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Application of treaty rules to hybrid entities

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many countries is that the outcomes of the Partnership Report cannot be obtained absent provisions in a tax treaty explicitly providing for such results.

In his presentation Mr. Louie described the provisions that are found in U.S. bilateral income tax treaties. The Committee discussed the U.S. provision and concluded that further work should be done to incorporate such a provision, and thus the principles of the Partnership Report, into the U.N Model. Mr. Louie observed that the OECD's Working Party 1 had undertaken the same task in recent years and had made significant progress drafting a new treaty provision and accompanying Commentaries for the OECD Model.

While the provision found in U.S. tax treaty practice and the provision that has been developed by Working Party 1 are broadly similar, the two provisions have some differences. After a discussion of those differences, the Committee concluded that the work on a possible new provision for the U.N. Model should be based on the OECD version of the provision, and not the U.S. version. Mr. Louie offered to consult with the OECD Secretariat and prepare a short paper for discussion at the 2014 meeting that would incorporate the new provision for payments made through hybrid entities into the U.N. Model.

At the 2014 meeting, the Committee is invited to discuss the following potential modifications to the U.N. Model:

A. Replace Article 1 of the Model Tax Convention by the following (additions to the existing text appear in bold, underlined italics):

Article 1

26.16 The last sentence of the paragraph clarifies that the paragraph is not intended to restrict

ANNEX 1

The following examples are intended to demonstrate the possible tax treaty issues that could arise in the context of payments made through a hybrid entity.

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

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

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

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

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

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

Treaty provision:

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

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

that State, by for instance, routing domestic source dividends through a company in the treaty partner.

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

Paragraph 4

Paragraph 4 contains the traditional saving clause found in all U.S. income tax treaties. The Contracting States reserve their rights, except as provided in paragraph 5, to tax their residents and citizens as provided under their domestic laws, notwithstanding any provisions of the Convention to the contrary. For example, if a resident of the other Contracting State performs professional services in the United States and the income from the

of any other U.S. tax treaty, and the individual does not waive the benefits of the relevant tax treaty.

Paragraph 5

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

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

to citizens or to persons who have acquired perman

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

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

For example, income from U.S. sources received by an entity organized under the laws of the United States, which is treated for tax purposes under the laws of the other Contracting State as a corporation and is owned by a shareholder who is a resident of the other Contracting State for its tax purposes is not considered derived by the shareholder of that corporation even if, under the tax laws of the United States, the entity is treated as fiscally transparent. Rather, for purposes of the treaty, the income is treated as derived by the U.S. entity.

As noted above, paragraph 6 is not an exception to the saving clause of paragraph 4. Accordingly, paragraph 6 does not prevent a Contracting State from taxing an entity that is