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subject: Application of Treaties to Branch Profits Tax of Certain Hybrid Entities

This memorandum responds to your request for generic legal advice. This advice may not be used or cited as precedent.

FACTS AND ISSUE

You have requested advice as to the extent to which relief is available under a U.S. income tax treaty from the branch profits tax imposed in respect of business profits earned by a foreign entity that is fiscally transparent for foreign tax purposes but treated as a corporation for U.S. tax purposes.

Scenario

RFHX, an entity formed under the laws of Country X, is taxable as a corporation under U.S. law and is treated as fiscally transparent[1] under the laws of Countries X, Y, and Z. RFHX has a single class of equity interests, with four equal owners as of the close of its taxable year at issue: A, an individual resident in Country Y; B, a corporation organized under the laws of, and tax resident in, Country Y, the principal class of shares of which has been regularly and primarily traded on a Country Y recognized stock exchange for more than twelve consecutive months as of such date; C, a privately held corporation

[1] Within the meaning of Treas. Reg. § 1.894-1(d) and the treaty provisions discussed below.

organized under the laws of, and tax resident in, Country Y, all the shares of which are owned by individuals resident in Country Z, and have been for more than half of the days of any twelve-month period that includes such date; and D, an individual resident in Country Z. Each owner has been a resident in its respective country for more than twelve consecutive months as of the close of RFHX's taxable year at issue.

RFHX's income is effectively connected with a U.S. trade or business.[2] All of that income is subject to corporate tax of 21% under sections 11 and 882. Additionally, absent any treaty relief, RFHX is also subject to the branch profits tax of 30% under section 884.[3] RFHX distributes all of its income to its owners as earned and does not reinvest any of it in its U.S. business. Thus, the "dividend equivalent amount" ("DEA") to which the branch profits tax applies generally is the same as its net income.

The United States has a bilateral income tax treaty in force with Country Y but not with Country X or Country Z. RFHX's income is business profits attributable to a U.S. permanent establishment under the U.S.-Country Y treaty. None of the owners of RFH has a separate permanent establishment in the United States.

As relevant here, the U.S.-Country Y treaty is worded consistently with the 2016 United States Model Income Tax Convention ("2016 Model"). Under the treaty's "fiscally transparent entity" provision ("FTE provision")

> . . . "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."[4]

The treaty provides that business profits of an enterprise of a resident of a Contracting State are taxable in the other Contracting State only if the enterprise carries on business in that other Contracting State through a permanent establishment to which those profits are attributable.[5] In the case of a company that is a resident of a Contracting State and that has a permanent establishment in the other Contracting State, a portion of the profits attributable to the permanent establishment (as well as income subject to tax under Article 6 or Article 13(1)) that compose the DEA may be

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[2] Alternatively, RFHX has income considered effectively connected with a U.S. trade or business from the operation of U.S. real property or the disposition of United States real property interests described in section 897(c)(1)(A). In such case, the treaty branch profits tax analysis would be similar to the analysis set forth herein.

[3] Section 884 imposes a 30-percent branch profits tax on the dividend equivalent amount of a foreign corporation. The dividend equivalent amount is the foreign corporation's effectively connected earnings and profits, adjusted for certain increases and decreases in U.S. net equity. In general, U.S. net equity is the excess of the basis of assets connected with the U.S. trade or business over liabilities so connected.

[4] See 2016 Model, Art. 1, para. 6.

[5] See 2016 Model, Art. 7, para. 1.

subject to an additional tax, branch profits tax, but the rate of such tax is subject to a reduction if the company has been a resident of the first-mentioned State (or a qualifying third State) for the twelve-month period ending on the date on which the entitlement to the DEA is determined ("BPT provision").[6]

The treaty includes a limitation on benefits provision ("LOB provision") that, in general, requires a resident claiming treaty benefits to be a "qualified person" at the time when the benefit would be accorded. A qualified person includes (among others) an individual, a company whose principal class of shares is primarily and regularly traded on a recognized stock exchange in the Contracting State in which the company is resident ("publicly traded company"), and a company (i) whose shares or other beneficial interests are owned at least 50 percent by certain qualified persons (including individuals and publicly traded companies) at the time when the benefit otherwise would be accorded and on at least half of the days of any twelve-month period that includes the date when the benefit otherwise would be accorded, and (ii) less than 50 percent of whose gross income is paid or accrued in the form of deductible payments to nonresidents and certain other connected persons.[7]

RFHX complies with applicable U.S. reporting requirements and satisfies its U.S. tax obligations, including with respect to corporate income tax and branch profits tax. It also meets any applicable documentation requirements associated with claiming a reduced rate of branch profits tax on its DEA.

CONCLUSION

RFHX is subject to corporate income tax at the applicable rate (currently, 21%) under sections 11 and 882 on its income that is effectively connected with a U.S. trade or business and which is business profits attributable to its U.S. permanent establishment for treaty purposes. RFHX is also subject to the branch profits tax on a DEA relating to such profits but, for the reasons explained below, RFHX is entitled to a reduction in the rate of branch profits tax to the extent that the DEA corresponds to the percentage interest of an owner in the profits or income of RFHX (as determined under the law of the owner's State of residence) as of the close of RFHX's taxable year, provided that such owner meets the following conditions as of such date: (i) is taxable on profits or income earned through RFHX under the laws of Country Y as a resident; (ii) has been a resident of Country Y for more than twelve continuous months (as required by the U.S.-Country Y treaty); and (iii) satisfies the applicable LOB provision under the U.S.-Country

[6] See 2016 Model, Art. 10, para. 10. As discussed below, because RFHX is not itself a resident under the U.S.-Country Y treaty, and considering the FTE provision, the twelve-month requirement should be applied at the owner level.

[7] See 2016 Model, Art. 22, para. 2. U.S. income tax treaties often provide alternative tests to satisfy the requirements of the LOB provision with respect to an item of income, such as an active trade or business test or derivative benefits test. See 2016 Model, Art. 22, paras. 3, 4. For purposes of this memorandum, we assume that none of these alternative tests is satisfied here.

Y treaty. Thus, under the facts set forth above (including compliance with reporting and documentation requirements), RFHX is entitled to a reduced rate of branch profits tax on the portion of the DEA corresponding to interests held by A and B.[8] RFHX must pay a 30% rate of branch profits tax on the portion of the DEA corresponding to interests held by C and D. The result would be the same if RFHX were organized in but still treated as fiscally transparent under the laws of Country Y.

ANALYSIS

Overview

There is little guidance directly addressing the interaction of U.S. income tax treaties and domestic law as applicable to a foreign entity that is taxable as a corporation for U.S. tax purposes but is fiscally transparent under the law of an owner's jurisdiction (a "reverse foreign hybrid") that earns business profits. Certain points may be helpful to the principal issue addressed by this memorandum.

- Even in the case of a reverse foreign hybrid organized under the laws of a treaty partner, the entity is not a resident for treaty purposes if it is fiscally transparent under the laws of the treaty partner, and thus cannot meet the "liable to tax" requirement for residence.
- The FTE provision of a treaty may allow treaty benefits with respect to income or profits earned by a reverse foreign hybrid to the extent that owners qualify for benefits under a treaty.
- It follows that the LOB provision of income tax treaties is applied on an owner-by-owner basis to determine if an owner that is a resident of a treaty partner is a treaty-qualified owner.
- If a reverse foreign hybrid entity earns business profits that are not attributable to a U.S. permanent establishment of either the entity or (to the extent of the owner's interest) a treaty-qualified owner of the entity, such business profits may qualify for exemption under the Business Profits article to the extent corresponding to the interest held by that treaty-qualified owner.
- The FTE provision does not change the identity of the taxpayer under source State tax law and does not disturb source State taxation of a reverse foreign hybrid that otherwise applies. Thus, if the business profits are attributable to a U.S. permanent establishment of either the entity or (to the extent of the owner's interest) an owner of the entity, such business profits will be taxable in the United States in accordance with the tax treaty at the corporate rate. The fact that the profits may be considered derived by a treaty-qualified owner who does not have a separate U.S. permanent establishment does not change the result.

[8] Consistent with the analysis below, the reduced rate of branch profits tax is determined under the BPT provision of each owner's treaty. Thus, in the case of an owner resident in a different treaty country, the rate under the BPT provision of such owner's treaty would apply to the portion of the DEA corresponding to its interest (assuming all other requirements for obtaining treaty benefits are met).

- A reverse foreign hybrid that earns business profits is required to file a U.S. corporate income tax return and report as gross income any non-exempt income and determine and satisfy its U.S. Federal income tax liability thereon.
- In addition, the reverse foreign hybrid is required to report and satisfy its liability under the section 884 branch profits tax provisions, as adjusted for applicable treaty reductions, if any, on its DEA in respect of income attributable to its permanent establishment. For this purpose, and as discussed below, the entity-level characterization of income as business profits of a company attributable to a U.S. permanent establishment applies in determining the branch profits liability of the reverse foreign hybrid corresponding to the interest of a treaty-qualified owner, even if that owner is not itself a company or does not have a separate U.S. permanent establishment.
- The remainder of this memorandum addresses in greater detail the potential applicability of a reduction to a reverse foreign hybrid's branch profits tax liability under the BPT provision of an income tax treaty taking into account the FTE provision, including the residence and LOB requirements for an owner to be treaty-qualified.

Business Profits Derived By or Through a Reverse Foreign Hybrid

The FTE provision of the U.S.-Country Y treaty applies in cases in which an item of income, profit or gain is derived by or through an entity (whether organized in a Contracting State or in a third State) treated as fiscally transparent under the laws of *either* the source State or residence State, which includes a reverse foreign hybrid.[9] In such a case, the item is considered to be derived by a resident of a Contracting State to the extent the item is subject to tax in such Contracting State as income of a resident.

By its terms, the FTE provision applies to any item of income, profit or gain derived by or through a fiscally transparent entity, which includes business profits earned by such an entity. The application of the FTE provision to business profits is supported by the

[9] The Technical Explanation of the 1996 United States Model Income Tax Convention ("1996 Model") explains that "income is 'derived through' a fiscally transparent entity if the entity's participation in the transaction giving rise to the income, profit or gain in question is respected after the application of any source State anti-abuse principles based on substance over form and similar analyses." Technical Explanation of 1996 Model, Art. 4, para. 1.

Recent OECD commentary also supports the application of the FTE provision to the income of a reverse foreign hybrid:

> The reference to "income derived by or through an entity or arrangement" has a broad meaning and covers any income that is earned by or through an entity or arrangement, regardless of the view taken by each Contracting State as to who derives that income for domestic tax purposes and regardless of whether or not that entity or arrangement has legal personality or constitutes a person . . . . It would cover, for example, income of any partnership or trust that one or both of the Contracting States treats as wholly or partly fiscally transparent.

Commentary on the 2017 OECD Model Tax Convention on Income and on Capital ("OECD Commentary"), at C(1)-4.

purpose of the provision, which is described in the Technical Explanation of the 2006 United States Model Income Tax Convention ("2006 Model") as follows:

> The intention of [the FTE provision] is to eliminate a number of technical problems that arguably would have prevented investors using [fiscally transparent] entities from claiming treaty benefits, even though such investors would be subject to tax on the income derived though 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 [FTE provision], and the corresponding requirements of the substantive rules of Articles 6 through 21, should be read with those two goals in mind.[10]

As the substantive rules of Articles 6 through 21 pertain to all of the types of income that are the subject of the treaty, including business profits under Article 7, the FTE provision is appropriately read as applying to all such income.[11]

The U.S.-Country Y treaty uses the term "enterprise" to reference the person deriving business profits.[12] An "enterprise" is defined under Article 3(1) of the 2016 Model as "the carrying on of any business" and includes "an enterprise carried on by a resident of a Contracting State through an entity that is treated as fiscally transparent in that Contracting State." As explained in the Technical Explanation of the 2006 Model:

> Subparagraph 1(c) further provides that *[the terms "enterprise of a Contracting State" and "enterprise of the other Contracting State"] also encompass an enterprise conducted through an entity (such as a partnership) that is treated as fiscally transparent in the Contracting State where the entity's owner is resident*. The definition makes this point explicitly to ensure that the purpose of the Convention is not thwarted by an overly technical application of the term "enterprise of a Contracting State" to activities carried on through partnerships and similar entities. In accordance with Article 4 (Resident), entities that are fiscally transparent in the country in which their owners are resident are not considered to be residents of a Contracting State (although income derived by such entities may be taxed as the income of a resident, if taxed in the hands of resident partners or other owners). It could be argued that an enterprise conducted by such an entity is not conducted by a resident of a Contracting State,

[10] Technical Explanation of 2006 Model, Art. 1, para. 6.

[11] This is made explicit in the Technical Explanation of the 2007 Protocol to the U.S.-Canada income tax treaty. See Technical Explanation of the Protocol Done at Chelsea on September 21, 2007 Amending the Convention between the United States of America and Canada with respect to Taxes on Income and on Capital, Art. 2, para. 6 ("New paragraph 6 applies not only in respect of amounts of dividends, interest and royalties, but also profit (business income), gains and other income.").

[12] This term reflects the fact that the person deriving the business profits may be a natural person, an entity without legal personality, or an entity with legal personality.

> and therefore would not benefit from provisions applicable to enterprises of a Contracting State. *The definition is intended to make clear that an enterprise conducted by such an entity will be treated as carried on by a resident of a Contracting State to the extent its partners or other owners are residents. This approach is consistent with the Code, which under section 875 attributes a trade or business conducted by a partnership to its partners and a trade or business conducted by an estate or trust to its beneficiaries.*[13]

Thus, each owner of an entity that is treated as fiscally transparent in the Contracting State in which such owner is resident is treated as carrying on the enterprise of the entity to the extent of its share of business profits. Similarly, if the enterprise is carried on through a permanent establishment, the owner is treated as carrying on the enterprise through such permanent establishment.

Applying the FTE provision here, the business profits earned by RFHX are considered to be derived by a resident of Country Y to the extent they are treated in Country Y as the income of a resident. Because RFHX is treated as a fiscally transparent entity in Country Y, each owner resident in Country Y is considered, for purposes of the U.S.-Country Y treaty, to derive its share of business profits as a resident.

Treating each owner resident in Country Y as deriving through a reverse foreign hybrid its share of profits (to the extent taken into account under Country Y law) for purposes of applying the treaty is consistent with the discussion in the Technical Explanation of the 2006 Model of the analogous situation of a U.S. entity that is a reverse hybrid vis-a-vis the other Contracting State and that earns income from that State:

> If a company that is a resident of the other Contracting State pays interest to an entity that is treated as fiscally transparent for U.S. tax purposes, the interest will be considered derived by a resident of the U.S. 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. In the case of 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 treat as deriving the . . . income through the partnership. . . . The same result obtains even if the entity were viewed differently under the tax laws of the other Contracting State (*e.g.*, as not fiscally transparent in the . . . example above where the entity is treated as a partnership for U.S. tax purposes).[14]

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[13] Technical Explanation of 2006 Model, Art. 3, para. 1 (emphasis added).

[14] Technical Explanation of 2006 Model, Art. 1, para. 6. While this statement in the Technical Explanation illustrating the FTE provision describes a payment made by a resident of another Contracting State to an entity owned by U.S. residents that is fiscally transparent for U.S. tax purposes but not under the tax laws of the other Contracting State, the same principle would apply when a payment is made by a U.S. resident to an entity owned

The regulations under section 894 ("section 894 regulations") addressing derivation of income through fiscally transparent entities also adopt this approach with respect to items of income subject to sections 871(a) and 881(a) ("FDAP income"). Under the section 894 regulations, an interest holder in an entity "derives" an item of FDAP income if the interest holder can establish that, under the laws of the jurisdiction in which the interest holder is a resident, the entity is fiscally transparent with respect to the item of income, and the interest holder is not fiscally transparent with respect to the item of income. While the preamble to the section 894 regulations expressly reserves on the application of treaty benefits to business profits earned by fiscally transparent entities,[15] the regulations were adopted when many U.S. income tax treaties did not include an FTE provision with wording such as that in the 2006 Model, and were intended to apply their principles to U.S. treaties generally. The FTE provision of most current treaties expressly provides for its application to any item of income, profit, or gain, not just FDAP income.[16] Further, the preamble to the section 894 regulations states that the approach in the section 894 regulations is consistent with the approach taken in the 1999 OECD Report[17] regarding the appropriate method for source States to follow to determine if they should provide treaty benefits on items of income paid to fiscally transparent entities. The OECD Report adopted an approach looking through an entity to its owners, similar *to that extent* to the approach in the section 894 regulations, but its application is not limited to items of FDAP income.

We note that, because the FTE provision provides that an item of income derived by or through a fiscally transparent entity is considered to be derived by "a resident" of a Contracting State to the extent that the item is treated in such Contracting State as income of a resident, the provision could also be interpreted to consider the fiscally transparent entity as the resident under the treaty. In this vein, the OECD Report stated that an alternative provision was considered which would have treated a partnership as a resident to the extent its income is subject to tax in the hands of its partners. However, this approach was not adopted.[18] The approach adopted instead does not treat the entity itself as a resident, even derivatively for business profits. The Technical Explanation of the 2006 Model is in accord.[19] However, as discussed below, the treaty does not change the person that is treated as the taxpayer under the law of the Contracting State imposing a tax and, as a result, the general rule may be subject to additional considerations in the case of, for example, a reverse foreign hybrid that earns business profits subject to the branch profits tax.

Branch Profits Tax

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by residents of the other Contracting State that is fiscally transparent under the laws of the other Contracting State but not for U.S. tax purposes (i.e., a foreign reverse hybrid).

[15] T.D. 8889, 65 F.R. 40993 (July 3, 2000).

[16] The same result may apply under earlier treaties, which generally do not specify the type of income to which applicable.

[17] The Application of the OECD Model Tax Convention to Partnerships ("OECD Report").

[18] See OECD Report at R(15)-13 - R(15)-17.

[19] See text accompanying FN 13.

The BPT provision of the U.S.-Country Y treaty allows a Contracting State to also impose a branch profits tax on the portion of business profits comprising a DEA of a "company" (resident in the other Contracting State) that has a permanent establishment in the taxing Contracting State to which the profits are attributable.[20] The term "company" is defined in the 2016 Model as follows: "*unless the context otherwise requires*: . . . any body corporate or any entity that is treated as a body corporate for tax purposes according to the laws of the Contracting State in which it is resident."[21] As explained below, the context in which the BPT provision operates requires that the law of the Contracting State imposing the tax be the reference point for this purpose.

The branch profits tax is imposed because an entity that earns business profits[22] attributable to its permanent establishment in a Contracting State is taxed as a body corporate under that State's law. In order to give effect to the treaty's BPT provision, that provision must be interpreted here in a manner that takes into account that classification.[23]

We note that a reverse foreign hybrid that is fiscally transparent in the State in which it is organized cannot be resident in that State for treaty purposes, and generally would not be a resident of any other State under the "liable to tax" standard of income tax treaties. In addition, applying the law of the owner's State of residence in this context would be inconsistent with the nature of the branch profits tax, which is a second-level tax on a body corporate.

In order to provide for a result that is consistent with the object and purpose of the BPT provision, the term "company" must be interpreted for this purpose by reference to the law of the Contracting State in which the business profits attributable to the permanent establishment are earned. Therefore, the U.S. law treatment of RFHX as a corporation

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[20] As noted above, while this memorandum refers to business profits attributable to a permanent establishment, similar treatment would apply to a company resident in a Contracting State that earns income taxable on a net income basis under Article 6 or Article 13(1) of the 2016 Model.

[21] 2016 Model, Art. 3, para. 1 (emphasis added).

[22] The fact that the income of a hybrid entity that is treated as fiscally transparent under the laws of a Contracting State in which an owner is resident is considered to be derived by a resident to the extent that the income allocable to such owner is taxed as the income of a resident does not mean that the income is not earned by the entity if the tax laws of the Contracting State imposing the tax consider the income to be earned by the entity. This is consistent with OECD commentary. See text accompanying FN 26.

[23] See Technical Explanation of 2006 Model, Art. 10, para. 8 ("A Contracting State may impose a branch profits tax on a company if the company has income attributable to a permanent establishment in the Contracting State . . . such tax is limited, however, to the portion of the aforementioned items of income that represents the amount of such income that is the 'dividend equivalent amount.'"). This implies that whether a Contracting State may impose the branch profits tax on an entity in the treaty context depends on whether *that* State regards the entity as a corporation, or "company."

subject to the branch profits tax is unchanged by treaty and the entity is treated as a company in this context.[24]

As discussed above, each owner resident in Country Y is considered, under the FTE provision of the U.S.-Country Y treaty, to derive its share of business profits earned by RFHX. The profits earned by RFHX are attributable to a U.S. permanent establishment and RFHX is subject to U.S. corporate income tax thereon. Each such owner is also treated as deriving a DEA comprising profits that similarly are characterized as profits *of a company* attributable to its U.S. permanent establishment for purposes of applying the BPT provision.

For treaty benefits to apply, the BPT provision requires a company subject to the branch profits tax to have been a resident of the other Contracting State or a qualifying third State for the twelve-month period ending on the date on which entitlement to the DEA is determined. Because the determination as to whether income is income of a resident is made at the owner level, the owner must satisfy the residency requirement of the BPT provision. In the case of a reverse foreign hybrid, the more than twelve-month period of residence, which must be met by the relevant owner, ends with the close of the reverse foreign hybrid's taxable year; that is the first date on which all facts needed to determine the DEA exists and thus the date as of which "entitlement to the [DEA] is determined" within the meaning of the U.S.-Country Y treaty (i.e., becomes fixed as an amount taxable to the company under the laws of the source State).[25]

Treaty benefits are thus available with respect to the branch profits tax, but only in a manner that takes into account the corporate income tax regime applicable to the entity under U.S. law. Therefore, the FTE provision does not support treatment of individuals who own interests in a reverse foreign hybrid as the relevant taxpayers, and thus does not support the positions that the reverse foreign hybrid's business profits allocable to individuals are taxed at the individual rate and that no branch profits tax applies on the reverse foreign hybrid's DEA corresponding to interests of individuals. Interpreting the interaction of the FTE and BPT provisions in this manner gives proper effect to both provisions while maintaining the source State's right to treat the entity as the taxpayer under its domestic law.

The foregoing analysis is in accordance with OECD Commentary interpreting the FTE provision:

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[24] This approach is clearly mandated under the BPT provision in the 1996 Model, which applies to a "corporation" that is a resident. 1996 Model, Art. 10, para. 8. The Technical Explanation of the 1996 Model confirms that this term "corporation" is defined in this context by reference to the domestic law of the source State, stating "[s]ince the term 'corporation' is not defined in the Convention, it will be defined for this purpose under the law of the first-mentioned (i.e., source) State." While the 2016 Model instead refers to a "company," we do not view this as intending to change which State's law applies in determining whether an entity is a corporation for purposes of applying the BPT provision.

[25] See 2016 Model, Art. 10, para. 10(b)(ii); section 884(b).

> The paragraph [dealing with income of fiscally transparent entities] only applies for the purposes of the Convention and does not, therefore, require a Contracting State to change the way in which it attributes income or characterizes entities for the purposes of its domestic law. In the example in paragraph 6 above, whilst paragraph 2 provides that half of the interest shall be considered, for the purposes of Article 11, to be income of a resident of State B, this will *only affect the maximum amount of tax that State A will be able to collect on the interest and will not change the fact that State A's tax will be payable by the entity*. Thus, assuming that the domestic law of State A provides for a 30 per cent withholding tax on the interest, the effect of paragraph 2 will simply be to reduce the amount of tax that State A will collect on the interest (so that half of the interest would be taxed at 30 per cent and half at 10 per cent under the treaty between States A and B) and *will not change the fact that the entity is the relevant taxpayer for the purposes of State A's domestic law*.[26]

These conclusions also adhere to the principles set forth in the OECD Report, discussed earlier. Consistent with the FTE provision, the OECD Report generally adopts a look-through approach in the context of an entity that is a reverse foreign hybrid, reasoning that denying treaty benefits in such context to treaty-qualified owners based on entity classification under domestic law of the source State would be contrary to the object and purpose of the treaty.[27] It later acknowledges, however, that "[d]ifficulties may arise . . . in the application of provisions which refer to the activities of the taxpayer, the nature of the taxpayer, the relationship between the taxpayer and another party to the transaction."[28] Thus, modifications to the general look-through rule are contemplated when certain characteristics or attributes of the entity that is the taxpayer under the law of the source State need to be taken into account.[29] Such modifications are appropriate here, specifically both (i) to give effect to the fact that business profits considered derived by the owner of a fiscally transparent entity under the treaty were earned by a company that is treated as the taxpayer with a permanent establishment in the source State, and (ii) to allow a treaty claim for a reduced rate of branch profits tax with respect to the entity's DEA corresponding to the interest of such owner.

This modified approach to application of the FTE provision applies only in the context of a DEA in respect of profits (or real property income or gain, in accordance with the BPT provision) derived through a fiscally transparent entity. It does not modify the approach

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[26] OECD Commentary, at C(1)-7 (emphasis added).

[27] OECD Report, at R(15)-25.

[28] OECD Report, at R(15)-33.

[29] See OECD Report, at R(15)-34 - R(15)-38. For example, the OECD Report concludes that (i) the activities of the partners of a service partnership are aggregated in determining whether the partnership carries on an enterprise through a permanent establishment in the source State, and (ii) the concepts of "employer" and "resident" are applied at the partner level in determining whether employment income paid by a partnership is that of an employer that is a resident of the source State.

that applies when FDAP income is derived through a fiscally transparent entity. In such a case, the entity's tax attributes and characteristics under source State law do not need to be taken into account, and context does not require a departure from the treaty-defined term "company."[30]

Limitation on Benefits

Under the LOB provision of the U.S.-Country Y treaty, a resident is only entitled to treaty benefits if it is a qualified person under the treaty. As discussed above, because the treaty determines whether income is income of a resident at the owner level, it requires that the LOB requirements also be tested at that level.

A, an individual, is a qualified person under the treaty at the time benefits under the BPT provision would be accorded, and thus benefits are available on the DEA corresponding to A's interest in the profits or income of RFHX. B, a publicly traded company, is a qualified person under the treaty at the time benefits under the BPT provision would be accorded, and thus benefits are available on the DEA corresponding to B's interest in the profits or income of RFHX. C, a privately held corporation that is a resident of Country Y but is owned entirely by individual residents of Country Z, which has no income tax treaty with the United States, is not a qualified person as it does not meet the ownership requirement both at the time the benefit otherwise would be accorded and on at least half of the days of any twelve-month period that includes the date when the benefit otherwise would be accorded. D, an individual resident in Country Z, is not a resident of a treaty country and therefore not a qualified person. Thus, benefits are not available on the DEA corresponding to C's or D's interest in the profits or income of RFHX.

Summary

Applying the foregoing analysis, the business conducted by RFHX in the United States is treated under the U.S.-Country Y treaty as an enterprise of a resident of Country Y to the extent RFHX's owners are residents of Country Y. Thus, each owner that is a resident of Country Y is treated as deriving through RFHX business profits attributable to a permanent establishment corresponding to its interest in the business profits of RFHX. Because the income derived by such owners retains characterization as business profits attributable to a permanent establishment, such income is not exempt under the treaty. Additionally, because RFHX is a corporation under U.S. law that is subject to the branch profits tax, each owner resident in Country Y is treated as deriving through RFHX the portion of the DEA corresponding to the owner's interest in the profits or income of RFHX (as determined under the law of the owner's State of residence, as

[30] For example, in determining whether a treaty resident is entitled to a reduced rate of tax under Article 10(2)(a) of the 2016 Model on dividend income not representing business profits that such resident derives as an owner of a fiscally transparent entity, it is appropriate to look to the law of the residence State in determining whether the resident owner is regarded as a "company" under the treaty and to such owner's percentage ownership in the payor corporation to determine the entity's rate of tax on income subject to section 881.

of the close of RFHX's taxable year) for purposes of applying the BPT provision. The BPT provision applies to reduce the rate of branch profits tax on such portion of the DEA, to the extent that such owner has been a resident of Country Y for more than twelve consecutive months ending with the close of RFHX's taxable year in question and satisfies the applicable LOB provision under the U.S.-Country Y treaty.

RFHX is entitled to claim a reduced rate of branch profits tax on the portion of its DEA corresponding to the interests held by A and B. RFHX must pay a 30% rate of branch profits tax on the portion of its DEA corresponding to the interests held by C, a Country Y resident but not a qualified person under the LOB provision, and D, a resident of Country Z. RFHX, as the taxpayer under U.S. law, is required to report its business profits and branch profits tax and pay Federal income tax thereon.

Conclusions under other Model Treaties

While we reach the above conclusions based on the language of the FTE provision of the 2016 Model (incorporated in the U.S.-Country Y treaty), the same results would obtain under treaties containing the language in the FTE provisions of the 1996 and 2006 Models. The 1996 and 2006 Models include language that differs slightly from the FTE provision in the 2016 Model as they refer to income derived "through an entity that is fiscally transparent" rather than "by or through an entity that is treated as wholly or partly fiscally transparent." We do not view that is as a substantive difference; rather, the change was likely intended to reflect that the FTE provision applies in the case in which one State views the income as earned by an entity while the other State views the income as earned through such entity (as well as in the case of an entity that is partially transparent under the laws of either the residence or source State).[31]

The conclusions would be similar under treaties containing the language in the FTE provision of the draft 1981 U.S. Model Income and Capital Tax Convention ("1981 Model"). The draft 1981 Model states "in the case of income derived or paid by a partnership, estate, or trust, [the term 'resident of a Contracting State'] applies only to the extent that the income derived by such partnership, estate, or trust is subject to tax in that State as the income of a resident, either in its hands or in the hands of its partners or beneficiaries." While this provision may be interpreted to treat the partnership[32] itself as a resident of a Contracting State in which an owner is resident,[33]

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[31] This is consistent with how this provision is interpreted under the Technical Explanation of the 1996 Model and OECD commentary. See FN 9.

[32] The reference to "partnership" is interpreted in this context to include an entity treated as a partnership in either the residence or source State. See, e.g., Technical Explanation of the Convention between the Government of the United States of America and the Government of the Italian Republic for the Avoidance of Double Taxation with respect to Taxes on Income and the Prevention of Fraud or Fiscal Evasion ("U.S.-Italy treaty"), Art. 4, para. 1 ("This subparagraph applies to any resident of a Contracting State who is entitled to income derived through an entity that is treated as fiscally transparent under the law of either Contracting State.").

[33] The 1981 FTE provision need not be read only in this manner as it references treatment of the income as that of a resident and does not expressly treat the entity itself as a resident, and further, the resident definition generally

like the FTE provision in the 2016 Model it does so only to the extent that the partnership derives income that is taxed to the owner under the laws of such State. Thus, under such a treaty, RFHX would be treated as a company that is a resident of Country Y to the extent it has an owner resident in Country Y that is a qualified person under the LOB provision (and meets such requirements consistent with the analysis set forth above).[34] RFHX would be entitled to a reduced rate of branch profits tax in respect of a DEA that corresponds to the owner's interest in RFHX's profits or income (as determined under the law of the owner's State of residence, as of the close of RFHX's taxable year).[35]

We note that the issues addressed in this memorandum may be addressed by future guidance, in which case this memorandum will be superseded for periods to which any such guidance applies.

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requires that the "person" (which term includes a partnership) be liable to tax in the Contracting State of residence. For example, the Technical Explanation of the U.S-Italy treaty, which adopts the 1981 FTE provision, states that the partners of a partnership are generally treated as deriving the income through the partnership and that, while the language of such provision differs from the FTE provision in the 1996 Model, "the results are intended to be the same." Technical Explanation of U.S.-Italy treaty, Art. 4, para. 1. Other treaties adopting language similar to the 1981 FTE provision, however, are more suggestive that the partnership should be treated as a resident. See, e.g., Convention between the Government of the United States of America and the Government of Australia for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income, Art. 4, para. 1.

[34] Consistent with the analysis described above, because the determination as to whether income is income of a resident is made at the owner level, the LOB requirements must also be tested at the owner level. Similarly, any applicable reduced rate of branch profits tax is determined under the BPT provision of each owner's treaty.

[35] The Tax Court of Canada took a similar approach in *TD Securities (USA) LLV v. The Queen*, 2010 TCC 186 (Can. Tax Ct. 2010). In that case, the Court addressed whether a U.S. limited liability company (LLC), which was treated as a corporation under Canadian law but was a disregarded entity under U.S. law having a single U.S. corporate owner, was entitled to treaty benefits in respect of the branch tax that applied under Canadian law. Although the U.S.-Canada treaty in force for the years at issue only provided a specific rule for determining residency with respect to income derived through fiscally transparent entities for trusts or estates (and not for fiscally transparent entities generally), the Court concluded, by analogy, that the LLC should be treated as a U.S. resident in order to give effect to the object and purpose of the treaty. As noted by the court, a subsequent protocol to the U.S.-Canada treaty included an FTE provision (similar to that in the 2016 Model) that, under the facts of the case, would treat the income as derived by the owner as a U.S. resident. See Convention Between the United States of America and Canada with respect to Taxes on Income and on Capital, Art. 4, para. 6.