item of income received by an entity that is fiscally transparent qualifies for reduced withholding tax under a treaty only to the extent that the "income is derived by a resident of the applicable treaty jurisdiction." For this purpose, the item of income may be derived by the entity receiving the item of income, by the interest holders in the entity, or by both. An item of income that is paid to an entity is considered to be "derived" by the entity only if the entity is not fiscally transparent under the law of the entity's jurisdiction with respect to the item of income (unless the income is paid directly to a type of entity specifically identified in a treaty as a resident of a treaty jurisdiction, in which case the income is treated as derived by a resident of the treaty jurisdiction). An item of income paid to an entity is considered to be derived by the interest holder in the entity only if the interest holder is not fiscally transparent in its jurisdiction with respect to the item of income and if the entity is considered to be fiscally transparent under the laws of the interest holder's jurisdiction with respect to the item of income.[21]

For purposes of these rules, an entity is generally fiscally transparent under the laws of the entity's jurisdiction with respect to an item of income to the extent that the laws of that jurisdiction require the interest holder in the entity, wherever resident, 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

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"ensure that income of transparent entities is treated . . . in accordance with the principles of the [OECD] Partnership Report").

[19] In fact, it has been noted by one leading treaty commentator that "only in exceptional cases, and only when expressly agreed to by the parties, is the exemption in one contracting state dependent upon whether the income or property is taxable in the other contracting state, or upon whether it is actually taxed there." Klaus Vogel, *Double Tax Treaties* 23, 82-83 (3d ed. 1997).

[20] *See* Walker, *Proceed with Caution: D(e)riving a Hybrid Down the Tax Treaty On-Ramp*, Tax Forum Paper No. 678 (Dec. 5, 2016) (hereinafter, "*Walker*"). At a fundamental level, the decision by a taxing jurisdiction not to assert a tax (or to defer taxation) on an item of income is an exercise of the jurisdiction's power of taxation over the income. For example, if a particular residence country taxes foreign-source business income on a remittance basis (such that the taxpayer is not subject to current tax on the income), the taxpayer would nevertheless be treated as "deriving" the income for treaty analysis purposes. The decision by the residence country's legislature to defer taxation on the income until repatriated is, in effect, an exercise of that jurisdiction's power of taxation over the income.

[21] Treas. Reg. § 1.894-1(d)(1).

in the hands of the interest holder are determined as if the item were realized directly from the source from which realized by the entity.[22]

Similarly, an entity is treated as 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 the interest holder's jurisdiction require the interest holder resident in that jurisdiction separately to 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 the item were realized directly from the source from which realized by the entity.[23]

This basic application of the Derived By Rule can be illustrated by its application to the examples of regular hybrid entities illustrated above in Figures 1 and 2 as well as to the examples of reverse hybrid entities illustrated in Figures 3 and 4 below.[24]

The Derived By Rule will deny treaty benefits to the Canadian members of US LLC in Figure 1 because they are not required under Canadian law to take into account their share of the U.S.-source interest income received by US LLC on a current basis, whether or not distributed. US LLC is not treated as fiscally transparent under Canadian law, and the Canadian members of US LLC are accordingly not treated as deriving their share of the U.S.-source interest income for purposes of the U.S.-Canada income tax treaty.[25]

Similarly, the British, Dutch and German owners in Figure 2 will not be able to claim their respective treaty benefits with respect to the interest income received by the Cayman hybrid entity because the Cayman hybrid is treated as a corporation in each of its members' jurisdictions. If one were alternatively to assume that German law would treat the Cayman entity as a pass-through entity, the German member's share of the U.S.-source interest income would be treated as "derived" by it and U.S. withholding tax on that portion of the interest payment may be eliminated by the U.S.-German tax treaty.[26]

[22] Treas. Reg. § 1.894-1(d)(3)(ii)(A).

[23] Treas. Reg. § 1.894-1(d)(3)(iii)(A). If an item of income is not separately taken into account by the interest holder, the entity is fiscally transparent in the entity's or interest holder's jurisdiction, as the case may be, if the item of income, if separately taken into account by the interest holder, would not result in an income tax liability for that interest holder different from that which would result if the interest holder did not take the item into account separately and the interest holder is required to take into account on a current basis the interest holder's share of all such non-separately stated items of income paid to the entity, whether or not distributed to the interest holder. Treas. Reg. §§ 1.894-1(d)(3)(ii)(A), (d)(3)(iii)(A).

[24] *See also* Treas. Reg. § 1.894-1(d)(5), Ex. 3 (hybrid entity).

[25] Treas. Reg. § 1.894-1(d)(5), Ex. 2 (drawing distinction between interest holders who are required to take into account income whether or not distributed and those who are not).

[26] *See* Treas. Reg. § 1.894-1(d)(5), Ex. 3(hybrid entity).

C. The Hybrid Entity Rules as Applied to Reverse Hybrid Entities

Under the Derived By Rule, treaty benefits are allowed with respect to an item of income earned through a foreign reverse hybrid entity by a treaty country resident interest holder. Assume the same facts as shown above in Figure 2, except that the Cayman entity is classified as a corporation for U.S. tax purposes and as transparent under the laws of its interest holders.

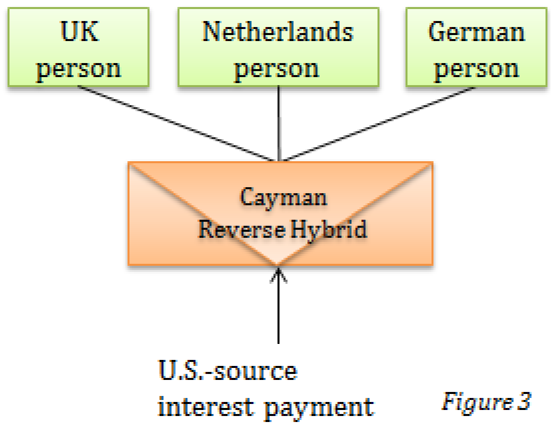

Figure 3

The British, Dutch and German owners in Figure 3 will be eligible to claim their respective treaty benefits with respect to the interest income received by the Cayman reverse hybrid entity because the Cayman hybrid is treated as transparent in each of its members' jurisdictions, notwithstanding that it is classified as a corporation for U.S. tax purposes. If one were alternatively to assume that German law would treat the Cayman entity as opaque, the German member's share of the U.S.-source interest income would not be treated as "derived" by it and U.S. withholding tax on that portion of the interest payment would not be eligible for treaty benefits. The application of the Derived By Rule to foreign reverse hybrids is specifically recognized in the regulations under Section 1441.[27]

By contrast, under the Hybrid Entity Rules, treaties are not available to reduce the U.S. tax liability of a "domestic reverse hybrid entity," both with respect to the entity itself and with respect to the interest holders in the entity.[28] A domestic reverse hybrid entity is a domestic entity that, with respect to the item of income, is treated as not fiscally transparent for U.S. tax purposes and as fiscally transparent under the laws of the interest holder's jurisdiction.

[27] Treas. Reg. § 1.1441-6(b)(4)(iv), Ex. 3 (recognizing the treaty status of an interest holder, but allowing the withholding agent to withhold using the rate applicable to the reverse hybrid or the interest holder, at its option).

[28] Treas. Reg. § 1.894-1(d)(2).

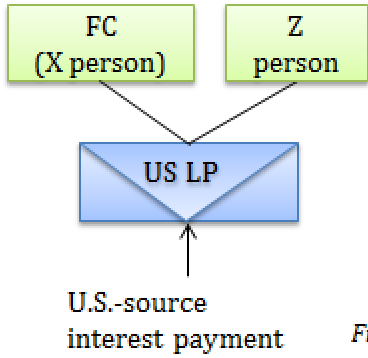

Figure 4

As illustrated in Figure 4,[29] assume US LP, a domestic limited partnership, elects to be classified as a corporation for U.S. tax purposes but is fiscally transparent under the tax laws of country X. Country X is the residence country of FC, an entity that owns an 85% interest in US LP and is not fiscally transparent under country X law. Neither US LP nor FC is entitled to the benefits of the U.S.-country X treaty with respect to U.S.-source income received by US LP.

By contrast, a payment by a domestic reverse hybrid to the foreign interest holder is generally treated as derived by the interest holder (provided the interest holder is not fiscally transparent in its jurisdiction with respect to the item of income, determined for this purpose as if the domestic reverse hybrid entity was not fiscally transparent under the laws of the interest holder's jurisdiction).[30] Thus, using the example given above, if US LP makes a distribution to FC, Section 316(a) determines whether the distribution is a dividend for treaty purposes, and if it is a dividend, the U.S. withholding tax rate is determined by the dividend article of the U.S.-country X treaty.[31] In addition, under Treasury regulation section 1.894-1(d)(2)(ii)(B), certain deductible payments by domestic reverse hybrid entities to related foreign persons are recharacterized as dividends for treaty purposes, and the withholding tax rate is thus determined under the dividend article of the relevant treaties.

III. <u>The Derived By Rule as Applied to Business Profits Not Attributable to a Permanent Establishment</u>

A. Background

As noted, the Hybrid Entity Rules only apply to FDAP.[32] The preambles to the 1997 proposed regulations and to the 2000 final regulations similarly state, without specific

[29] *See* Treas. Reg. § 1.894-1(d)(2)(iii), Ex. 1.

[30] Treas. Reg. § 1.894-1(d)(2)(ii)(A).

[31] *See* Treas. Reg. § 1.894-1(d)(2)(iii), Ex. 2. But this is not the rule under paragraph 7(b) of Article IV of the U.S.-Canada treaty (as amended by the Fifth Protocol to that treaty). *See* Rubinger, *New U.S.-Canada Treaty Protocol Will Affect Both Inbound and Outbound Investments*, 108 J. OF TAX'N (Mar. 2008); NYSBA, TAX SEC., *Canadian-U.S. Treaty Protocol – Payments Through Hybrids* (Rep. No. 1148, Jan. 29, 2008).

[32] Treas. Reg. § 1.894-1(d)(1).

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explanation, that the Hybrid Entity Rules "address only the treatment of U.S. source income that is not effectively connected with the conduct of a U.S. trade or business."[33] The preambles acknowledge, however, that it may be appropriate to extend the principles of the Hybrid Entity Rules to the availability of treaty benefits with respect to business profits earned by fiscally transparent entities.[34]

The basis for the distinction drawn by the Hybrid Entity Rules between FDAP and non-FDAP income is not clear. Treasury's reservations may have been premised on the principle, reflected in most U.S. income tax treaties, that residence state taxation is more appropriate in the context of passive (FDAP) income than with respect to business income, and therefore, it is more appropriate to look to residence-country law in determining the availability of treaty benefits in the FDAP context.[35] Alternatively, Treasury's reservations may stem less from any doubts as to the proper policy outcome and more out of a concern for potential practical obstacles to implementing a hybrid entity regime similar to the Hybrid Entity Rules for business income.

We have previously commented on this issue in the 2010 Report as it applies to a fact pattern where a treaty-eligible foreign corporation has business activities in the United States that are carried on through a domestic hybrid entity.[36] In our 2010 Report, we recommended that the Hybrid Entity Rules should be expanded to disallow treaty benefits in this case because treaty benefits should be limited to cases where there would otherwise be double taxation.[37]

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[33] TD 8722 (June 30, 1997); TD 8889 (July 3, 2000).

[34] TD 8722 ("Treasury and the IRS may issue additional regulations addressing the availability of other tax treaty benefits, such as the application of business profits provisions, with respect to income of fiscally transparent entities."); TD 8889 ("IRS and Treasury may issue additional regulations addressing the availability of other tax treaty benefits, such as the application of business profits provisions, with respect to the income of fiscally transparent entities, particularly where a conflict in entity classification exists.").

[35] This policy justification for the promulgation of the Hybrid Entity Rules is seen in the preambles to both the 1997 proposed and the 2000 final regulations. To quote from the Preamble to 2000 final regulations:

> the basic principle that tax treaties are intended to relieve double taxation or excessive taxation. Accordingly, the United States and its treaty partners agree to cede part or all of their taxation rights on income arising from sources within their respective borders on the mutual understanding that the other party is asserting tax jurisdiction over the items of income. This objective is generally achieved through treaty provisions that limit or eliminate the tax that the source state may impose on income arising within its borders to the extent that the income is considered to be derived by a resident of the other jurisdiction. In general, an item of income will be considered derived by a resident for treaty purposes only when the residence country is asserting taxing jurisdiction over the item of income. TD 8889; s*ee also* TD 8722.

[36] 2010 Report at 9-11.

[37] *Id.*

The 2010 Report recommended that the Hybrid Entity Rules should apply to both business profits and the BPT (which we discuss in more detail in **Part IV** of this report) in the same way that they apply to FDAP. The 2010 Report recommended a change to the Section 894 regulations both in the case of a "regular" hybrid and a "reverse" hybrid; and, in the case of a reverse hybrid, recommended that the regulations specify that they apply to FDAP as well as business profits. Thus, if a foreign corporation is subject to tax in its home jurisdiction on business profits it earns through a foreign reverse hybrid entity operating directly in the United States, treaty benefits should apply to reduce the U.S. tax on those profits (to the extent not attributable to a permanent establishment), or to the extent that the business profits are attributable to a permanent establishment, treaty benefits should apply to reduce the BPT.

B. Treaty Provisions Applying Hybrid Entity Rules to Non-FDAP Income

Modern U.S. income tax treaties often include specific provisions addressing hybrid entities, which supplant the regulatory rules. These provisions generally adopt the same Derived By Rule as the Hybrid Entity Rules adopt, allowing treaty benefits to be claimed only for income "derived by or through" a hybrid entity based on the entity's classification in its or its holders' respective jurisdictions.

Unlike the Hybrid Entity Rules, modern treaty hybrid provisions are often not limited to FDAP. For example, the U.S.-Canada treaty has a broadly drafted provision that treats income as "derived" through an entity only when the owner country treats the entity as fiscally transparent, with no stated limit on the applicable scope of that test.[38] That treaty's legislative history makes clear that the provision is intended to apply not only to portfolio income but also to business income. Treasury's technical explanation of the fiscal transparency rule contained in the 2007 protocol to the Canada-U.S. treaty specifically describes the rule as applying to business profits:

> New paragraph 6 applies not only in respect of amounts of dividends, interest and royalties, but also profit (business income), gains and other income. It may thus be relevant in cases where a resident of one Contracting State carries on business in the other State through an entity that has a different characterization in each of the two Contracting States.

Another example is the 2003 U.S.-Japan treaty, which contains one of the most detailed variations of the fiscally transparent entity provision. In general, the provisions are consistent with the principles underlying the Hybrid Entity Rules, but they are not limited to withholding taxes and thus apply to all taxes covered by the treaty. Unlike the more general statement in the 2006 Model Treaty[39] discussed below, Article 4(6) of the U.S.-Japan treaty sets out five specific

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[38] The U.S.-Canada treaty is broader than the Derived By Rule in other respects as well. *See* NYSBA, TAX SEC., *Canadian-U.S. Treaty Protocol – Payments Through Hybrids* (Rep. No. 1148, Jan. 29, 2008); Rubinger, *New U.S.-Canada Treaty Protocol Will Affect Both Inbound and Outbound* Investments, 108 J. OF TAX'N (Mar. 2008).

[39] United States Model Income Tax Convention of November 15, 2006 (the "2006 Model Treaty").

fact patterns and provides results with respect to each. In addition, the protocol accompanying the U.S.-Japan treaty provides specific guidance regarding the application of the provisions to a *tokumei kumiai*, and Treasury's technical explanation of the U.S.-Japan treaty elaborates on the treatment of hybrid entities in additional contexts. One reason for the level of detail (which was likely important for the Japanese representatives) was that under Japanese domestic law, an item of income is generally not "deemed" to belong to another taxpayer, and thus Japanese domestic law lacks the concept found under U.S. domestic law that allows an item of income to flow from a partnership or other fiscally transparent entity up to its beneficiaries, members or participants.[40] Thus, the provisions served to ensure that the terms were understood by both parties to the agreement.

Although somewhat less explicit and detailed than either the U.S.-Canada treaty or the U.S.-Japan treaty,[41] the 2006 Model Treaty's hybrid entity provision also does not appear to be limited to FDAP. Article 1(6) of the 2006 Model Treaty provides as follows:

> 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 laws of such Contracting State as the income, profit or gain of a resident.[42]

The technical explanation of the 2006 Model Treaty explains as follows:

> The intention of paragraph 6 is to eliminate a number of technical problems that arguably would have prevented 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 the use of such entities to claim treaty benefits in circumstances where the person investing through such an entity is not subject to tax on the income in its State of residence.

The technical explanation goes on to say that "the requirements of the substantive rules of Articles 6 through 21 [*i.e.*, inclusive of both FDAP and non-FDAP income] should be read with

[40] Joint Committee of Taxation ("**JCT**"), Explanation of Proposed Income Tax Treaty between the United States and Japan, 46 (Feb. 19, 2004).

[41] In our report on the 2006 Model Treaty, we commented that the 2006 Model Treaty technically applies to any item of income and thus seems to include income that would be taxable under Section 871(b) or Section 882. 2007 Report, at 21.

[42] Article 1(6) of the 2016 Model Treaty contains a similar provision with only minor drafting differences. As of the date of this report, the Treasury Department has yet to issue its technical explanation of the 2016 Model Treaty.

those two goals in mind." Thus, consistent with the principles underlying the Hybrid Entity Rules, Article 1(6) of the 2006 Model Treaty looks to the tax laws of the country of residence to determine whether a person is considered to have earned the income for which treaty benefits are being claimed, with respect to both FDAP and non-FDAP income.[43]

The United States has entered into a number of treaties and protocols with comparable provisions. For example, in addition to Canada and Japan, the U.S. treaty with each of Belgium, Finland, France, Germany, Iceland, Sweden and the United Kingdom contains a provision similar to Article 1(6) of the 2006 Model Treaty, quoted above. Thus, it appears that under these treaties, business profits earned by or through a hybrid entity would only qualify for treaty benefits if treated as income of a resident of the treaty jurisdiction in the hands of the entity or in the hands of its owners.[44]

C. The Derived By Rule as Applied to Non-FDAP Income

Again, under current law, the Derived By Rule does not apply to business profits, and the availability of treaty benefits with respect to business income earned through a hybrid entity is uncertain in a number of respects. This **Part III.C** explains, through the use of examples, our proposals for applying the Derived By Rule to business profits.

We believe that, from a policy perspective, the Derived By Rule should be applied to non-FDAP income. In a number of fact patterns, the Derived By Rule is easily extended to non-FDAP income. In other cases, however, there may be administrative or practical impediments to applying the Derived By Rule to business income, and those impediments may or may not outweigh the importance of achieving the underlying policy objectives of the Derived By Rule.

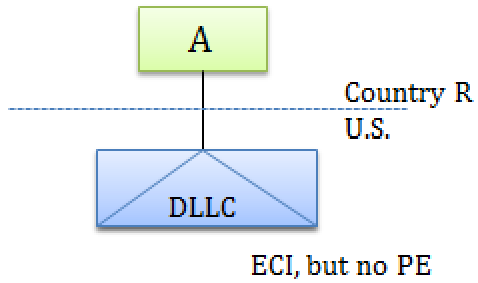
Example (1) (domestic hybrid entity; no PE). Assume Corporation A is a qualified resident of Country R,[45] which has an income tax treaty with the United States with language tracking the

[43] In addition, the 2006 Model Treaty defines an "enterprise" to include an enterprise conducted by a resident of a contracting state through an entity treated as fiscally transparent in that state. This definition, read in conjunction with the operative Business Profits article, could be read to suggest that a hybrid entity's business profits are not profits "of an enterprise of" its owner (the resident in the other contracting state), and, consequently, the business profits are not entitled to the protection of the Business Profits article.

[44] It has been reported, however, that at least in one case, the IRS has informally declined to agree that a similar provision then found in Article 4(2)(B)(iv) of the U.S.-French treaty (prior to revision in the 2009 protocol) was applicable to the BPT, notwithstanding that the provision was broadly drafted and is not, by its terms, limited to FDAP. The provision stated that, "[t]he term 'resident of a Contracting State' includes a partnership or similar pass-through entity . . . but only to the extent that the income derived by such partnership [or] similar entity . . . is subject to tax in the Contracting State as the income of a resident, either in the hands of such partnership or entity . . . or in the hands of its partners, beneficiaries, or grantors."). *See generally* Miller and Zhang, *Reflections on the Application of Income Tax Treaties to Hybrid Entities That Earn Non-FDAP Income*, 36 INT'L TAX J. 5 (Jan.-Feb. 2010).

[45] For ease of reference, we have adopted the following conventions: "Country R" generally refers to the country of residence, "Country H" generally refers to the jurisdiction in which the regular or reverse hybrid entity is organized (where it is organized in a country other than the residence or source country), and our examples generally assume that the United States is the source country.

2006 Model Treaty. Corporation A forms a domestic limited liability company ("**DLLC**") treated as a disregarded entity for U.S. tax purposes and as a corporation under Country R law. DLLC operates a business in the United States and earns business profits that are treated under U.S. tax law as income effectively connected with a U.S. trade or business ("**ECI**"). DLLC's business activities do not constitute a permanent establishment ("**PE**") in the United States.



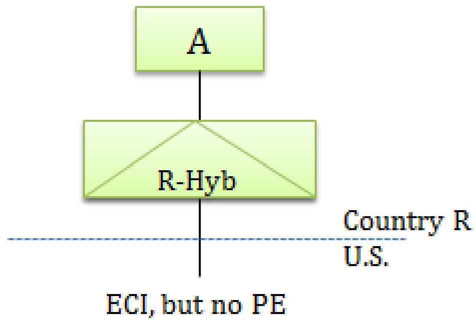
Applying the Derived By Rule to the facts in Example (1), Corporation A would not be able to claim treaty benefits under the U.S.-Country R treaty because Corporation A does not derive the business profits earned by DLLC, under Country R law.

Note that had Corporation A operated the U.S. business directly or through a legal branch, the business profits earned by Corporation A's U.S. activities would be treated as derived by Corporation A (because Country R would directly "see" the business profits) and would therefore qualify for treaty benefits. The same distinction is also extant in the FDAP context, where the Derived By Rule allows for treaty benefits for FDAP directly earned by a qualified resident as opposed to FDAP earned through a domestic hybrid entity. This is appropriate, as the policy objective of avoiding both double taxation and double non-taxation,[46] applies equally in both the FDAP and non-FDAP income contexts.

[46] As discussed in **Part II.B** above, the fundamental policy consideration reflected in the Derived By Rule does not ask whether the item of income is subject to actual double taxation or actual double non-taxation. Rather, the question is whether the item of income is "seen" by one or more taxing jurisdictions and included in the "notional" tax base of those jurisdictions. Thus, even if, for example, Country R taxed Corporation A's foreign-source business income earned through a U.S. branch on a remittance basis (such that Corporation A was not subject to current tax on the income), Corporation A would nevertheless be treated as "deriving" the income for treaty analysis purposes. The decision by Country R's legislature to defer taxation on the income until repatriated is, in effect, an exercise of Country R's power of taxation over the income. It should be noted, however, that the approach reflected in the Derived By Rule is not uniform across treaty access rules nor entirely consistent with other provisions which look to actual, not notional, taxation by the residence country. For example, many treaties contain a "triangular branch" provision intended to limit treaty benefits for income attributable to a third-country PE if little or no tax is paid in the PE's jurisdiction and the residence state of the head office does not require the entity to recognize the income attributable to the third-country PE. Triangular branch provisions prevent such arrangements by denying certain treaty benefits to income attributable to a PE that the treaty resident entity maintains in a third-country if the combined rate of tax imposed by the third-country and head office residence country is less than a specified percentage (typically, 50% or 60%) of the tax that would have applied had the income been earned by the head office directly rather than through the PE. If the combined tax of the residence countries of both the finance branch and the treaty resident is less than this threshold, the United States, as source country, is not required to grant treaty relief from withholding tax on the income. Conversely, if the third country taxes the income at a rate at or above the relevant threshold, treaty benefits would be allowed, notwithstanding that the source country may not tax

(continued...)

Example (2) (foreign hybrid entity; no PE). Same as Example (1) except that Corporation A operates the U.S. business through a Country R hybrid entity ("**R-Hyb**"). R-Hyb is classified as a corporation for Country R purposes but elects to be treated as a pass-through for U.S. tax purposes.

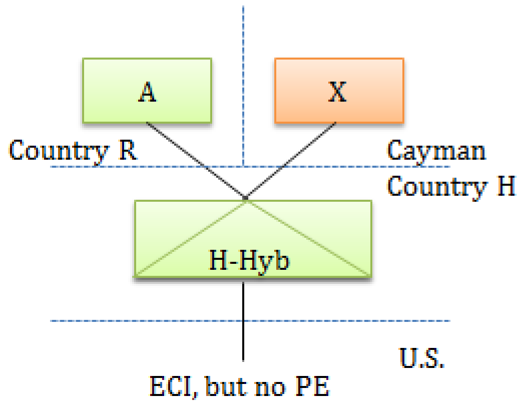


Applying the Derived By Rule here, the income is treated as "derived by" R-Hyb because R-Hyb is required to take the income into account under Country R's tax laws. R-Hyb should therefore be permitted to claim treaty benefits under the Business Profits article of the U.S.-Country R treaty, provided it meets the limitation on benefits article. This conclusion also seems appropriate, does not give rise to any material policy challenges and is consistent with the result reached under the existing Hybrid Entity Rules for FDAP.

Example (3) (foreign hybrid with multiple owners). Corporation A is a resident of Country R, and Corporation X is a Cayman resident. Corporation A and Corporation X form H-Hyb, a Country H entity treated as opaque in Country H and as a pass-through for U.S. tax purposes. H-Hyb operates a U.S. business that earns ECI, but H-Hyb does not have a PE in the United States. Country H has an income tax treaty with the United States, tracking the language of the 2006 Model Treaty.

(continued...)

the income at all. Thus, the principle reflected in the triangular branch provision looks to the degree to which the income is subject to actual taxation, an approach obviously different from the question asked by the Derived By Rule, which looks only to whether the residence country "sees" the income.



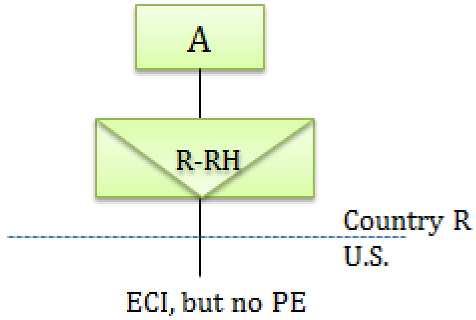
Applying the Derived By Rule to this example, the ECI is "derived by" H-Hyb, a resident of Country H. Thus, H-Hyb can claim treaty benefits under the Business Profits article of the U.S.-Country H treaty provided it meets the limitation of benefits provisions of that treaty. This example illustrates that as a result of the Derived By Rule, Corporation X, which is not a resident of a tax treaty jurisdiction, can collaterally benefit from the treaty benefits enjoyed by H-Hyb (just as Corporation A, which is a treaty resident of Country R, can).

Some have questioned whether it is appropriate to allow a Cayman resident to enjoy U.S.-Country H treaty benefits indirectly. However, this result exists under the current Hybrid Entity Rules for FDAP as well. The justification for this result in the FDAP context, that income subject to tax in the residence country should not be additionally subject to tax in the source country, applies equally to business profits. Therefore, as long as H-Hyb satisfies the U.S.-Country H treaty limitation on benefits requirements, we do not think it should be denied treaty benefits because of the status of its ultimate owners.

Note that if Country R treated H-Hyb as transparent for its tax purposes, Corporation A would also be able to claim treaty benefits under the U.S.-Country R treaty because the income would be treated as "derived by" Corporation A for Country R tax purposes. Although all of the U.S. treaties provide for a 0% rate on business profits where there is no PE, treaties can vary in their definitions of a PE. It can therefore be relevant for Corporation A to claim treaty benefits under the U.S.-Country R treaty in situations where the U.S.-Country H treaty defines a PE more broadly than the U.S.-Country R treaty does.[47]

Example (4) (foreign reverse hybrid entity; no PE). Same as Example (1) except that Corporation A operates the U.S. business through a Country R reverse hybrid entity ("**R-RH**"). R-RH is fiscally transparent for Country R tax purposes but elects to be treated as a corporation for U.S. tax purposes.

[47] This is further illustrated in Example (4), *infra*.



Applying the Derived By Rule here, the income is treated as "derived by" Corporation A because R-RH is transparent for Country R tax purposes. Corporation A is therefore eligible to claim treaty benefits under the Business Profits article of the U.S.-Country R treaty.

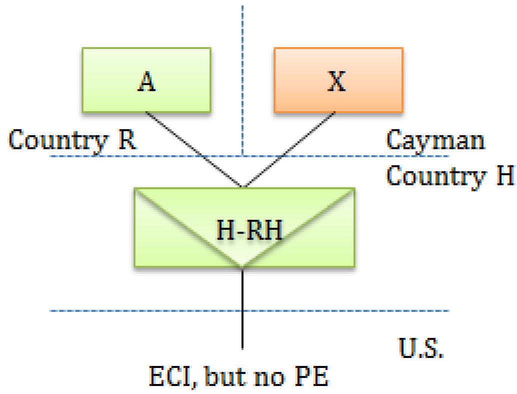
From a U.S. perspective, R-RH is a foreign corporation with income effectively connected with a U.S. trade or business, and is therefore required to file a U.S. tax return reporting the ECI. Presumably, R-RH would include an IRS Form 8833 disclosing that its return reflects a treaty-based return position.[48] Corporation A, in turn, could establish its treaty eligibility by providing R-RH with beneficial ownership documentation, similar to the regime currently in place for owners of a foreign reverse hybrid entity claiming a reduced rate of U.S. withholding tax with respect to FDAP under an income tax treaty.[49]

Note that if Corporation A engages in a U.S. trade or business through a third-country reverse hybrid entity, it is Corporation A's home country's treaty that is relevant for purposes of determining benefits under its treaty, regardless of whether the third country has an income tax treaty with the United States (unless benefits are to be claimed under the third-country treaty because the entity is not transparent there). For example, extended services result in a PE under the PE clauses of the Canadian and Indian treaties, which is not the case under other treaties. Thus, if a Canadian reverse hybrid entity provides extended services in the United States, and the entity's sole owner is a U.K. resident, the service income is derived by the U.K. owner, assuming the entity is treated as a pass-through under U.K. tax law. Because under the U.S.-U.K. treaty there is no PE, the U.K. owner should be exempt from U.S. taxation, notwithstanding that there is a PE under the U.S.-Canada treaty.

[48] A foreign corporation that is engaged in a U.S. trade or business that does not constitute a PE and that is claiming treaty benefits is required to file IRS Form 1120-F (U.S. Income Tax Return of a Foreign Corporation) and IRS Form 8833 (Treaty-Based Return Position Disclosure Under Section 6114 or 7701(b)). *See* Section 6114(a); Treas. Reg. §§ 301.6114-1(b)(5)(i) (requiring a foreign corporation or nonresident alien to report a treaty position that income that is effectively connected with a U.S. trade or business is not attributable to a permanent establishment or a fixed base of operations in the United States and, thus, not subject to net-basis taxation); *see also* Instructions to IRS Form 1120-F (U.S. Income Tax Return of a Foreign Corporation), at 2.

[49] Treas. Reg. § 1.1441-6(b)(2) (allowing withholding to be based on "flow-through withholding certificates").

Example (5) (foreign reverse hybrid with owners in multiple jurisdictions). Assume the same facts as in Example (3) except that the Corporation A and Corporation X conduct the business through H-RH, a Country H partnership treated as transparent for Country H tax purposes but as opaque for U.S. tax purposes (either by reason of a check-the-box election or by default).[50]



Applying the Derived By Rule, H-RH would not be permitted to claim treaty benefits because it is transparent for Country H tax purposes. Corporation A, however, may be entitled to treaty benefits if Country R treats H-RH as transparent for Country R tax purposes and Corporation A's allocable share of this income is subject to tax in Country R. Corporation X would not be entitled to treaty benefits.

However, this result presents certain practical challenges. Because H-RH is treated as a foreign corporation for U.S. tax purposes, H-RH would be required to pay U.S. taxes associated with the business income. As discussed above, applying the Derived By Rule would allow H-RH to reduce the income tax liability shown on its tax return to reflect Corporation A's claim of treaty benefits with respect to the portion of the income allocable to Corporation A. Presumably, H-RH would include an IRS Form 8833 disclosing that its return reflects a treaty-based return position, and Corporation A would provide H-RH with beneficial ownership documentation certifying its treaty eligibility.

It is not clear, however, under what principles H-RH would determine the amount of income allocable to Corporation A for this purpose. As an example, a regime could look only to U.S. tax principles, similar to the one currently in place under Section 1446 in the context of a partnership's withholding on ECI allocable to a foreign partner. Under this approach, treaty benefits will be available to the extent the U.S. tax law would allocate income to Corporation A if H-RH were a partnership for U.S. tax purposes. Alternatively, the amount of income allocable to Corporation A could be calculated exclusively under Country R principles, under the theory that it is a Country R resident that is claiming the treaty benefit with respect to its income. Or, as a third alternative, U.S. tax principles could be used to determine the amount of income at the H-

[50] For example, if each member of H-RH has limited liability, H-RH would by default be treated as a corporation for U.S. tax purposes, absent an election otherwise. Treas. Reg. § 301.7701-3(b)(2)(i)(B).

RH level, while Country R principles could be applied for purposes of determining how to allocate that income between Corporations A and X.

These alternative approaches would produce different U.S. tax consequences, because treaty resident countries may have entirely different rules for including items of income and allowing items of deduction, and also for determining the timing of these inclusions and deductions. The United States would tax H-RH's business income on a net basis, taking into account all of the items of H-RH's business income, gain, loss or deduction. The portion of that tax properly allocable to Corporation A under Country R principles may not be easily determinable. For example, if H-RH's partnership agreement, like a typical limited partnership agreement, had a distribution waterfall provision that included a preferred return and/or a "catch-up" between Corporation A and Corporation X, these provisions presumably would need to be taken into account in determining the amount of H-RH's treaty reduction.

Although these questions are present to a lesser extent in the FDAP context as well, the issue is less complex in that context, because FDAP withholding is imposed with respect to each specific item of income separately. In the FDAP context, the allocation principle can be illustrated by the following numerical example.

Assume that H-RH has an operating agreement that provides for targeted allocations and has the following distribution waterfall: In a liquidation or a hypothetical liquidation, 1) all assets will be distributed to Corporation A until Corporation A recovers its capital and receives an IRR of 8% to the extent out of net profits; 2) then all assets will be distributed to Corporation X until Corporation X recovers its capital; 3) thereafter, all assets will be distributed proportionally to Corporation A and Corporation X on an 80%-20% split. Assume further that Corporation A and Corporation X respectively contributed $800 and $200 when H-RH was formed. This is a simplified formulation of common targeted allocation provisions.

Assume that H-RH does not have any income or loss in the first two years, and its assets do not depreciate in value. In the third year, H-RH receives a $100 U.S.-source dividend, earns $500 of foreign-source income that is unrelated to its U.S. trade or business, and promptly liquidates. Under H-RH's distribution waterfall and targeted allocation provisions, Corporation A will be allocated $1,321.56 (including $800 return of capital, $207.80 IRR on capital for a three-year period and $313.76 of Corporation A's proportionate share of the remaining income), and Corporation X will be allocated $278.44 (including $200 return of capital and $78.44, 20% of the income remaining after taking into account Corporation A's 8% IRR). Therefore, Corporation A will have income of $521.56, representing roughly 87% of H-RH's $600 of income, and Corporation X will have income of $78.44, representing approximately 13% of H-RH's $600 of income. Both classes of income will be treated as earned by Corporation A and Corporation X in this proportion. Therefore, of the $100 U.S.-source dividend income, Corporation A will be treated as deriving $87 and can thus claim U.S.-Country R treaty benefits at a reduced or eliminated rate with respect to this portion of that U.S.-source income. On the other hand, the $13 of U.S.-source dividend derived by Corporation X is subject to the full 30% withholding tax.

In the business profits context, this mechanism of looking only at U.S. allocation principles could also work. Assume the same example as above except that instead of earning

$100 of U.S.-source FDAP, H-RH earns $100 of net ECI. If H-RH does not have a PE under the U.S.-Country R treaty, the treaty would exempt Corporation A's $87 share of the ECI from tax, while Corporation X's $13 share of the ECI would be subject to U.S. tax.

We note that Country R and the U.S. could have tax base differences; however, this should not be a concern under the Derived By Rule. As long as an item of income or deduction is "seen" by the residence country, whether it actually taxes the income or allows the deduction should be irrelevant. To simplify the administration of the Derived By Rule in this context, we recommend that the proportion of income that is treaty eligible be determined based on U.S. principles, as if the entity was a partnership for U.S. tax purposes.

D. Certain Collateral Considerations and Consequences of Extending the Derived By Rule

1. Imputation of PE

A fixed place of business in the United States of a partnership is generally attributed to a foreign person that is a limited or general partner in the partnership for purposes of determining whether the partner has a PE.[51] For example, in *Donroy, Ltd. v. United States*, for example, the Ninth Circuit held that for purposes of taxing industrial or commercial profits under the 1942 Canadian treaty, a limited partnership should be treated as an aggregate of its partners, and, thus, each partner should be treated as owning an undivided interest in the assets of the partnership and as a general agent of the other partners.[52]

Where the entity is treated as opaque in one of the jurisdictions, there can be a difference in approach between the two jurisdictions regarding whether the business profits are attributable to a PE. The general treaty rule, that source-country tax principles control when there is a question of law,[53] can lead to odd results when applied in this context, as illustrated in Example (6).

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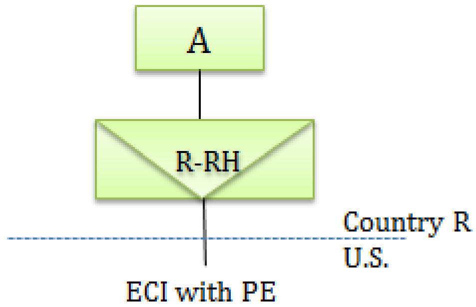
[51] *E.g.*, *Donroy, Ltd. v. United States*, 301 F.2d 200 (9th Cir. 1962); *Unger v. Comm'r*, 936 F.2d 1316 (D.C. Cir. 1991) (Canadian dentist who was limited partner in Massachusetts real estate partnership was taxed based on PE of the partnership); *Johnston v. Comm'r*, 24 TC 920 (1955); Rev. Rul. 91-32, 1991-1 CB 107; Rev. Rul. 90-80, 1990-2 CB 170; GCM 38201; Priv. Ltr. Ruls. 8316109, 541205720A. C*f*. Priv. Ltr. Rul. 7923075 (joint venture between French corporation and U.S. corporation did not result in a PE for French co-venturer where costs were not shared and no deemed partnership found).

[52] *Donroy, Ltd. v. United States*, 301 F.2d 200 (9th Cir. 1962).

[53] *See* Article 3(2) of the 2006 Model Treaty ("As regards the application of the Convention at any time by a Contracting State any term not defined therein shall, unless the context otherwise requires . . . have the meaning which it has at that time under the law of that State for the purposes of the taxes to which the Convention applies . . ..").

Example (6) (attributing PE status from a reverse hybrid entity). Assume the same facts as in Example (4) except that R-RH's U.S. trade or business gives rise to a PE.[54]



Under U.S. law, R-RH (and not its partners) has a PE in the United States under the U.S.-Country R treaty, because R-RH is classified as a corporation for U.S. tax purposes.[55] As noted above, the general treaty rule is that source-country tax principles control where there is a question of law. Under U.S. law, there is no PE under the U.S.-Country R treaty with respect to A, and Corporation A is the resident claiming treaty benefits. Does that mean that Corporation A can claim treaty benefits with respect to R-RH's income, such that it would not be subject to U.S. tax on the business profits? Assuming the U.S.-Country R treaty is silent on this issue, this seems like an inappropriate result, because the income is derived through a PE in the United States under the U.S.-Country R treaty.

We think that the better approach would be to impute a PE to the interest holder of a reverse hybrid entity where the reverse hybrid itself has a PE, solely for the purpose of determining whether income from the reverse hybrid is entitled to treaty relief. We therefore recommend that, if Treasury and the IRS extend the Derived By Rule to business profits earned through a reverse hybrid entity, guidance be issued clarifying that a PE of the reverse hybrid entity is attributed to its interest holders to the extent those interest holders would otherwise be entitled to claim treaty benefits with respect to the entity's business profits.

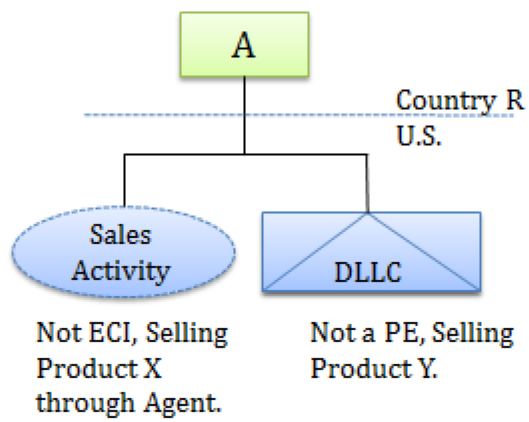
This recommendation is also in line with the Consistency Principle discussed in Example (8) below. It seems inappropriate and inconsistent to allow the interest holder to claim treaty benefits on the theory that it should be treated as deriving the income through the reverse hybrid, because the reverse hybrid is treated as transparent in the interest holder's jurisdiction, and at the same time to treat the reverse hybrid as opaque for purposes of not attributing to the interest holder the PE of the reverse hybrid with respect to which the income is attributable.

[54] *See OECD Partnership Report*, at 32. Note that the converse situation (*i.e.*, where the income is earned through a foreign hybrid entity) would not give rise to this issue because business profits earned by an entity treated as fiscally opaque for Country R tax purposes would not be treated as "derived" by Country R residents and would therefore not qualify for treaty benefits under the Derived By Rule.

[55] It may be the case that under general agency principles, Corporation A would be treated as having a PE in the United States under Country R law by virtue of being a partner in R-RH. *See OECD Partnership Report*, at 32. However, we think that a PE attribution rule turning on the treaty counterparty's agency principles is not warranted and, as noted in the text, is not consistent with general treaty principles.

2. Force of Attraction and Interest Expense Allocation Considerations

Example (7) (interaction of limited force of attraction rule and trade or business operated by domestic hybrid entity). Assume Corporation A, a Country R resident, manufactures Product X in Country R and sells the product in the United States through an independent contractor, such that Corporation A does not have a U.S. trade or business by reason of its sales of Product X. Corporation A also forms DLLC to sell Product Y in the United States, and those sales activities constitute a U.S. trade or business under Section 864 but do not constitute a PE of Corporation A under the U.S.-Country R Treaty. DLLC is treated as opaque under Country R law and as a disregarded entity for U.S. tax purposes.



Applying the Derived By Rule to the income earned through DLLC from the sale of Product Y, Corporation A would not be entitled to claim treaty benefits, notwithstanding the absence of a PE, because Corporation A is not treated as "deriving" the income. In addition, under the limited force of attraction rule of Section 864(c), Corporation A's non-FDAP U.S.-source income from Product X is treated as effectively connected with Corporation A's trade or business operated by DLLC. It has been suggested that the sales income from Product X may not be eligible for treaty benefits, because it is effectively connected with the U.S. trade or business of DLLC under the limited force of attraction rule and DLLC's income is not entitled to treaty protection under the Derived By Rule.[56]

We believe, however, that Corporation A should be permitted to claim treaty benefits with respect to Corporation A's income from the sale of Product X. Because the sales activity income is earned directly by Corporation A, the Business Profits article of the U.S.-Country R treaty should protect the income from U.S. tax regardless of whether or not Corporation A has other activities that do not qualify for treaty benefits.

It is true that under the longstanding limited force of attraction rule, the income is treated as effectively connected with the conduct of a U.S. trade or business, and income earned by Corporation A through DLLC's U.S. business is not eligible for treaty benefits, because DLLC is

[56] *See* Walker, at 34-35.

treated as opaque for Country R purposes. However, it seems appropriate to distinguish between Corporation A's income earned through DLLC, on the one hand, and Corporation A's income earned directly but treated as effectively connected with Corporation A's U.S. trade or business, on the other hand. In the case of the former, the income is not subject to tax in Country R and therefore would not be entitled to treaty benefits under the Derived By Rule. In the case of the latter, by contrast, the income is subject to tax in Country R and should therefore be eligible for treaty benefits. The fact that the United States treats this income as effectively connected with a U.S. trade or business does not mandate that the United States apply the treaty to the sales income in the same manner the treaty is applied to DLLC's income.

Moreover, and perhaps more fundamentally, the limited force of attraction rule as embodied in Section 864(c)(3) does not require that the Product X income be treated as effectively connected with *the Product Y* trade or business; it provides only that in the case of a foreign taxpayer engaged in a U.S. trade or business, U.S.-source non-FDAP income shall be "treated as effectively connected with the conduct of *a trade or business within the United States*."[57] Because the Code does not treat the relevant income as effectively connected with a specific U.S. trade or business, but just as "effectively connected income," the determination of whether or not Corporation A is entitled to treaty benefits with respect to the Product X income should not depend on whether the Product Y income is eligible for treaty benefits.

A variation of this issue arises with respect to the allocation of interest or other expenses in computing ECI. Assume, for example, that DLLC's activities in Example (7) constitute a PE. Under treaty principles, branch profits treated as attributable to a PE are determined by treating the branch as an independent corporation dealing with its head office on an arm's-length basis.[58] Accordingly, branch borrowings, branch swaps and branch licenses of property from the parent corporation, normally disregarded for U.S. tax purposes, would be regarded and respected to the extent they satisfied the arm's-length standard, and business profits not attributable to a PE are excluded. Conversely, in determining the ECI of a U.S. trade or business under general tax principles, interest expense on interbranch borrowings (and interest income on interbranch loans) is disregarded and the interbranch loans are not treated as "U.S. assets" in calculating the foreign company's U.S. interest expense deduction.[59]

Where DLLC's activities constitute a PE, there are two independent and alternative bases for subjecting the ECI to U.S. taxation. One is that the treaty does not provide for a reduced U.S.

[57] Emphasis added.

[58] *See, e.g.*, Article VII(2) of the 2006 Model Treaty. *See generally Nat'l Westminster Bank v. U.S.*, 512 F.3d 1347 (Fed. Cir. 2008) ("**NatWest**").

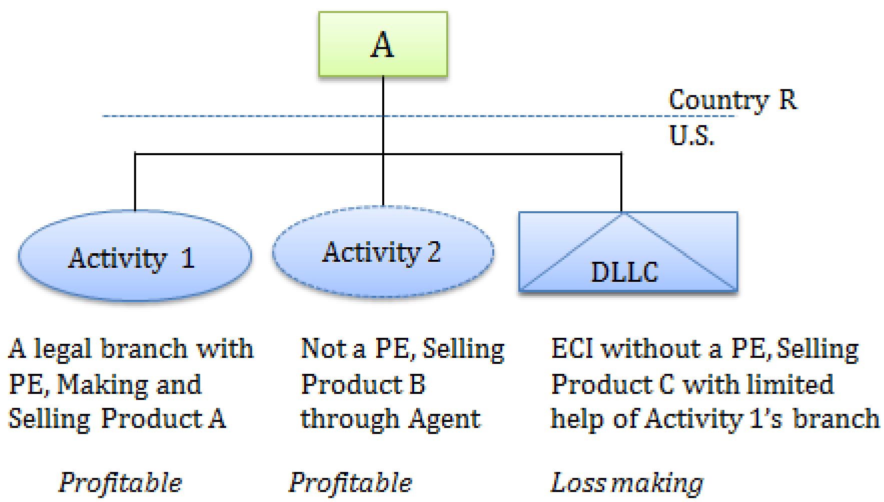
[59] Treasury regulation section 1.882-5 contains a statutory formula for calculating the amount of interest expense a foreign entity is permitted to allocate to the U.S. branch for purposes of determining ECI. For purposes of those rules, inter-branch transactions are disregarded (*e.g.*, interest payments from U.S. branch to foreign parent). Historically, some foreign banks took the position that under Article 7(3) of most treaties, expenses are allocated using a "separate entity" approach, which allows the taxpayer to respect inter-branch payments (and reduce ECI accordingly). The court in *NatWest* held for the taxpayer and found that the Section 1.882-5 formulary apportionment regime is inconsistent with Article 7(3) of the U.S.-U.K. treaty.

tax rate on ECI where the income is attributable to a PE. The second is that Country R does not "see" the income under the Derived By Rule, and Corporation A is therefore not eligible to claim treaty benefits even where the treaty does provide for a reduced rate. Although either alternative would disallow treaty benefits, the calculation of the amount subject to tax would differ depending on which approach is taken. If treaty benefits are denied on the basis that the income is attributable to a PE, the amount taxable would be determined under treaty principles on an enterprise-by-enterprise basis. Denying treaty benefits on the basis of the Derived By Rule, by contrast, makes treaty principles inapplicable in determining the allocation of expenses to DLLC's income, and Treasury regulation section 1.882-5 principles would apply instead.

We believe that applying section 1.882-5 principles to determine the amount of DLLC's income is the better approach. The United States should not be required to ignore domestic law and use treaty principles for the purpose of calculating the amount of U.S. tax imposed where the income is not "seen" by the treaty counterparty.

3. Treaty Consistency Considerations

Example (8) (treaty consistency considerations). Same as in Example (7) except that DLLC's business activities generate a loss and Corporation A also conducts a third activity which generates income and constitutes a PE in the United States (*i.e.*, Activity 1 and Activity 2 are profitable, while DLLC generates a loss).



As discussed above, the 2006 Model Treaty determines taxability and attributes taxable income with respect to income attributable to a PE on an enterprise-by-enterprise basis.[60] However, if we applied the Derived By Rule in this fact pattern, Corporation A would not be entitled to treaty benefits with respect to the business profits earned through DLLC because Corporation A has not "derived" the income under Country R law. The question then arises

[60] *See* Article 7(1). *See generally* NYSBA, TAX SEC., *Treaty Consistency Principle* (Rep. No. 1325, Jul. 14, 2015).

whether Corporation A can use the losses incurred by DLLC to offset the income attributable to Activity 1's PE, which is subject to tax.

Under what is known as the "**Consistency Principle**," the Service has taken the position that it is inappropriate for a taxpayer to elect to utilize tax treaty benefits and Code benefits inconsistently, at least with respect to the same class of income in the same tax year.[61] In Revenue Ruling 84-17, the taxpayer conducted a profitable business, *A*, through a PE. The taxpayer sought to elect treaty benefits to avoid paying U.S. tax on income from a separate profitable business, *B*, not involving a U.S. PE, while simultaneously electing Code principles and forgoing the treaty in order to use losses from yet another separate business, *C*, not attributable to a U.S. PE, to offset profits from business *A* attributable to the U.S. PE. The taxpayer's cherry-picking of Code and treaty benefits was deemed inappropriate in this case, because the taxpayer would end up paying less tax to the United States on business *A* than the negotiated treaty benefit prescribed.

However, it appears that a basic premise of the Consistency Principle is that the taxpayer has affirmatively elected the application of both domestic law and treaty principles in an inconsistent manner. Where, in contrast, the unavailability of treaty benefits with respect to the loss-producing activity was not by election of the taxpayer but by function of the Derived By Rule, the Consistency Principle arguably should not come into play, and the taxpayer may well argue that the losses from *C* can be used, under domestic law principles, to offset the income from *A*.

As applied to the facts in Example (8), Corporation A would therefore argue that DLLC's losses are not "seen" by Corporation A, because DLLC is treated as opaque under Country R principles. Corporation A is therefore not "electing" to apply treaty principles to either gain or loss produced from that activity and should therefore be permitted to use domestic law principles to offset DLLC's losses against Corporation A's income from the sales activity.[62]

We believe this result is appropriate. The premise of the Derived By Rule is that the United States should be permitted to exercise taxing jurisdiction over items of income, gain, loss or deduction to the extent those items are not taken into account in the residence country's notional tax base, and should not be permitted to exercise taxing jurisdiction over those items to the extent taken into account in the residence country's notional tax base. In the case of a resident's income attributable to a PE in the source country, the treaty parties have agreed that the source country has the first bite of the apple. It therefore follows that source-country principles should apply in determining the amount of that income that is subject to tax by the source country. Thus, U.S. tax principles should apply, and Corporation A should be permitted to offset DLLC's losses against the PE income subject to U.S.-source taxation.

[61] *See* Rev. Rul. 84-17, 1984-1 C.B. 308. This report is not intended to address whether the Consistency Principle should be interpreted as "strong" or "weak" consistency, and generally assumes that the less controversial weak consistency principle applies as applicable. *See* Land, *Treaty Consistency*, 66 TAX LAW. 113 (2012); NYSBA, TAX SEC., *Treaty Consistency Principle* (Rep. No. 1325, Jul. 14, 2015).

[62] *See* Walker, at 35-36.

Of course, on the facts posited in Revenue Ruling 84-17, had the taxpayer not claimed treaty benefits with respect to the *B* income (or had not conducted business *B* during the tax year), the Treaty Consistency Principle would not have come into play, because the taxpayer would not have been claiming treaty benefits with respect to business profits for the year. Thus, it is solely because the taxpayer chose to apply treaty principles to business *B* and inconsistently chose domestic law principles with respect to business *C* that the ruling concluded that the taxpayer was taking inconsistent positions. We do not see the Consistency Principle as applicable where, by contrast, the taxpayer did not have the ability to choose treaty benefits with respect to business *C*.

Suppose, for example, that DLLC had income, and not loss, for the tax year. It would be quite clear (assuming that the Derived By Rule was extended to business profits) that treaty benefits would not be applied to DLLC's business, and domestic tax principles would be applied with respect to DLLC's taxable income, notwithstanding that Corporation A was applying treaty principles with respect to Activity 2. We see no reason why the tax principles at play should change solely as a result of the fact that DLLC incurred a loss instead of a profit for a particular tax year. We therefore think it is appropriate, and not in contravention of the Consistency Principle, that Corporation A be permitted to apply domestic law to offset DLLC's losses against the income from Activity 1. One commentator has raised a concern that this may allow for tax planning to sidestep the Consistency Principle by carrying on activities that are more likely to generate losses through a domestic hybrid entity, instead of through a branch that would otherwise qualify for a treaty exemption.[63] However, we believe that profits and losses should be treated consistently in this circumstance, despite the potential planning opportunity.

E. Tax-Exempt Beneficial Owners

Our 2010 Report, as well as our 2007 Report, recommended that there should be an exception to the Hybrid Entity Rules in the case of payments made to a hybrid entity not itself a resident of a treaty country if the owners of the entity are themselves treaty residents and tax-exempt (such as foreign pension funds) and would therefore not be subject to tax on the income had they received it directly.[64] We continue to recommend this exception, and if guidance is issued extending the Derived By Rule to business income earned through a hybrid entity, it should apply in that context as well in cases in which the tax-exempt would not have been subject to tax on the unrelated business profits had they been earned directly.[65]

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[63] *See id.,* at 41.

[64] As we noted in the 2010 Report, the same point can be made in respect of a foreign investor in a hybrid that would, if the income of the hybrid was derived directly, have been exempt from tax in its country of residence because, in lieu of a foreign tax credit, that country simply exempts from tax the business profits of a foreign permanent establishment. There is no reason to deny treaty benefits in respect of the business income in this case.

[65] This would also be in line with existing IRS guidance on this question. *See IRS Announces U.S.-Netherlands Agreement on Pension Funds*, IR-2003-37 (March 21, 2003) (the IRS announced a Competent Authority ruling with respect to the U.S.-Netherlands income tax treaty that Dutch pension plans can claim treaty benefits on income earned through U.S. hybrid entities). A further argument for applying U.S. law in this case is (continued...)

IV. Application of the Derived By Rule to Branch Profits

A. Background and Policy of the Branch Profits Tax

The BPT was enacted to achieve greater parity in the taxation of foreign companies doing business directly in the United States compared with those doing business in the United States through domestic corporate subsidiaries.[66] The earnings of a domestic corporate subsidiary of a foreign business are subject to both a corporate-level tax (currently at a 35% rate) and (subject to elimination or reduction by any applicable treaty) a 30% withholding tax on distributions of profits to the foreign parent.[67] By contrast, although earnings of a U.S. branch of the foreign corporation would generally be subject to tax as effectively connected income under Section 882(a), there was, prior to the enactment of the BPT, no additional layer of tax on the repatriation of profits, because branches are not separately incorporated entities and thus the repatriation was treated as a transfer of wealth within the corporation and not a dividend.[68]

The BPT is intended to remedy this perceived inconsistency by taxing the "dividend equivalent amount" of a foreign corporation doing business in the United States.[69] The dividend equivalent amount is intended as a proxy for the amount of U.S. earnings and profits that would be subject to dividend withholding tax had the foreign company conducted the business through a domestic corporate subsidiary.[70] The dividend equivalent amount consists of the foreign corporation's earnings that are effectively connected with the conduct of a U.S. trade or business for the tax year, reduced by any increase in U.S. net equity for the tax year and increased by any reduction in U.S. net equity for the tax year.[71] The dividend equivalent amount is generally

(continued...)

that this exception would advance the U.S. tax policy objective of the check-the-box rules, which is to remove constraints on form of organization when those constraints do not advance a tax policy.

[66] JCT, *General Explanation of the Tax Reform Act of 1986*, Pub. L. No. 514, 99th Cong., 2d Sess., JCS-10-87 (1987), at 1036; HR Rep. No. 841, 99th Cong., 2d Sess. II-647 (Conf. Rep. 1986).

[67] Sections 871(a) and 881(a).

[68] Section 861(a)(2), as in effect prior to the enactment of Section 884(a), did provide that a further dividend distribution from the foreign company to its shareholders could be proportionately treated as U.S.-source income technically subject to U.S. withholding tax if (i) at least 50% of the corporation's gross income for the preceding three years was effectively connected with a trade or business in the United States or (ii) the dividend is distributed from earnings and profits that the corporation inherited from a domestic corporation. However, this rule was difficult to enforce and was not practically effective.

[69] Section 884(b).

[70] JCT, *General Explanation of the Tax Reform Act of 1986*, JCS-10-87 (1987), at 1038.

[71] More specifically, the dividend equivalent amount is the amount of the foreign corporation's effectively connected earnings and profits ("**ECE&P**") determined without reduction for any dividends paid during the year and adjusted for certain specified items. Section 884(b)(2); Treas. Reg. § 1.884-1(b)(1). Under the principal adjustment, ECE&P are reduced by the amount of those earnings that have been reinvested in a U.S. trade or business. The amount of a foreign corporation's ECE&P that have been reinvested in a U.S. trade or business is the

(continued...)

intended to reflect the amount of U.S. earnings and profits that have not been reinvested in the U.S. trade or business of a foreign corporation and thus that are treated as if "distributed" to the home office.

U.S. tax treaties entered into or amended after the enactment of the BPT generally address the BPT. These treaties typically permit the imposition of the BPT where the business profits are subject to tax in the source state, for example, because they are attributable to a PE of foreign corporate taxpayer in the source state. However, they often provide for a reduced or eliminated BPT rate, which typically mirrors the reduction or elimination of the gross-basis taxation of dividends.

Nondiscrimination articles are often a consideration in the application of the BPT. For instance, in the context of a permanent establishment, Article 24(2) of the 2006 Model Treaty provides that:

> The taxation on a permanent establishment that an enterprise of a Contracting State has in the other Contracting State shall not be less favorably levied in that other Contracting State than the taxation levied on enterprises of that other Contracting State carrying on the same activities.

However, modern treaties, including the 2006 Model Treaty, also generally exclude the BPT from the scope of the nondiscrimination article of the treaty.[72]

A foreign corporate taxpayer that is eligible for treaty benefits is subject to the BPT with respect to business profits attributable to a PE. Alternatively, the BPT could potentially apply to business profits of the treaty country resident not attributable to a PE in the source state where the business profits are earned through an entity that is treated as fiscally opaque in the country of residence (such as in the case of business profits earned through a domestic or third country hybrid entity).

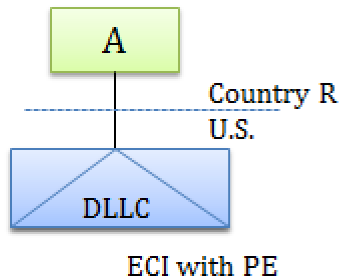
(continued...)

amount of the increase in the U.S. net equity of the foreign corporation at the close of the current tax year over the U.S. net equity at the close of the preceding tax year. Treas. Reg. § 1.884-1(b)(2).

[72] When Congress enacted the BPT, it recognized that the nondiscrimination provisions in many U.S. income tax treaties arguably restricted the imposition of the BPT and that the BPT should therefore not override preexisting U.S. income tax treaty obligations (as long as the foreign corporation was a qualified resident of the treaty partner). *See* JCT, *General Explanation of the Tax Reform Act of 1986*, Pub. L. No. 514, 99th Cong., 2d Sess., JCS-10-87 (1987), at 1038. However, Congress included that protection for existing treaty benefits on "the understanding that the Treasury Department will attempt to renegotiate outstanding treaties that prohibit the imposition of the tax." S. Rep. No. 99-313, at 402 (1986); *see also* Treas. Reg. § 1.884-1(g) (listing countries for which the BPT would not be imposed or for which it would be imposed at a lower rate until the applicable treaty is modified).

B. Application of the Derived By Rule to the Branch Profits Tax

Example (9) (branch profits tax on income earned through a domestic hybrid entity). Assume the same facts as in Example (1) except that DLLC's U.S. business activities give rise to a PE.



As explained above in our discussion of Example (1), where Corporation A's ECI is not attributable to a PE we believe that the Derived By Rule should apply to disallow treaty benefits to Corporation A with respect to the taxation in the United States of business profits it earns through DLLC. We believe that the same analysis should be extended to the treatment of the BPT in Example (9), so that treaty benefits would not be available with respect to the BPT in Example (9). This is because Corporation A is not deriving the business profits upon which the BPT is imposed under Country R law.[73]

The premise of the Derived By Rule is the avoidance of both double taxation and double non-taxation. It is true that the income would, at least under our recommended expansion of the Derived By Rule to include business profits, be subject to one layer of tax in the United States as ECI without eligibility for treaty benefits (as illustrated in Example (1)). However, as applied to the second layer of U.S. tax for which the BPT serves as a proxy, allowing for treaty benefits may result in Corporation A's business profits not being subject to the second layer of tax either in Country R or in the United States. Accordingly, we favor applying the Derived By Rule in Example (9) without modification.

We recognize that there is an alternative approach to analyzing Example (9). The aim of the BPT, as discussed in **Part IV.A** above, is to create tax parity between a foreign corporation that is doing business in the United States through a domestic subsidiary and a foreign corporation that is directly doing business in the United States. Applying the regular Derived By Rule to Example (9), in contrast, would result in the denial of treaty benefits with respect to the BPT notwithstanding that the repatriation of the income through dividends would have qualified for treaty benefits had the income been earned through a domestic subsidiary.

Moreover, as an analytical matter, the "derived by" construct is not as straightforward to apply in the context of the BPT as it is in the FDAP or ECI context. The "deemed dividend" construct of the BPT is a fiction of U.S. tax law and so is not something "derived by" the foreign

[73] *See* 2010 Report, at 10; s*ee also* Willard B. Taylor, *Fiscally Transparent Entities and U.S. Tax Treaties*, 36 TAX MGM'T INT'L J. 663 (2007).

corporation; residence countries do not "see" the deemed dividend even in the non-hybrid context. It is therefore not clear that an unmodified extension of the Derived By Rule to the BPT makes sense.

There is thus some justification for the view that Corporation A should be eligible for treaty benefits with respect to the BPT in Example (9). Had Corporation A operated the business through a domestic subsidiary and repatriated the earnings as dividends, Corporation A would have been treated, under the regular Derived By Rule, as deriving the income under Country R law and would have been eligible for treaty benefits with respect to those dividends. Under this modified approach to applying the Derived By Rule to the BPT earned through a domestic hybrid entity, we would first determine whether Corporation A would be eligible for treaty benefits under the regular Derived By Rule had it operated through a domestic subsidiary instead of through the hybrid entity. If it is ascertained that treaty benefits would have been available with respect to dividends in that scenario, treaty benefits would similarly be available with respect to the BPT. Stated differently, this approach would, to some extent, take the "deemed dividend" construct of the BPT at its face and apply derived by principles by reference to that deemed dividend.[74]

Although not directly parallel, an analogy for the concept reflected in this modified Derived By Rule can be found in the tax treaty regime currently in place for branch-level interest taxes. Section 884(f)(1) provides that any interest "paid by" the U.S. trade or business of a foreign corporation will generally be treated as if it were paid by a domestic corporation. The payments are therefore treated as U.S.-source to the extent attributable to the U.S. branch, with the effect that the recipient is subject to U.S. withholding tax on the interest payment unless it qualifies for a specific exemption under the Code or a treaty. In addition, interest allocated to the branch under Treasury regulation section 1.882-5 in excess of actual payments ("**excess interest**") is treated under Section 884(f)(2) as paid by the branch as if the branch was a domestic subsidiary making payments on a notional loan from its foreign corporate parent (the home office). This excess amount is subject to 30% withholding, absent an exemption under the Code or a relevant treaty.

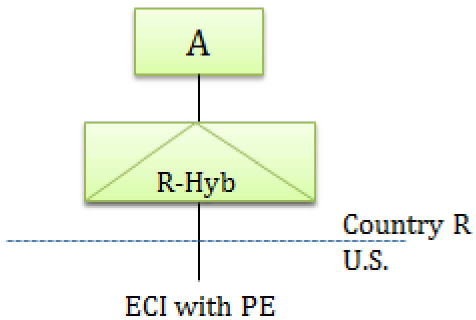
The Code treats branch-level interest and excess interest as if paid by a domestic corporation for all income tax purposes, including for purposes of applying treaty rules to those payments as if the interest payments were actually made.[75] While the BPT rules do not provide

[74] We recognize that this "deemed dividend" analogy is not entirely parallel. For example, in determining a foreign corporation's dividend equivalent amount, ECE&P are not reduced by earnings withdrawn from the U.S. business and invested in a foreign branch because such an investment would not result in an increase in "U.S. net equity." Those earnings would therefore be subject to the BPT. By contrast, earnings of a domestic subsidiary that are reinvested in foreign operations or other non-ECI generating activities without being distributed to the foreign parent would generally not attract U.S. withholding taxes. Nevertheless, as discussed in Part IV.A above, it is clear that the BPT was intended as a rough proxy for the withholding tax that a repatriation of the earnings from a domestic subsidiary would attract. The fact that the resulting parity is imperfect should not change this analysis.

[75] Section 884(f)(1)(A); Treas. Reg. § 1.884-4(a)(1). In the case of U.S. withholding tax on interest actually paid by a branch to a foreign recipient, the appropriate treaty will be that between the United States and the country of the recipient. Treas. Reg. § 1.884-4(b)(8)(ii). For purposes of determining whether the tax on the excess interest is to be reduced or eliminated by treaty, the applicable income tax treaty is the one between the United States and the
(continued...)

for a "deemed" domestic corporation, applying the modified Derived By Rule in Example (9) would use a similar approach for the limited purpose of determining whether treaty benefits should be available with respect to the BPT imposed on business profits earned by interest holders in a hybrid or reverse hybrid entity.

Example (9.1) (branch profits tax on income earned through a foreign hybrid entity). Same as Example (2), except that R-Hyb's business activities are treated as a PE under the U.S.-Country R treaty.



Under the Code, Corporation A is subject to the BPT on ECI that it earns through R-Hyb. Under the Derived By Rule, Corporation A would not be able to claim treaty benefits because Country R treats R-Hyb as opaque and Corporation A does not "derive" the business profits upon which the BPT is imposed.

The question of whether R-Hyb can claim treaty benefits under the U.S.-Country R treaty is less clear. The United States is not imposing any tax on R-Hyb, so from the U.S. perspective it is arguable that R-Hyb should not be permitted to claim treaty benefits with respect to a tax imposed on income earned by Corporation A. On the other hand, under Country R principles, R-Hyb derives the income with respect to which the BPT is imposed. Country R would likely argue that under "derived by" principles, and in order to avoid double taxation, treaty benefits should be available for R-Hyb. In the FDAP context, the regulations allow the foreign hybrid entity to claim treaty benefits for the tax imposed under Sections 871(a) and 881(a) on the interest holders.[76] We believe the Derived By Rule should also apply in the BPT context to allow R-Hyb to claim treaty benefits under the U.S.-Country R treaty.

This should be the case even when Corporation A and the foreign hybrid entity are residents of different treaty jurisdictions. Assume the same facts as in Example (9.1), except that the foreign hybrid entity is a resident of Country H instead of Country R. The U.S.-Country H

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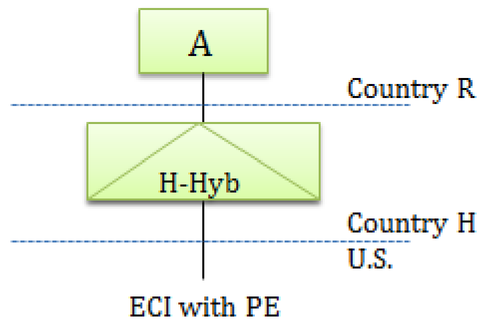
country of the corporation's home office. Treas. Reg. § 1.884-4(c)(3); *see* TD 8432, 1992-2 CB 157, 160 ("[T]he Treasury Department has concluded that the tax on excess interest is not prohibited by the non-discrimination provision or any other provision in any income tax treaty to which the United States is a party.").

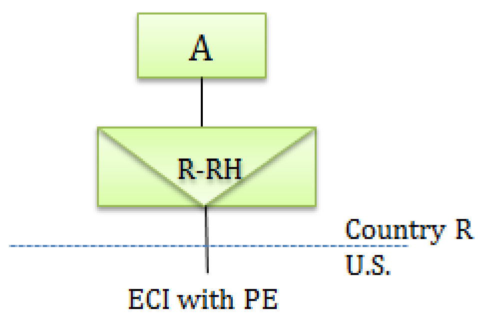
[76] Treas. Reg. §§ 1.894-1(d), 1.1441-6.

treaty provides for a reduced BPT rate and is identical to the 2006 Model Treaty in all relevant provisions.



From the U.S. perspective, H-Hyb is not subject to the BPT on the income treated as earned by Corporation A, and the U.S.-Country H treaty is therefore arguably irrelevant. Under Country H principles, in contrast, H-Hyb derives the income with respect to which the BPT is imposed. Thus, a principled application of the Derived By Rule would allow H-Hyb to claim the U.S.-Country H treaty with respect to the BPT.

Example (10) (branch profits tax on income earned by/through a foreign reverse hybrid). Same facts as in Example (6). The U.S.-Country R treaty provides for a 5% reduced rate for the BPT.[77]



One approach to Example (10) would be not to apply the Derived By Rule to Corporation A with respect to the BPT. The interest holders in a foreign reverse hybrid will typically have made an election to treat the foreign reverse hybrid as a corporation for U.S. tax purposes (or would have chosen to operate through an entity otherwise classified as a corporation for those

[77] As discussed in Example (5) above, applying the Derived By Rule in the case of business profits earned through a foreign reverse hybrid entity introduces a number of practical complications and considerations, which should inform whether the Derived By Rule should be extended in the first instance to business profits earned through a foreign reverse hybrid entity. The following discussion assumes that the Derived By Rule should and will apply to the facts of Example (5) so that business profits not attributable to a PE and earned through a foreign reverse hybrid entity will be eligible for treaty benefits under the business profits article of the relevant treaty.

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purposes). Having elected corporate classification for the entity, this approach would argue, the interest holders should bear the BPT, which is one negative consequence of that election.[78]

We believe, however, that as a policy matter Corporation A should be entitled to treaty benefits with respect to the BPT under the facts of Example (10). We do not think Corporation A's eligibility for treaty benefits should hinge on a subjective inquiry into its motivations for operating through R-RH. Moreover, Corporation A would have been eligible for treaty benefits under the Derived By Rule with respect to dividend withholding tax had R-RH operated in the United States through a domestic subsidiary, and we think the Derived By Rule should equally apply to the BPT imposed on R-RH's profits where R-RH operates in the United States directly.[79]

Accordingly, we believe that the Derived By Rule should be applied in Example (10).

C. BPT Treaty Benefits for Individual Interest Holders

Additional considerations are relevant when the foreign reverse hybrid is held in whole or in part by individuals who are treaty residents of the relevant treaty jurisdiction. This subsection explores different approaches to the application of the Derived By Rule when the entity involved is a foreign reverse hybrid and the owners are individuals otherwise qualifying for treaty benefits.

Example (11) (branch profits tax for individual interest holders in foreign reverse hybrid). Same as in Example (10), except that R-RH is owned by Country R Corporation A and individuals. R-RH engages in a U.S. business through a branch in the United States, which earns ECI through a PE.

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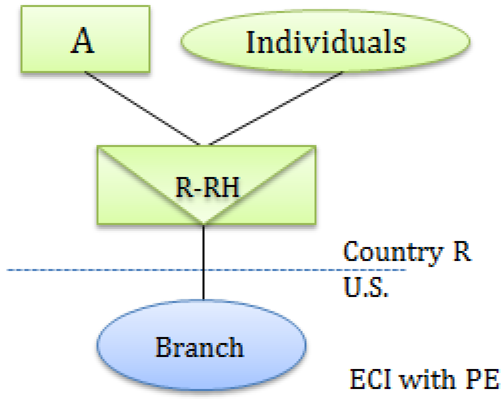
[78] As pointed out in the text immediately below, however, under the Hybrid Entity Rules treaty benefits would be available for income derived through a foreign reverse hybrid entity in the FDAP context, notwithstanding that the interest holders may have elected corporate treatment of the entity for U.S. tax purposes.

[79] Although obviously not controlling, this would be consistent with the view taken by the Tax Court of Canada. In a 2010 case, that court held that the treaty rate was available with respect to the Canadian "branch tax" on income derived by a U.S. corporation conducting business in Canada through a U.S. limited liability company disregarded for U.S. tax purposes and treated as opaque for Canadian tax purposes (which, of course, would be a foreign reverse hybrid from the perspective of Canada). *TD Securities (USA) LLC v. The Queen*, 2010 TCC 186 (Can. Tax Ct. 2010).



A simple application of "derived by" principles would suggest that the individuals should be permitted to claim treaty benefits on their allocable share of the foreign reverse hybrid's dividend equivalent amount, because the individuals are subject to tax on the income in their resident jurisdictions. This application of "derived by" principles would support allowing the foreign reverse hybrid, the corporate taxpayer for U.S. tax purposes, to reduce its BPT to the extent of the dividend equivalent amount allocable to the individuals.

However, this example raises additional concerns. Under "derived by" principles, it would be the individuals, not the foreign reverse hybrid, who would claim treaty benefits (to the extent the income is attributable to the individuals). As a threshold matter, it is not clear that it is appropriate to allow individuals to claim treaty benefits with respect to a tax that is imposed under U.S. law only on corporate taxpayers. In addition, there is some concern that individuals should not be permitted to invest in an entity that has elected to be treated as a corporation for U.S. tax purposes in order to enjoy the benefit of, for example, being "blocked" from a U.S. trade or business and ECI, while at the same time claiming treaty benefits for the BPT imposed on ECI attributable to a PE of the "blocker." Denying treaty benefits on that basis, however, relies to some degree on a subjective judgment regarding the individual owners' intent in making the election and on the pervasiveness of the utilization of these types of structures for tax benefits, and may also be less compelling in circumstances (however unlikely) where the entity is a *per se* corporation for U.S. federal income tax purposes.

We believe that some form of treaty benefits should be available to individual interest holders in a foreign reverse hybrid entity with respect to BPT imposed on the entity. By limiting the imposition under Section 884 of the BPT to foreign corporations, the United States has made a policy determination that foreign individuals should not be subject to the BPT.[80] This supports

[80] It should be noted, however, that as discussed in note 72, in concluding that the BPT should not override preexisting U.S. income tax treaty obligations, Congress recognized the tension inherent in nominally imposing a branch profits tax only on foreign corporations notwithstanding the fact that the economic burden of the tax will be shared indirectly by the corporation's shareholders. *See* JCT, General Explanation of the Tax Reform Act of 1986, JCS-10-87 (1987), at 1038 ("Although Congress generally believed that a branch profits tax does not unfairly discriminate against foreign corporations because it treats foreign corporations and their shareholders together no worse than U.S. corporations and their shareholders, it understood that most treaty nondiscrimination articles relating to permanent establishment arguably operate to consider corporations and their shareholders separately in
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the conclusion that the individual interest holders should, as a policy matter, be entitled to claim treaty benefits with respect to the BPT that they are treated as bearing directly under the law of their residence jurisdiction.

Assuming the individuals in Example (11) should be permitted to claim treaty benefits with respect to the BPT imposed on their share of R-RH's income, the next question is what treaty rate should apply. A related question is whether the individuals should be required to claim the benefits of a specific provision of the Country R treaty (so that, absent a specific treaty provision on point, they would not be entitled to treaty benefits), or whether they can claim that the BPT is inapplicable to them under general nondiscrimination and "derived by" principles.

Regardless of any policy determination, because of the way the branch profits provisions in many treaties are worded, the specific provision through which a foreign individual would avail itself of treaty benefits for the BPT is unclear. For example, Article 10(8) of the 2006 Model Treaty provides as follows:

> (a) A **company** that is a resident of one of the States and that has a permanent establishment in the other State . . . may be subject in that other State to a tax in addition to the tax allowable under the other provisions of this Convention.
>
> (b) Such tax, however, may be imposed i) on only the portion of the business profits **of the company** attributable to the permanent establishment . . . that, in the case of the United States, represents the dividend equivalent amount of such profits or income . . . and ii) at a rate not in excess of [5%]. (Emphasis added.)

The term "company" is, in turn, defined in Article 3(1)(b) of the 2006 Model Treaty as meaning "any body corporate or any entity that is treated as a body corporate for tax purposes according to the laws of the state in which it is organized." Thus, purely as a technical matter Article 10(8) apparently applies to only corporate taxpayers and not individuals: 10(8)(a) allows the imposition of BPT on corporations, and 10(8)(b) provides the possibility of a rate reduction. Situations where the tax is imposed on income that could be considered to be "derived by" individuals are not contemplated by the model treaty.

Another related question is whether the individual owner should have a return filing obligation in connection with claiming treaty benefits for the BPT. There appears to be no mechanism similar to Treasury regulation section 1.1441-6(b)(2)—which provides a regime for owners of foreign reverse hybrid entities to claim a reduced rate of U.S. withholding tax under an income tax treaty—for interest holders in a foreign reverse hybrid to claim a reduced rate of U.S. tax on effectively connected income.[81] Thus, unless a specific mechanism is provided for to

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determining whether discriminatory tax rules exist. Congress did not intend to override U.S. income tax treaty obligations that arguably prohibit imposition of the branch profits tax").

[81] *See also* TD 8734 (October 6, 1997) ("The regulations under § 1.1441-6(b)(4)(ii) finalize the rules regarding the type of withholding certificates that must be furnished in situations involving hybrid entities where the

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allow the foreign reverse hybrid to make the treaty claim on the individual's behalf, the owner of a foreign reverse hybrid might have to file a U.S. tax return in order to claim a complete or partial refund of the BPT paid by the reverse hybrid entity.

We recognize that there can be more than one approach in addressing these questions. One alternative (the "**Nondiscrimination Approach**") would allow individual interest holders to claim treaty benefits with respect to their share of the BPT imposed on the foreign reverse hybrid on the basis of their status as individuals who would not be subject to the BPT in the first instance under U.S. tax principles. Under this approach, the BPT would be eliminated entirely with respect to an individual's share of the foreign reverse hybrid's business profits.

The policy argument for adopting the Nondiscrimination Approach is that additional taxes on permanent establishments are expressly prohibited by most treaties and U.S. individuals would not be subject to the BPT at any rate. Indeed, as illustrated by the language of Article 10(8)(a) of the 2006 Model Treaty quoted above, many treaties allow the tax to be imposed only on "companies."[82] One can argue that the United States should not be allowed to circumvent that restriction by treating the hybrid as a corporation because, under "derived by" principles, the individual is the taxpayer on the income under the residence country's law.

We believe, however, that a better approach would be to condition any treaty BPT exemption for a foreign individual upon the effectively connected income of the foreign reverse hybrid being subject to U.S. tax at the interest holder's individual income tax rates (the "**Consistency Approach**"). It seems inappropriate to permit the individual to rely on the status of the reverse hybrid as opaque to avoid individual tax rates with respect to the U.S. tax on effectively connected income, while inconsistently relying on the status of the entity as transparent under the "derived by" rule to avoid the BPT. Without addressing the specific question of whether taking both these positions would technically constitute a violation of the Consistency Principle because each relates to the same underlying income of the entity, it seems

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payment is made to the entity but the benefit is determined by the status of the interest holder. Generally, a partnership Form W-8 would have to be provided by the interest holder, which form must be presented by the entity on behalf of the interest holder. In order to reduce the burden in the case of reverse foreign hybrid entities (*e.g.*, foreign mutual funds treated as corporations for U.S. tax purposes but as fiscally transparent entities for foreign countries' law purposes), the final regulations allow those entities to become qualified intermediary, so that, like foreign partnerships and entities acting as intermediaries for others, they may present a global Form W-8 to a U.S. withholding agent instead of furnishing individual forms for each of their shareholders who claim a benefit under an income tax treaty."); Treas. Reg. § 301.6114-1(b)(3) (requiring a foreign corporation to report a return position that a treaty provides the foreign corporation an exemption from or reduction for the BPT).

[82] An income tax treaty never imposes additional tax; it serves only to reduce a tax imposed under domestic law. Article 1(2) of the 2006 Model Treaty ("This Convention shall not restrict in any manner any benefit now or hereafter accorded by the laws of either Contracting State"). The BPT provision of many treaties uses language "allowing" the source country to impose the BPT on a "company" does not seem to directly prohibit the United States from imposing the BPT on a foreign corporation even where the residence country deems the tax to be imposed on the individual interest holder. It does illustrate, however, that the treaty partners did not intend that the BPT would be imposed on foreign individuals (which it effectively is under the residence country's law).

inappropriate for the individual interest holders to get a better result (*i.e.*, lower tax rates on ECI combined with a treaty-based exemption from the BPT) than could be obtained by either an individual or a corporation earning the same income directly rather than through a reverse hybrid. Consistency could be achieved, by contrast, either by not applying the Derived By Rule and instead disallowing the individuals' claim for treaty benefits for the BPT by looking to the entity's U.S. tax classification, or by allowing a treaty BPT exemption under the Derived By Rule but only if tax is paid on the ECI at the owners' tax rates.[83]

A potential objection to application of the Consistency Approach is that it would result in more tax to the foreign reverse hybrid than would have been the case had it operated the U.S. business through a domestic subsidiary and repatriated the earnings as dividends. As discussed in **Part IV.A** above, the purpose of the BPT is to achieve greater parity in the taxation of foreign companies doing business directly in the United States compared with those doing business in the United States through domestic corporate subsidiaries. Had the foreign reverse hybrid entity operated in the United States through a domestic subsidiary, the earnings would have been subject to U.S. tax at regular corporate tax rates, and the foreign reverse hybrid would have been entitled to a reduced withholding rate for the dividends when the earnings were repatriated as dividends. Under the Consistency Approach, the individual interest holder would be faced with choosing between two alternative regimes, each of which would arguably result in more tax than the domestic subsidiary construct. If the individual claimed treaty benefits for the BPT, the ECI would also be subject to tax at individual income tax rates. If the individual chooses not to claim treaty benefits but instead have the ECI be taxed at corporate rates, the income will be subject to the full second layer of BPT.

On balance, however, we believe that the consistency considerations discussed above should outweigh these objections. Even if the BPT is intended as a proxy for the consequences of investing through a domestic corporate subsidiary, the actual tax consequences resulting from the two regimes are clearly not identical. The BPT is not imposed on any dividend or other distribution, but on the "dividend equivalent amount," the calculation of which depends in large part on the somewhat mechanical definition of "U.S. net equity," and often differs substantially from amounts actually repatriated to the home office.[84]

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[83] We have also considered an approach (the "**BPT Rate Approach**") that would allow the individuals to claim the benefit of the BPT provision of the treaty of the jurisdiction in which they are resident. In contrast to the Nondiscrimination Approach and Consistency Approach discussed in the text, the BPT Rate Approach would potentially reduce, not eliminate, the BPT tax with respect to the individual interest holders. The individuals would thus indirectly bear the BPT at the same 5% rate to which a foreign corporation is directly subject under most treaties. Although this approach may be less justified conceptually (because the BPT and BPT treaty benefits do not apply to individuals as a technical matter), the potential justification for this approach is a more practical one—an individual interest holder should not be worse off with respect to the BPT than a corporate interest holder. Under the BPT Rate Approach, the individual would be no worse off, and no better off, than if the interest was held by a corporate interest holder. The BPT Rate Approach would also be simpler to implement than the Consistency Approach and would avoid many of the practical complications discussed in Example (11.1) below.

[84] Moreover, the treaty dividend withholding rate for individuals is typically 10% or 15%, while the treaty BPT rate under the Consistency Approach would be 0%. Thus, if the individual interest holders elect to claim the BPT treaty exemption under the Consistency Approach at the cost of subjecting the ECI to higher tax rates, the after-treaty tax consequences to the individuals may be no worse than the after-treaty tax consequences of operating

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In Example (11), application of either the Nondiscrimination Approach or the Consistency Approach would allow the individuals to claim treaty benefits with respect to their allocable share of R-RH's business profits. Under the Consistency Approach, R-RH would also be required to pay tax on R-RH's effectively connected income allocable to the individuals at each individual's respective income tax rates.

We recognize that application of the Consistency Approach raises a number of practical challenges and considerations. For example, if each individual owner was free to make the election separately with respect to his or her share of the entity's income, applying the Consistency Approach might be administratively impracticable or impossible, particularly where the reverse hybrid had individual (direct or indirect) owners resident in different treaty jurisdictions.[85] To address this concern, treaty benefits for any individual interest holder could be conditioned on a uniform election by all individual interest holders to have the entity pay tax on the ECI at individual interest rates.

Another challenge under the Consistency Approach is the potential complexities in determining the individual income tax rates to which the ECI would be subject, as illustrated by Example (11.1) below. One approach could be to require a determination of the respective individual tax rates for each individual as if the income was earned by the individuals directly, taking into account any differences in amounts of income, and taking into account all sources of ECI. Another, and perhaps simpler, approach might be to require the entity to pay tax on the ECI at a tax rate determined as if the entity was an individual. Yet a third approach could be simply to tax all of the income being claimed at the highest individual tax rate (*e.g.*, 39.6%).

Example (11.1) (branch profits tax for individual interest holders with different tax profiles). Same as in Example (11), except that Individual 1 is entitled to 20% of R-RH's income, and Individual 2 and Individual 3 are each entitled to 40% of R-RH's income. Individual 3 also has $1 million of ECI from a direct investment in a domestic operating partnership, and is allocated another $2 million from an investment in another foreign reverse hybrid entity with ECI from a PE. R-RH has ECI of $2.5 million for the 2017 tax year, and

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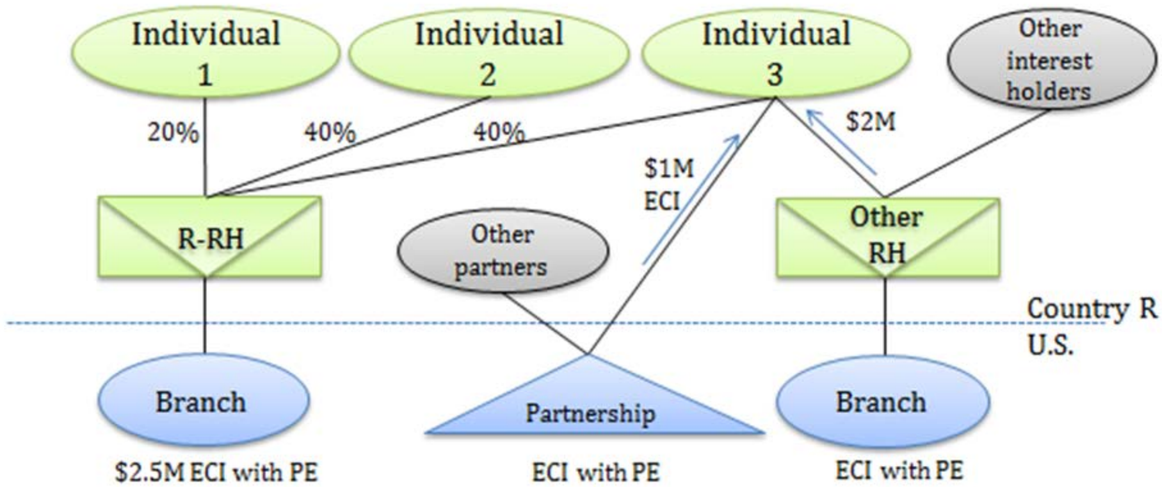
in the United States through a domestic subsidiary, paying corporate tax rates on the ECI and subjecting the income to a 10% or 15% dividend withholding tax rate.

[85] Moreover, allowing some individuals to elect individual tax rates and others to apply corporate tax rates could have unintended results. For example, assume one individual resides in a treaty country that treats the entity as transparent, and the other individual resides in a non-treaty jurisdiction. If the first individual were to obtain treaty benefits at the cost of higher individual tax rates on ECI allocable to that individual, the effect would be to reduce the amount of the entity's remaining ECI subject to corporate tax rates. If the remaining income was modest, it could benefit from lower corporate tax rates to a greater degree than if all of the entity's income were taken into account at corporate rates. In that case, the income allocable to the second individual would be more lightly taxed by reason of the first individual's treaty claim—a result that would be hard to justify. For a thoughtful discussion of these and other considerations, see Land, *Treaty Consistency*, 66 TAX LAW. 113, at 203-06 (2012).

elects to claim treaty benefits for the BPT on income attributable to its individual interest holders.[86]



If R-RH was required to determine each individual's tax rate separately in Example (11.1), R-RH would have an effective tax rate of approximately 30.8% with respect to the $500,000 allocated to Individual 1, an effective tax rate of approximately 35.2% with respect to the $1,000,000 allocated to Individual 2 and an effective tax rate of approximately 38.5% with respect to the $1,000,000 allocated to Individual 3.[87] In contrast, if R-RH was required to pay tax on the full $2.5 million at a rate determined *as if* R-RH was an individual, R-RH's effective tax rate would be 37.8% on the entire $2 million.[88] Alternatively, R-RH could be required to pay tax on the full $2.5 million at the highest individual income tax rate, 39.6%.

In order to determine the applicable individual tax rates, it would be necessary for R-RH to ascertain the respective individual tax rates for each of its individual interest holders. The simplest way to do this might be to require each individual claiming treaty benefits to file a U.S. tax return.[89] Moreover, it can be argued that the individuals should be required, under either

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[86] An additional complexity, not addressed by this example, is whether losses of the individual from another U.S. trade or business can have the effect of reducing the foreign reverse hybrid's tax rate on its ECI.

[87] For the purpose of this example we have estimated effective tax rates using the tax rate table applicable to an unmarried individual under Section (1)(c). *See* Rev. Proc. 2016-55, § 3.01 (setting forth tax rate tables for taxable years beginning in 2017). Note that the effective corporate tax rate on each individual's share of the income would be lower than the individual tax rate, regardless of tax bracket. *See* Section 11(b)(1).

[88] Note that under this approach, if a foreign individual was otherwise subject to U.S. tax on a net basis, the individual could economically have a double benefit from graduated income tax rates.

[89] Foreign individuals claiming FDAP treaty benefits are generally not required to file a U.S. tax return under current law—treaty benefits are instead permitted based on beneficial ownership documentation. *See* Treas. Reg. § 1.1441-6(b)(2) (allowing withholding to be based on "flow-through withholding certificates"). Treasury regulation section 301.6114-1(a)(1)(ii) generally provides that a taxpayer that is not otherwise required to file a U.S. tax return must nonetheless file a return in order to disclose a treaty-based position on Form 8833, although the

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alternative, to file a U.S. tax return under the theory that the Consistency Approach adopts a look-through approach as a trade-off for treaty benefits.

On the other hand, this would require each foreign individual to agree to file a U.S. tax return, even those not eligible for treaty benefits, a result that may not be realistic in many scenarios. Moreover, Treasury may be less concerned with requiring the individuals to report the income because, in contrast to FDAP, the entity's ECI will in any event be reported to the IRS because the foreign reverse hybrid will be required to file a U.S. tax return, given the presence of a taxable permanent establishment.

As an alternative method to determine each individual's separate tax rate (if that is the approach taken), each foreign individual could be required to certify to the foreign reverse hybrid entity what his or her tax rate would be, and the entity would file on that basis. Under any alternative, the foreign reverse hybrid should be required to file a Form 8833 disclosing a treaty-based return position.[90]

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taxpayer's tax return need only include the taxpayer's name, address and taxpayer identification number, and be signed under penalties of perjury. However, the regulations exempt disclosure of a treaty-based return position for FDAP withholding in most cases, and in all cases if otherwise properly reported by the withholding agent on IRS Form 1042-S (Foreign Person's U.S. Source Income Subject to Withholding). Treas. Reg. § 301.6114-1(b)(4)(ii).

[90] *See* Treas. Reg. § 301.6114-1(b)(3) (requiring disclosure on Form 8833 of a position "that a treaty exempts a foreign corporation from (or reduces the amount of tax with respect to) the branch profits tax (section 884(a))." We think a Form 8833 should suffice under the Nondiscrimination Approach, and the foreign individuals should not be required separately to file U.S. tax returns.