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## The Evolution of Limitation On Benefits, Beneficial Ownership, and Similar Rules: Recent Trends and Future Possibilities


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As U.S. treaty policy evolves, the Treasury Department considers, and reconsiders, what requirements should be satisfied before an entity formed in a foreign country should be allowed to enjoy the benefits of a U.S. income tax treaty. In recent years, the Limitation on Benefits (''LOB'') article, and other LOB-type restrictions, including anti-hybrid rules and beneficial ownership requirements, have become more restrictive in some respects and more permissive in others. Some of these trends are discussed below.

## BACKGROUND

An entity generally will be entitled to the benefits of an income tax treaty between the United States and a foreign country (each typically referred to as a ''State'' or a ''Contracting State'') only if, among other requirements, such entity is a resident of a Contracting State within the meaning of the treaty and satisfies the requirements of the LOB article of the treaty. Furthermore, to qualify for treaty benefits with respect to an item of income, the entity must be considered the ''beneficial owner'' of such income.

The LOB article is premised upon the view that a resident of a Contracting State must have some further connection to that country in order to benefit from that Contracting State's income tax treaty with the United States. Thus, the LOB article limits the ability of third-country residents to engage in ''treaty shopping'' by establishing legal entities in either the United States or a foreign country to obtain the benefits of a U.S. income tax treaty.

Each LOB article sets forth a number of objective tests. A resident of a Contracting State that satisfies any of those objective tests generally is entitled to the benefits of the applicable income tax treaty (subject to the application of other rules, such as those pertaining to beneficial ownership), even if such resident was formed or availed of for purposes of tax avoidance. The common objective tests include: (1) a public company test; (2) an ownership and base erosion test; (3) an active trade or business test; and (4) in some cases, a derivative benefits test. A resident of a Contracting State that fails to satisfy any of the objective tests may potentially be granted treaty benefits by the applicable competent authority.

Even if a person is a resident of a treaty country and also qualifies under the LOB article of the treaty between that country and the United States, treaty benefits for a particular item of income will only be permitted if such person is considered the beneficial owner of that item of income under both U.S. and, to some extent, foreign tax principles. Thus, the United States disallows treaty benefits for payments subject to U.S. withholding tax where the ''anti-hybrid'' regulations issued under §894(c)[1] or the ''anti-conduit'' rules of Regs. §1.881-3 or other beneficial ownership principles apply.

# DISCUSSION

## LOB Article

The specific rules of the LOB article can vary significantly from treaty to treaty. In part, this is because each treaty involves different parties with their own objectives and priorities. But, in addition, it is clearly possible to observe certain trends in U.S. treaty policy. Some of these trends are discussed below, with a focus on changes from the 1996 U.S. Model Treaty (the ''1996 Model'') to the 2006 U.S. Model Treaty (the ''2006 Model'') and beyond.[2]

### Stricter Public Company Test

Pursuant to the ''public company test,'' a corporation that satisfies certain public trading requirements generally qualifies for treaty benefits. Under Article 22(2)(c)(i) of the 1996 Model, the public company test was satisfied if ''all the shares in the class or classes representing more than 50% of the voting power and value of the company are regularly traded on a recognized stock exchange'' in *either* Contracting State.[3] Notably, this provision did not require a company to satisfy a ''same country'' listing or trading requirement or to have any other connection (apart from residency) to its own Contracting State.

A great many LOB articles include tests similar to the tests found in the 1996 Model. As reflected in these treaties, the Treasury Department has historically been relatively unconcerned about the risk that a public company might be used for treaty-shopping purposes. In the last several years, however, the public company test appears to have been tightened considerably.

The public company test in the 2004 Protocol to the 1992 U.S.-Netherlands Income Tax Treaty (the ''2004 Dutch Protocol'') adopted a stricter approach by requiring a public company to have a meaningful nexus with the Contracting State of residence.

Under the 2004 Dutch Protocol, the public company test of the 1992 U.S.-Netherlands Income Tax Treaty is satisfied only if:

- The company's principal class of shares (and any disproportionate class of shares) is (a) listed on a recognized stock exchange located in either State and (b) regularly traded on one or more recognized stock exchanges worldwide; and
- The company has a ''substantial presence'' in its State of residence.

A company will be considered to have a substantial presence in its State of residence if it satisfies either a two-part trading test or a management and control test.[4] The two-part trading test will be satisfied if the aggregate volume of trading in the company's stock on recognized stock exchanges in its ''primary economic zone'' satisfies certain thresholds.[5] The management and control test will be satisfied if the company's ''primary place of management and control'' (i.e., the location where day-to-day decisions are made) is in its State of residence.[6]

A number of treaties and protocols signed after 2004 are similar to the 2004 Dutch Protocol.[7] Indeed, if anything, the trend is towards an even stricter pub-

[1] Unless the context indicates otherwise, all ''§'' references are to the U.S. Internal Revenue Code of 1986, as amended (''the Code''), and all ''Regs. §'' references are to the regulations issued thereunder (and set forth in 26 CFR).

[2] For a detailed discussion of the changes from the 1996 Model to the 2006 Model, see the comparison prepared by the Joint Committee on Taxation, dated May 8, 2007, (JCX-27-07).

[3] By its terms, Art. 22(2)(c)(i) does not impose any limitation on where the recognized stock exchange may be located. Pursuant to 2006 Model, Art. 22(5), however, the term ''recognized stock exchange'' means ''a) the NASDAQ System owned by the National Association of Securities Dealers, Inc. and any stock exchange registered with the U.S. Securities and Exchange Commission as a national securities exchange under the U.S. Securities Exchange Act of 1934; and b) [stock exchanges of the other Contracting State].''

[4] 2004 Dutch Protocol, Art. 26(8)(d).

[5] *See* 2004 Dutch Protocol, Art. 26(8)(d)(i).

[6] 2004 Dutch Protocol, Art. 26(8)(d)(ii).

[7] *See* 2006 U.S.-Belgium Income Tax Treaty, Art. 21(c)(i); 1999 U.S.-Denmark Income Tax Treaty, Art. 21(2)(c)(i), as modified by Art. IV of the Protocol signed in 2006; 1989 U.S.-Finland Income Tax Treaty, Art. 16(2)(c)(i), as modified by Art. VI of the Protocol signed in 2006; 1994 U.S.-Sweden Income Tax Treaty, Art. 17(2)(c)(i), as modified by a Art. VI of the Protocol signed in



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lic company test. For example, under the 2006 Protocol to the 1989 U.S.-Germany Income Tax Treaty (the ''2006 German Protocol''), the trading test can only be satisfied through trading on a German exchange.[8] The public company in the 2006 Model is substantially similar to the test set forth in the 2006 German Protocol.[9]

The stricter formulation set forth in the 2006 German Protocol and the 2006 Model does not appear to foreclose the availability of a more lenient standard in appropriate circumstances, e.g., if the other country is fairly small and lacks a particularly robust exchange. Nevertheless, even under the more lenient standard of the 2004 Dutch Protocol, U.S. treaty policy towards public companies clearly has become significantly stricter. Long gone are the days when public trading on any recognized exchange is itself sufficient to survive LOB scrutiny.

### Stricter Ownership and Base Erosion Test

An entity that is a resident of a Contracting State generally qualifies for treaty benefits under the ''ownership and base erosion test'' if: (1) a specified percentage of beneficial interests in such entity is owned by certain residents of the Contracting States; and (2) it erodes no more than a specified percentage of its gross income through certain deductible payments to certain persons.

Under Article 22(2)(f) of the 1996 Model, an entity generally satisfied the ownership and base erosion test if: (1) on at least half the days of the taxable year certain residents of *either* Contracting State that were entitled to treaty benefits under certain provisions of the LOB article owned, directly or indirectly, at least 50% of each class of shares or other beneficial interests in the entity;[10] and (2) less than 50% of the entity's gross income for the taxable year was paid or accrued, directly or indirectly, to third-country residents in the form of payments that were deductible for income tax purposes in the entity's State of residence.[11]

Subject to certain variations, a great many U.S. income tax treaties have an LOB article including a fairly similar ownership and base erosion test. Under any of these treaties, a foreign corporation can satisfy the ownership and base erosion test even if all of its equity is owned by (and all of its gross income is eroded through deductible payments to) residents of the United States.

In the last few years, however, the United States has signed a number of treaties and protocols that take a less liberal approach. Under the 2004 Barbados Protocol, for example, an entity that is a resident of a Contracting State can satisfy the ownership and base erosion test only if: (1) on at least half the days of the taxable year certain qualified residents of the *same* Contracting State own, directly or indirectly, more than 50% of the shares or other beneficial interests in the entity;[12] and (2) less than 50% of the entity's gross income is paid or accrued, directly or indirectly, to persons who are not qualifying residents of the *same* Contracting State in the form of payments that are deductible under the tax laws of such Contracting State (excluding arm's-length payments in the ordinary course of business for services or tangible property).[13]

The 2004 Barbados Protocol was in significant part a reaction to certain very public inversion transactions and is, therefore, a bit of a special case. Accordingly, the strict test adopted therein to prevent abuse of the Barbados treaty does not appear to reflect a change in U.S. treaty policy. Indeed, as of this writing, no subsequent treaty characterizes all payments by a resident of one Contracting State to residents of the *other* Contracting State as base-eroding payments.

Few of the post-2004 LOB articles, however, permit a resident of a Contracting State to satisfy the ownership prong of the ownership and base-erosion test through ownership by qualified residents of the *other* Contracting State.[14] Not surprisingly, then, under the ownership prong of the ownership and base erosion test of the 2006 Model, only same-country ownership is treated as ''good'' ownership. This would now appear to be a standard (possibly universal) feature of new U.S. income tax treaties.

### Active Trade or Business Test

A resident of a Contracting State generally may qualify for treaty benefits if such resident is engaged in an active trade or business in such Contracting State and certain other requirements are satisfied.

2005. *But see* 2004 U.S.-Bangladesh Income Tax Treaty, Art. 17(1)(d) (allowing treaty benefits for any ''company in whose principal class of shares there is substantial and regular trading on a recognized stock exchange'' in either Contracting State or as otherwise agreed by the Competent Authorities) and Art. 25 of the pending 2007 Protocol to the U.S.-Canada Income Tax Treaty, Art. XXIXA. (similar test provided, which also applies to any disproportionate class of shares).

[8] *See* 1989 U.S.-Germany Income Tax Treaty, Art. 28(2)(c)(aa), as modified by Art. XIV of the 2006 German Protocol. The pending protocols signed with Iceland and Bulgaria in 2007 would impose a similarly strict test.

[9] *See* 2006 Model, Art. 22(2)(c)(i).

[10] In addition, each intermediate owner must qualify for the benefits of the treaty under certain provisions of the LOB article.

[11] Payments that are attributable to a permanent establishment situated in either State are also disregarded.

[12] In the case of indirect ownership, each intermediate owner must be a resident of such Contracting State.

[13] 1984 U.S.-Barbados Income Tax Treaty, as amended by the 2004 Barbados Protocol, Art. 22(1)(d).

[14] For exceptions, see 2004 U.S.-Bangladesh Income Tax Treaty, Art. 17(1)(c)(i); 1992 U.S.-Netherlands Income Tax Treaty, Art. 26(2)(f)(i), as amended by the 2004 Dutch Protocol; and 1980 U.S.-Canada Income Tax treaty, Art. XXIXA(2)(e)(i), as amended by Art. 25 of the pending 2007 Protocol.



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Under the 1996 Model, the active trade or business test was satisfied if: (1) a resident of a Contracting State was engaged in the active conduct of a trade or business in such Contracting State; (2) the income earned in the other Contracting State was ''connected with or incidental to'' such trade or business; and (3) such trade or business was ''substantial'' in relation to the activity generating the income in the other Contracting State.[15]

For purposes of the basic active trade or business requirement, the 1996 Model provided that the business of making or managing investments was not considered an active trade or business unless the activity was banking, insurance, or securities activity conducted by a bank, insurance company, or registered securities dealer.[16]

For purposes of the ''connected with or incidental to'' requirement, the 1996 Model provided that the requisite connection was present if the activity in the Contracting State in which the income arose was a line of business that formed a part of, or was complementary to, the trade or business in the Contracting State of residence. Alternatively, income was incidental to a trade or business if it facilitated the conduct of the trade or business in the Contracting State of residence.[17]

For purposes of the substantiality requirement, the 1996 Model set forth a ''safe harbor'' whereby a trade or business was deemed substantial if, for the preceding taxable year or for the average of the three preceding taxable years, the following two requirements were met: (1) the asset value, the gross income, and the payroll expense that were related to the trade or business in the Contracting State of residence constituted at least 7.5% of the resident's (and any related parties') proportionate share of the asset value, gross income, and payroll expense, respectively, that were related to the activity that generated the income in the other Contracting State; and (2) the average of the three ratios exceeded 10%.[18]

The active trade or business test has not changed dramatically, but the 2006 Model did make a few minor adjustments. First, the 2006 Model revised the exclusion of certain investment activities from trade or business status. Whereas the 1996 Model provided that making or managing investments would never qualify (except in the case of a banking, insurance, or securities activity conducted by a bank, insurance company, or registered securities dealer), the exclusion in the 2006 Model only applies to ''making or managing investments for the resident's own account'' (except in the case of banking, insurance, or securities activities carried on by a bank, insurance company, or registered securities dealer). The new test appears more lenient.

Second, the 2006 Model eliminated: (1) the description of circumstances in which income will satisfy the ''in connection with or incidental to'' test; as well as (2) the safe harbor under the substantiality test. It does not appear that either change reflects any sea change.

Finally, the 2006 Model added a new attribution rule whereby, for purposes of the active trade or business test, a person's activities are deemed to include the activities of persons ''connected'' to such person.[19] Persons are considered to be connected if: (1) a 50% ownership test is satisfied; (2) one person has control of the other; or (3) both are under the control of the same person or persons. The new attribution clearly makes it easier for the relevant company in a group to satisfy the active trade or business test without ''footfaulting'' by reason of activities being conducted by the ''wrong'' member of the group.

**Derivative Benefits Test**

Under some U.S. income tax treaties, a company that does not otherwise satisfy any of the LOB tests may nevertheless qualify for treaty benefits pursuant to a ''derivative benefits test.'' Under most derivative benefits tests, a company will qualify for derivative benefits if: (1) shares possessing at least 95% of the aggregate voting power and value (and at least 50% of any disproportionate class of shares) are owned by seven or fewer ''equivalent beneficiaries''; and (2) the company satisfies a base erosion test.

An ''equivalent beneficiary'' generally means any person that:

1. Is a resident of a Member State of the EU, any state of the EEA, a party to NAFTA, or, in some cases, Switzerland (each, a ''Qualifying Country'');

2. Is entitled to the benefits of a comprehensive income tax treaty between such Qualifying Country and the Contracting State from which treaty benefits are claimed and satisfies certain LOB requirements (even if that treaty has no LOB article); and

3. In the case of dividends, interest, royalties, and possibly certain other items, would be entitled, under the treaty between the Qualifying Country and the Contracting State in which the income arises, to a rate of tax with respect to the particu-

[15] 1996 Model, Art. 22(3)(a).

[16] *Id.* at Art. 22(3)(b).

[17] *Id.* at Art. 22(3)(d).

[18] *Id.* at Art. 22(3)(c).

[19] 2006 Model, Art. 22(3)(c).



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lar class of income or the particular item for which benefits are claimed that is ''at least as low as'' the rate provided for under the treaty between the Contracting States.[20]

The fundamental premise of the derivative benefits provision is that no impermissible treaty-shopping benefit is being obtained with respect to an item of income if the corporation claiming treaty benefits is owned by ''equivalent beneficiaries'' who would have been entitled to the same (or perhaps more favorable) treaty benefits if they had earned such income directly.

Historically, relatively few LOB articles have included a derivative benefits test. More recently, however, it appears that derivative benefits tests are far more common,[21] but only in the case of treaties with countries within the EU. For example, such a test is included in the 2004 Dutch Protocol, 2005 Swedish Protocol, 2006 German Protocol, 2006 Danish Protocol, and 2006 U.S.-Belgium Income Tax Treaty.[22] Moreover, only certain EU residents (or residents of any party to NAFTA) may qualify as equivalent beneficiaries. From a historical perspective, this is understandable because the derivative benefits provision only came about due to certain EU-specific concerns.[23] Nevertheless, the derivative benefits provision appears to reflect sound treaty policy in that treaty benefits need not, and ought not, be denied where no improper treaty-shopping benefit is sought. Thus, apart from the inertia arising from historical precedent, there does not appear to be any good reason for limiting derivative benefits to treaties with EU countries or for only allowing residents of Qualifying Countries to qualify as equivalent beneficiaries. Indeed, the New York City Bar's Committee on Taxation of Business Entities recently proposed the elimination of such unnecessary geographic restrictions.[24]

## ANTI-HYBRID RULES

### Section 894(c) Regulations

Regs. §1.894-1(d)(1) provides as follows:[25]

> *(1) In general.* The tax imposed by sections 871(a), 881(a), 1443, 1461, and 4948(a) on an item of income received by an entity, wherever organized, that is fiscally transparent under the laws of the United States and/or any other jurisdiction with respect to an item of income shall be eligible for reduction under the terms of an income tax treaty to which the United States is a party only if the item of income is derived by a resident of the applicable treaty jurisdiction. For this purpose, an item of income may be derived by either the entity receiving the item of income or by the interest holders in the entity or, in certain circumstances, both. An item of income paid to an entity shall be considered to be derived by the entity only if the entity is not fiscally transparent under the laws of the entity's ju-

[20] In the case of income beneficially owned by a U.S. company and arising in the other Contracting State, however, the derivative benefits provisions typically deems the ''as low as'' requirement to be satisfied if the equivalent beneficiary is a resident of a Member State of the EU. *See, e.g.,* U.S.-Netherlands Income Tax Treaty, Art. 26(8)(g).

[21] Interestingly, relatively ''liberal'' derivative benefits provisions have become more common at a time when other LOB rules (such as ownership and base erosion and the public companies test) have gotten stricter. In connection with the ownership and base erosion test, we question what treaty shopping scheme is averted by denying benefits to an otherwise treaty-eligible entity owned principally by U.S. persons. As our discussion on ''Stricter Ownership and Base Erosion Test'' notes, anti-inversion legislation is meant to address the tax concerns arising from U.S. ownership. While current treaty policy tightens the rules for U.S. ownership (they are included as equivalent beneficiaries under the derivative benefits rules, but such rules are more restrictive than the ownership and base erosion rules in terms of ownership requirements), it expands benefits for third country equivalent beneficiaries. We believe the latter expansion is proper but note how anomalous it looks in connection with the tightening up on our own residents.

[22] *See* 1992 U.S.-Netherlands Income Tax Treaty, as modified by 2004 Dutch Protocol, Art. 26(3); 1994 U.S.-Sweden Income Tax Treaty, as modified by 2005 Swedish Protocol, Art. 17(3); 1989 U.S.-Germany Income Tax Treaty, as modified by 2006 German Protocol, Art. 28(3); 1999 U.S.-Denmark Income Tax Treaty, as modified by 2006 Denmark Protocol, Art. 22(3); and 2006 U.S.-Belgium Income Tax Treaty, Art. 21(3).

[23] The European Community Treaty (formally the Treaty of Rome) contains four freedoms that can apply to taxation policy. Two of these freedoms are arguably applicable to Member States' tax treaties. These are the freedom of establishment for businesses and the freedom of movement of capital. In the area of taxation, the European Court of Justice has interpreted such nondiscrimination principles extremely broadly. Accordingly, EU Member States may possibly be considered to violate such nondiscrimination principles merely by entering into a tax treaty with another country that permits such other country to improperly discriminate against an EU enterprise on the basis of where in the EU its owners reside. Such EU concerns apparently were in large part the impetus for the derivative benefits provisions that appear in U.S. income tax treaties with EU Member States.

[24] *See* Committee on Taxation of Business Entities of the New York City Bar, ''Report Offering Proposals Regarding the 'Derivative Benefits' Provision Found in the Limitation on Benefits Article of Certain U.S. Income Tax Treaties,'' (5/21/08), discussed and accessible at 102 *BNA Daily Tax Rpt.* I-4 (5/28/08). As a matter of full disclosure, it should be pointed out that the authors of this article also prepared the New York City Bar Report.

[25] Special rules addressing payments from U.S. ''reverse hybrid'' entities are set forth in Regs. §1.894-1(d)(2).




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risdiction, as defined in paragraph (d)(3)(ii) of this section, with respect to the item of income. An item of income paid to an entity shall be 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, as defined in paragraph (d)(3)(iii) of this section. Notwithstanding the preceding two sentences, an item of income paid directly to a type of entity specifically identified in a treaty as a resident of a treaty jurisdiction shall be treated as derived by a resident of that treaty jurisdiction.

As made clear in the first sentence of the regulation, an item of income will be eligible for a reduced rate of withholding tax under an income tax treaty between the United States and another country only if, in addition to satisfying all other applicable requirements, such item of income is ''derived'' by a resident of such country.

The succeeding sentences of the regulation essentially provide that, in order for an item of income to be ''derived'' by a resident of a treaty country, that country must consider its resident to have derived the income. More precisely, the regulations provide that an item of income paid to an entity is considered to be derived by the entity if, and only if, the entity is not ''fiscally transparent'' [26] under the laws of its jurisdiction with respect to such item of income. Therefore, an entity that is a resident of a treaty jurisdiction, and otherwise satisfies all other, including LOB, requirements, may claim treaty benefits for income paid to such entity.

The regulations similarly provide that an item of income paid to an entity is considered to be derived by the interest holder in the entity if, and only if: (1) the interest holder is not fiscally transparent in its jurisdiction with respect to the item of income; and (2) the entity is considered to be fiscally transparent under the laws of the interest holder's jurisdiction with respect to the item of income. Therefore, an interest holder in an entity may claim treaty benefits for income paid to such entity if such interest holder is a resident of a treaty jurisdiction, and otherwise satisfies all other requirements, provided that the tax laws of such treaty jurisdiction view the entity as fiscally transparent with respect to such item of income.

[26] The definition of fiscal transparency is set forth in Regs. §1.894-1(d)(3)(ii).

Interestingly, the §894(c) regulations allow treaty benefits to be claimed by entities that are not even treated as taxpayers for U.S. tax purposes. Thus, for example, an example in the regulations confirms that an entity treated as a partnership for U.S. tax purposes may claim treaty benefits if that entity is not considered to be ''fiscally transparent'' in its home (treaty) jurisdiction and all other treaty requirements are satisfied.[27] The same result clearly should follow even if the entity is wholly owned and thus is generally disregarded as an entity separate from its owner for U.S. income tax purposes. Before promulgation of the §894(c) regulations, few practitioners would have thought that a disregarded entity would be entitled to treaty benefits.

To the extent that these regulations are viewed as precluding U.S. withholding tax benefits under U.S. tax treaties that by their terms allow such benefits, the propriety of such unilateral treaty override by the United States is open to question.[28] However, the Preamble to the Treasury decision that adopted these regulations argues that the regulations are fully consistent with existing U.S. treaties, because such treaties ''rely on the basic principle that tax treaties are intended to relieve double taxation or excessive taxation.'' [29] The Preamble acknowledges, however, that the other country need not actually impose tax on a given item.

Although not clearly articulated in the Preamble, the principle appears to be that an item of income may qualify for treaty benefits only if, in certain key respects, the tax laws of the residence State consider the person claiming treaty benefits to be the beneficial owner. Putting aside the key ''procedural'' question of how such a rule ought properly to be adopted, the substance of the rule clearly seems appropriate as a policy matter. We discuss this further in the Beneficial Ownership section of this article.

[27] Regs. §1.894-1(d)(5) *Ex. 3.* The example also concludes that an interest holder residing in a different treaty country may access its own U.S. income tax treaty if the interest holder's jurisdiction considers such interest holder not to be fiscally transparent and also considers the entity deriving the income to be fiscally transparent.

[28] Note that if a treaty expressly identifies an entity as a resident of one of the treaty jurisdictions, an item of income paid directly to such an entity will be treated as derived by a resident of such treaty jurisdiction, without regard to the rules otherwise applicable under the anti-hybrid regulations. Regs. §1.894-1(d)(1) (last sentence).

[29] Preamble to T.D. 8889, (at I.), 65 Fed. Reg. 40993 (7/3/00).



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### 2006 Model, Article 1(6)

Article 1(6) of the 2006 Model provides as follows:[30]

> 6. An item of income, profit or gain derived through an entity that is fiscally transparent under the laws of either Contracting State shall be considered to be derived by a resident of a State to the extent that the item is treated for purposes of the taxation law of such Contracting State as the income, profit or gain of a resident.

Consistent with the principles underlying the §894(c) regulations, Article 1(6) of the 2006 Model looks to the tax principles of the Contracting State of the recipient or beneficial owner to determine whether a resident of that State is considered to have earned the income for which treaty benefits are being claimed. As explained in the Treasury Department's Technical Explanation:

> 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.

Thus, for example, ''if a company that is a resident of the other Contracting State pays interest to an entity that is treated as fiscally transparent for U.S. tax purposes, the interest will be considered derived by a resident of the U.S. only to the extent that the taxation laws of the United States treats [sic] 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.'' The Technical Explanation also confirms that the treatment of such entity under the tax laws of the source country or the country of which the entity is a resident is irrelevant.[31]

In contrast with the §894(c) regulations, the application of Article 1(6) of the 2006 Model is not limited to withholding taxes. Thus, for example, Article 1(6) should prevent a treaty resident doing business in the United States through a hybrid entity formed in a non-treaty country from invoking the Business Profits article of the applicable U.S. tax treaty to escape U.S. income tax on any business profits not attributable to a U.S. permanent establishment. By the same token, however, treaty benefits under the Business Profits article should be available in such situation if the entity is a non-U.S. reverse hybrid (treated as a corporation for U.S. tax purposes but as a pass-through under the laws of the treaty jurisdiction).

Over the last several years, a number of treaties and protocols have been signed that include provisions comparable to Article 1(6) of the 2006 Model, e.g., with Belgium, Iceland (pending), Finland, Germany, and Sweden. This is a good thing for at least two reasons. First, using the tax rules of the residence country to determine who derived the income clearly advances the policy objective of avoiding double taxation as well as double nontaxation. Second, putting those rules in the treaty itself avoids the ''treaty override'' issue that arises when the United States unilaterally imposes such treatment under the §894(c) regulations. It should be assumed that, over time, all U.S. income tax treaties will adopt some version of the §894(c) principles set forth in Article 1(6) of the 2006 Model. As discussed below, however, it should not be assumed that all such provisions will be alike.

### Pending Fifth Canadian Protocol

Under Article 2(2) of the pending Fifth Protocol to the Canadian Treaty (the ''Pending Canadian Protocol''),[32] Article 4(6) and (7) of the Canadian treaty would provide as follows:

> 6. An amount of income, profit or gain shall be considered to be derived by a person who is a resident of a Contracting State where:
>
> > (a) The person is considered under the taxation law of that State to have derived the amount through an entity (other than an entity that is a resident of the other Contracting State); and
> >
> > (b) By reason of the entity being treated as fiscally transparent under the

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[30] Art. 1(8) of the 2001 U.S.-U.K. Income Tax Treaty is virtually identical. Article 4(6) of the 2004 U.S.-Japan Income Tax Treaty provides greater detail.

[31] ''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 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.'' One key exception, however, is that the ''savings clause'' of the applicable treaty generally would allow the source country to tax its own residents as if such treaty were not in effect.

[32] The Protocol was approved by the U.S. Senate on Sept. 23, 2008, and is now awaiting exchange of the instruments of ratification.



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> laws of the first-mentioned State, the treatment of the amount under the taxation law of that State is the same as its treatment would be if that amount had been derived directly by that person.
>
> 7. An amount of income, profit or gain shall be considered not to be paid to or derived by a person who is a resident of a Contracting State where:
>
> (a) The person is considered under the taxation law of the other Contracting State to have derived the amount through an entity that is not a resident of the first-mentioned State, but by reason of the entity not being treated as fiscally transparent under the laws of that State, the treatment of the amount under the taxation law of that State is not the same as its treatment would be if that amount had been derived directly by that person; or
>
> (b) The person is considered under the taxation law of the other Contracting State to have received the amount from an entity that is a resident of that other State, but by reason of the entity being treated as fiscally transparent under the laws of the first-mentioned State, the treatment of the amount under the taxation law of that State is not the same as its treatment would be if that entity were not treated as fiscally transparent under the laws of that State.

Article 4(6) would solve the ''LLC problem'' that currently exists under Canadian law.[33] Moreover, the application of this provision clearly is not limited to withholding taxes and also applies to, for example, benefits under the Business Profits article. In that connection, as illustrated in the Technical Explanation, if a U.S. LLC (treated as a partnership for U.S. income tax purposes) does business in Canada, but not through a Canadian permanent establishment, such U.S. LLC will be exempt from Canadian tax on the share of its business profits that is allocable to the U.S. residents who are interest holders in the U.S. LLC.

Unfortunately, Article 4(7)(b) appears problematic for U.S. residents with investments in Canadian ULCs (unlimited liability companies).[34] As confirmed by the Joint Explanation of the U.S. Treasury Department and the Government of Canada, Article 4(7)(b) would disallow treaty benefits where dividends or other payments are made by a hybrid [35] Canadian ULC to its U.S. owner, because the treatment in the United States (the Contracting State of residence) is not the same as if the ULC had not been fiscally transparent in the United States.

From a policy perspective, it is difficult to see a compelling reason for denying treaty benefits in this fact pattern, particularly in the case of dividends, which are nondeductible to the distributing ULC. The treatment of the U.S. owner is different than if the ULC had not been fiscally transparent in the United States, but only because the United States *already taxed* such U.S. owner on its share of the ULC's income. In such circumstances, allowing treaty benefits for income that, in effect, has previously been taxed by the Contracting State of residence seems entirely appropriate. In this respect, the negotiators of the Pending Canadian Protocol appear to have done a poor job. Where all residency and LOB requirements are satisfied, and income is subject to tax in both Contracting States, treaty negotiators should look for ways to avoid double taxation.

Fortunately, Article 4(7) will not take effect until the first day of the third calendar year that ends after the Pending Canadian Protocol enters into force.[36] Therefore, even if the Pending Canadian Protocol enters into force in 2008, Article 4(7) will not apply until January 1, 2010. One can always hope that, before any real damage can be done (other than consternation for tax advisors on both sides of the border), the treaty negotiators will go back to the drawing board and get it right the next time around.[37]

## Beneficial Ownership Requirements

### In General

The third leg of the requirements for treaty eligibility is beneficial ''ownership'' of the item of income. The 1996 Model, the 2006 Model, the 2005 OECD

[33] Canada considers U.S. LLCs to be corporations. In the absence of any ''look-through rule,'' a U.S. LLC that is characterized as a disregarded entity or partnership for U.S. income tax purposes is considered by Canada to be a corporation that is not liable for any U.S. tax and thus does not qualify for treaty benefits.

[34] These days Canadian ULCs can be either NSULCS (Nova Scotia unlimited liability companies) or AULCS (Alberta unlimited liability companies).

[35] The term ''hybrid'' refers to an entity treated as a corporation for applicable foreign tax purposes and as a disregarded entity or partnership for U.S. income tax purposes.

[36] *See* Art. 27(3)(b) of the Pending Canadian Protocol.

[37] Indeed, Treasury Department representatives have informally indicated that they intend to do just that (and that Article 4(7)(b) will not become a fixture in future U.S. income tax treaties).



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Model Income Tax Convention, and most bilateral income tax treaties with the United States expressly impose a beneficial ownership requirement for treaty benefits in the dividend, interest, royalty, and other income articles of the treaty.[38] In making that determination, the law of the source State controls, unlike the residency and anti-hybrid rules, which are determined in accordance with the law of the residence State.[39] Article 3(2) of both the 1996 Model and the 2006 Model provides:

> 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, or the competent authorities agree to a common meaning pursuant to the provisions of Article 25 (Mutual Agreement Procedure), have the same meaning which it has at that time under the laws of that State for the purposes of the taxes to which the Convention applies, any meaning under the applicable tax laws of that State prevailing over a meaning given to the term under other laws of that State.

Because the term ''beneficial ownership'' is not defined in either model treaty or in most bilateral treaties, source country laws control, pursuant to Article 3(2).

As a policy matter, it makes sense to have source country laws control, as beneficial ownership rules provide the primary function of determining, as a threshold matter, who is the proper person that, in the case of U.S. payments, is subject to the income tax laws of the United States on that income.[40] Treaty benefits, on the other hand, are a secondary concern to the basic question of who is liable for source country taxes. Thus, the source country laws should control on the issue of beneficial ownership.

The rules for determining treaty benefit entitlement in the case of entities work reasonably well when the entity and its owners are treated alike under the tax laws of all relevant jurisdictions. Thus, for example, if an interest payment is made by a U.S. person to a Dutch entity that is wholly owned by a French resident, and both the United States and the Netherlands treat the Dutch entity as a corporation for tax purposes, treaty benefit application is straightforward. If Dutch law subjects the entity to tax, and the entity is not holding the income, under U.S. tax principles, as agent, nominee or conduit, for its owner or any other person, the entity, assuming further it meets all LOB requirements, will be considered the beneficial owner and treaty benefits will apply. It would not even seem to matter whether Dutch tax law treats the payment as belonging to another under its beneficial ownership rules, although in a perfect world allowing treaty benefits in that case is open to question.[41]

Problems quickly arise when the relevant jurisdictions take differing views on the transparency or non-transparency of the entity receiving the income (or a direct or indirect owner of an interest in such entity). Assume, for example, that an election is made to treat the Dutch corporation in the above example as a disregarded entity for U.S. income tax purposes. In that case, notwithstanding its status as a disregarded entity for U.S. income tax purposes, the Dutch company remains eligible to claim treaty benefits under the residency and §894(c) principles discussed in the prior section of this article.[42]

Under U.S. tax principles, however, it is the French resident that is considered the beneficial owner of the income if the Dutch entity has disregarded entity treatment. Because the Dutch company is not the beneficial owner under U.S. (i.e., source-state) tax principles, a literal reading of the interest article of the treaty (in conjunction with Article 3(2), requiring source-country principles to apply where not otherwise indicated) would not permit the allowance of treaty benefits. This result makes little sense, however, because the Dutch entity is subject to tax in the Netherlands and presumably pays tax on receipt of the interest income. Assuming that under U.S. tax principles the disregarded entity is not a nominee, agent, or conduit for its owner or any other person, there is no reason why treaty benefits should be disallowed. Fortunately, the United States does not attempt to disallow treaty benefits in this type of situation.[43]

The 1996 Model did not address the specific issues arising in the hybrid setting. The 1996 Model Technical Explanation of Article 11(1) (Interest) provides:

> The ''beneficial owner'' of a payment of interest is understood generally to refer to any

[38] This is not meant to imply that the requirement is not implicit for other items as well.

[39] To the extent that anti-hybrid rules are viewed as imposing a requirement of beneficial ownership under the tax laws of the residence state, there is a question whether such rules may be inconsistent with Article 3(2).

[40] *See, e.g., Lucas v. Earle*, 281 U.S. 111 (1930), and *Knetsch v. U.S.*, 364 U.S. 361 (1960).

[41] It is not too difficult for the source State withholding agent to determine whether the other Contracting State entity is subject to tax generally for purposes of the residency and anti-hybrid rules. However, it would be far more difficult for the withholding agent to determine whether some special rule under the tax laws of such other State (which may have no analog under U.S. tax principles) causes another person to be considered the beneficial owner of a particular item of income.

[42] *See also* Regs. §§1.1441-1(c)(6) and 1.1441-6(b)(2).

[43] See the discussion below regarding the ''anti-hybrid'' regulations issued under §894(c).



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> person resident in a Contracting State to whom that State attributes the payment for purposes of its tax. Paragraph 1(d) of Article 4 (Residence) makes this point explicitly with regard to income derived by fiscally transparent persons. Further, in accordance with paragraph 8 of the OECD Commentaries to Article 11, the source State may disregard as beneficial owner certain persons that nominally may receive an interest payment but in substance do not control it. See also, paragraph 24 of the OECD Commentaries to Article 1 (General Scope).

The 1996 Model Technical Explanation suggests, therefore, that the way to look at the issue is to determine first how the Contracting State of residence views beneficial ownership, and then to determine whether such entity is holding the income as agent, nominee, conduit, etc. under the tax principles of the source State. Under this approach, the disregarded Dutch entity in the example above would be entitled to treaty benefits because the income is ''attributed'' to it for Dutch tax purposes and nothing suggests that the Dutch entity is holding the payment as a nominee or conduit for its parent French resident (or any other person) under U.S. tax principles.

The 2006 Model Technical Explanation, in contrast to the 1996 Model Technical Explanation, clearly looks to source State tax principles to determine beneficial ownership. The explanation of Article 10(2) (Dividends) provides, in part, as follows:

> The term ''beneficial owner'' is not defined in the Convention, and is, therefore, defined as under the internal law of the country imposing tax (*i.e.,* the source country). The beneficial owner of the dividend for purposes of Article 10 is the person to which the income is attributable under the laws of the source State.

The 2006 Model Technical Explanation of the same treaty paragraph also, however, expressly addresses the hybrid structure in connection with dividend payments (although it does so, in our view, in a somewhat less than clear manner):

> In the case of a hybrid entities (that is, an entity treated as fiscally transparent under the laws of one State and non-fiscally transparent under the laws of the other, or of a third State), it may be that the person who ''derives'' the income under Article 1(6) is not the same person as the ''beneficial owner'' under Article 10. This will not prevent a claim for treaty benefits, so long as each of the requirements is met by one or more residents of the other Contracting State.

The Technical Explanation does not specifically bless our example of a Dutch entity owned by a French resident, but does address the issue subsequently. It also provides that, with respect to same country residents, the entity is eligible for the preferred dividend withholding rate, whether the owner of the entity is an individual or a corporation. However, looking at the entity and its owner as a combined entity (to use the phrase of the Technical Explanation) for beneficial ownership purposes is not fully consistent with permitting the preferred ''corporate'' rate on dividends rather than the 15% rate applicable to individuals.[44]

Where the owner of the entity is not resident in the other Contracting State, the 2006 Model Technical Explanation of Article 10(2) provides:

> If PCo. were not a resident of the other Contracting State, the analysis would be slightly different. From the U.S. perspective, the combined entity that is PCo. and SubDE [an intermediate entity organized in the other Contracting State] meets the 10% ownership requirement, and it owns the shares directly. From the perspective of the other Contracting State, SubDE is a resident of the other Contracting State. Accordingly, all of the requirements of Articles 1(6) and 10(2) are met, and the 5% withholding rate applies to the dividends paid by USCo. Alternatively, PCo. might be able to claim an exemption from the withholding tax altogether under another treaty to which the United States is a party. That would be the case if PCo. were established in, and resident of, a country with which the United States has entered into a tax treaty eliminating the withholding tax on dividends, and that other country viewed SubDE as fiscally transparent.

No rationale is given for permitting treaty benefits other than stating that the analysis is ''slightly different'' than the case where both the entity and the owner hail from the other Contracting State. Further, permitting in appropriate circumstances both the entity and its owner to be separately eligible for treaty benefits raises conceptual issues at odds with beneficial own-

[44] The May 21, 2008 New York City Bar Report (fn. 24 above) comments on analogous overly generous allowances of preferred dividend treaty rates in various treaty technical explanations in the derivative benefits setting where the entity owner is an individual.



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ership. The purpose of the beneficial ownership test is to seek the true owner of income for purposes of imposing tax. How can there be two true owners of the same income?[45]

Perhaps the better way to analyze the issue in the hybrid scenario is to recognize the function served by the beneficial ownership requirement in the treaty setting. Beneficial ownership requirements are part of the broad array of rules discussed in this article designed to curb treaty shopping. Pursuant to §894(c) and the regulations thereunder, as well as withholding tax Regs. §1.1441-6(b)(2), disregarded entities are recognized for the limited purpose of providing treaty benefits to the recognized beneficial owner of the income.[46]

In our view, the 1996 Model Technical Explanation provides a better foundation for analyzing beneficial ownership than the 2006 Model Technical Explanation by first viewing the entity otherwise eligible for treaty benefits under §894(c) as the beneficial owner of the income, because its country treats the income as subject to tax. After that determination has been made, we should determine under U.S. principles whether the entity in the other Contracting State is holding the income in its own right, or as agent, nominee, or conduit, employing U.S. tax law principles.

Thus, in our prior example, we would not look to the French resident as beneficial owner due to the check-the-box election, but rather would look at the Dutch company which has derived the income under Dutch law, and ask whether it holds the income as an agent, nominee, conduit, etc. for its parent French resident (or any other person), employing U.S. tax principles in making that determination. Under our facts, the Dutch disregarded entity, which is regarded for treaty purposes, would be deemed the owner of the income and treaty benefits would apply. The results are sound in that no treaty shopping has occurred and the entity is subject to Dutch tax on the income, provided that any base erosion or other applicable LOB requirements are satisfied.

In July of this year, Treasury issued, with the Canadian government, a joint Technical Explanation to the Pending Canadian Protocol. This contains a discussion of the interaction of the §894(c)-type rules in new Article IV(6) of the treaty (as added by Article 2(2) of the Protocol), which are similar to rules in Article 1(6) of the 2006 Model, with the determination of beneficial ownership, as follows:

> Special rules apply in the case of income, profits or gains derived through a fiscally transparent entity, described in new paragraph 6 of Article IV. Residence State principles determine who derives the income, profits or gains, to assure that the income, profits or gains for which the source State grants benefits of the Convention will be taken into account for tax purposes by a resident of the residence State. Source country principles of beneficial ownership apply to determine whether the person who derives the income, profits or gains, or another resident of the other Contracting State, is the beneficial owner of the income, profits or gains. The source State may conclude that the person who derives the income, profits, or gains in the residence State is a mere nominee, agent, conduit, etc., for a third country resident and deny benefits of the Convention. If the person who derives the income, profits or gains under paragraph 6 of Article IV would not be treated under source State's principles for determining beneficial ownership as a nominee, agent, custodian, conduit, etc., that person will be treated as the beneficial owner of the income, profits, or gains for purposes of the Convention.

This language is consistent with our suggested analysis of beneficial ownership in treaty settings and, in particular, the relationship to hybrid entities. In effect, the party deriving the income, whether or not otherwise disregarded under U.S. tax law, is regarded for purposes of determining under U.S. tax principles whether it is the beneficial owner of the income or mere agent or conduit. It avoids recognizing the legal fiction created by the check-the-box regulations that a legal entity does not exist, permits granting of treaty benefits where equities determine they should be granted, and, as will be shown subsequently, avoids granting of benefits where inappropriate.

[45] Consistent with the Technical Explanation, however, see fn. 42 concerning the treatment of dual treaty benefit claims under the withholding regulations.

[46] Note that the check-the-box regulations do not prevent disregarded entities from being taken into account for this purpose. So-called disregarded entities are not disregarded for all purposes of the U.S. tax laws. Moreover, while the source State treatment generally applies in the case of undefined terms, Article 3(2) of the 2006 Model also provides "unless the context otherwise requires." In construing this phrase, the 2006 Model Technical Explanation provides:

> The reference in both paragraphs 1 and 2 to the "context otherwise requir[ing]" a definition different from the treaty definition, in paragraph 1, or from the internal law definition of the Contracting State whose tax is being imposed, under paragraph 2, refers to a circumstance where the result intended by the Contracting States is different from the result that would obtain under either the paragraph 1 definition or the statutory definition. Thus, flexibility in defining terms is necessary and permitted.



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An example provided in the penultimate paragraph of the Technical Explanation of Article 2 of the Pending Canadian Protocol is consistent with our analysis:

> Assume, for instance, that interest arising in the United States is paid to CanLP, an entity established in Canada which is treated as fiscally transparent for Canadian tax purposes but is treated as a company for U.S. tax purposes. CanCo, a company incorporated in Canada, is the sole interest holder in CanLP. Paragraph 6 of Article IV provides that CanCo derives the interest. However, if under the laws of the United States regarding payments to nominees, agents, custodians and conduits, CanCo is found to be a nominee, agent, custodian, or conduit for a person who is not a resident of Canada, CanCo will not be considered the beneficial owner of the interest and will not be entitled to the benefits of Article XI with respect to such interest. The payment may be entitled to benefits, however, if CanCo is found to be a nominee, agent, custodian or conduit for a person who is a resident of Canada.

The example is instructive on several levels. First, unlike the examples in the 2006 Model Technical Explanation, the Canadian Technical Explanation provides an example of a reverse hybrid situation. The entity is a corporation for U.S. tax purposes, and presumably is considered the beneficial owner of the interest under U.S. tax law. However, the interest holder, CanCo, is considered to derive the income for treaty purposes and the beneficial ownership analysis is made with respect to its rights to the income. Because there is no suggestion that CanCo is holding as agent, etc., it is deemed for this purpose to be the beneficial owner of the interest income under U.S. tax principles. So the fact that, under generally applicable U.S. income tax principles, CanLP is considered to be the beneficial owner and subject to U.S. tax would not matter and is not mentioned in the example.

On a second level, the analysis adopted in the Canadian Technical Explanation avoids the novel, but somewhat unsupported, combined entity doctrine set forth in the 2006 Model Technical Explanation. Both reach the same result.

### Anti-Conduit Regulations

A subset of the beneficial ownership requirements is the specific ''anti-conduit'' regulations issued pursuant to §7701(l) (and prior case law [47]). The United States takes the position, under the regulations, that treaty benefits are unavailable in the case of certain back-to-back loans and other similar transactions, because the treaty resident may be considered a ''conduit'' and, therefore, not the beneficial owner of certain U.S.-source payments.[48] In very general terms, the regulations disallow treaty benefits only if, among other requirements, the treaty resident is an ''intermediate entity'' in a ''financing arrangement'' that includes two or more ''financing transactions.''

The anti-conduit regulations have been criticized on the ground that they override the obligations to U.S. treaty partners. The Treasury Department takes the view that those regulations supplement the LOB article ''by determining which person is the beneficial owner of income with respect to a particular financing arrangement.'' [49] Whatever the merits of that debate, it seems clear that the anti-conduit regulations are here to stay.

### Interaction of §894(c) and Anti-Conduit Regulations

As noted above, the §894(c) regulations allow treaty benefits to be claimed by ''entities'' that are generally considered to be disregarded entities for U.S. income tax purposes. This has apparently given some tax planners interesting ideas about how to avoid the anti-conduit regulations.

Suppose that a U.K. resident corporation owns 100% of a Cayman Islands subsidiary that in turn owns 100% of another U.K. resident corporation. Suppose further that both subsidiaries are hybrids, i.e., disregarded for U.S. income tax purposes and treated as corporations for U.K. tax purposes. Under these facts, a payment of U.S.-source dividends or interest to the U.K. subsidiary that otherwise qualifies for the benefits of the 2001 U.S.-U.K. Income Tax Treaty arguably still qualifies even if the U.K. subsidiary makes a ''back-to-back'' interest payment to its disregarded Cayman parent.[50] This is obviously the type of financing arrangement to which the anti-conduit regulations were meant to apply, but it is uncertain whether those rules would apply here. If the subsidiaries are disregarded for purposes of applying the anti-conduit regulations, there would not appear to be

[47] The leading case in the area is *Aiken Industries, Inc. v. Comr.*, 56 T.C. 925 (1971). *See also Northern Indiana Public Service Co. v. Comr.*, 105 T.C. 341 (1995), *aff'd*, 115 F.3d 506 (7th Cir. 1997); *Del Commercial Properties., Inc., v. Comr.*, T.C. Memo 1999-411, *aff'd*, 251 F.3d 210 (D.C. Cir. 2001).

[48] *See generally* Regs. §1.881-3. Like the §894(c) regulations, the anti-conduit regulations only apply to amounts subject to U.S. withholding tax.

[49] *See* Preamble to T.D. 8611 (at B.1.), 60 Fed. Reg. 40997 (8/11/95).

[50] The authors have not considered whether the back-to-back loan structure described above would actually be viable for U.K. tax purposes.



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any back-to-back loan (or other financing arrangement involving two or more financing transactions) to which such regulations could apply. Inasmuch as no special rule applies for this purpose, taxpayers might successfully argue that the general rule requiring the subsidiaries to be disregarded as entities separate from their owner for U.S. income tax purposes applies for purposes of applying the anti-conduit regulations.

The authors would not be as confident as others that this is the result that a court would adopt if the matter were litigated. Under the analytic framework the authors have suggested and the Canadian Technical Explanation supports, the beneficial ownership test is examined in the person deriving the income and therefore claiming treaty benefits. In this case it would be the U.K. subsidiary, which for treaty purposes would be considered the beneficial owner subject to agency, conduit, etc. findings under U.S. tax principles. Under U.S. tax principles, however, solely for purposes of determining eligibility for treaty benefits, the U.K. subsidiary ought to be considered to be a mere conduit for its Cayman parent company, which ought to be considered to exist for purposes of applying the anti-conduit rules, notwithstanding the check-the-box election. Clearly it would be desirable for the Treasury Department to avoid the present uncertainty and amend the regulations to provide that, in the treaty context, the anti-conduit regulations should be applied based on the entity-classification principles of the treaty country whose resident derives the income.

## Proposed Legislation

Amendments to §894 proposed in Congress in 2007 in two separate bills would impose a further, and novel, limitation on treaty benefits.[51] Each bill would in certain circumstances limit or deny treaty benefits by increasing the withholding tax imposed on certain deductible payments (particularly interest and royalty payments) made to a related party ultimately owned by a foreign parent corporation.

In the event that the foreign parent corporation of the recipient is also entitled to the benefits of a U.S. income tax treaty, and the treaty rate under the parent's treaty with the United States is higher than that available under the recipient's treaty, the Doggett Bill would in effect disallow treaty benefits to the extent necessary to increase the withholding rate to the higher rate applicable under the foreign parent corporation's treaty.[52] If instead the foreign parent corporation is not eligible for the benefits of any U.S. income tax treaty, both bills would entirely disallow treaty benefits.

In such circumstances, treaty benefits would be wholly or partially denied even though the recipient of the payment: (1) qualifies as a resident of a country with which the United States has an income tax treaty; (2) satisfies the requirements, if any, of the LOB article of that treaty; (3) derives the income within the meaning of the §894(c) regulations; and (4) is considered to be the beneficial owner under U.S. tax principles, including the anti-conduit regulations.

Both bills seem misguided. The United States simply ought not unilaterally override its treaty obligations. If Congress believes that the LOB articles of U.S. income tax treaties are too easily satisfied, it should coordinate with the Treasury Department to adopt tougher LOB articles in the future. In contrast with the anti-hybrid and anti-conduit regulations that at least arguably supply rules for determining beneficial ownership, the Rangel and Doggett Bills would require the United States to withhold treaty benefits to which, under the terms of the relevant treaties, the residents of the U.S. treaty partners are undeniably entitled.

## CONCLUSION

Even though the LOB article and other LOB-type restrictions (including anti-hybrid rules and beneficial ownership requirements) have been in place for some time, U.S. treaty policy in this area is continuing to evolve. In particular, the U.S. Treasury Department (and U.S. treaty partners) continue to struggle with whether treaty benefits should be allowed in certain circumstances where, due to differing views of the status of the relevant entities, the parties to the applicable treaty have fundamentally different views of who, if anyone, earned what income. At the same time, some members of Congress have proposed entirely new LOB restrictions that would unilaterally disallow certain U.S. treaty benefits for foreign subsidiaries that would otherwise enjoy lower rates of U.S. withholding tax than their foreign parent corporations. More is yet to come. Stay tuned.

[51] H.R. 3160, 110th Cong. 1st Sess. (the "Doggett Bill"); H.R. 3970, 110th Cong. 1st Sess. (the "Rangel Bill").

[52] The Rangel Bill would not apply in such circumstances.



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