§ 1.894–1 Income affected by treaty.

(a) Income exempt under treaty. Income of any kind is not included in gross income and is exempt from tax under Subtitle A (relating to income taxes), to the extent required by any income tax convention to which the United States is a party. However, unless otherwise provided by an income tax convention, the exclusion from gross income under section 894(a) and this paragraph does not apply in determining the accumulated taxable income of a foreign corporation under section 535 and the regulations thereunder or the undistributed personal income of any person entitled to the benefits of this title.

(b) Income exempt under treaty. Income of any kind is not included in gross income and is exempt from tax under Subtitle A (relating to income taxes), to the extent required by any income tax convention to which the United States is a party. However, unless otherwise provided by an income tax convention, the exclusion from gross Income of any kind is not included in gross income and is exempt from tax under Subtitle A (relating to income taxes), to the extent required by any income tax convention to which the United States is a party. However, unless otherwise provided by an income tax convention, the exclusion from gross income under section 894(a) and this paragraph does not apply in determining the accumulated taxable income of a foreign corporation under section 535 and the regulations thereunder or the undistributed personal income of any person entitled to the benefits of this title.

(c) Tax conventions, consular conventions, and international agreements—(1) Exemption dependent upon internal revenue laws. A tax convention or consular convention, or international agreement provides that compensation paid by a foreign government or international organization to its employees is exempt from Federal income tax, and the application of this exemption is not dependent upon the provisions of the internal revenue laws.

(2) Exemption not dependent upon internal revenue laws. If a tax convention, consular convention, or international agreement provides that compensation paid by the foreign government or international organization to its employees is exempt from Federal income tax, and the application of this exemption is not dependent upon the provisions of the internal revenue laws, the exemption so conferred is not affected by the execution and filing of a waiver under section 247(b) of the Immigration and Nationality Act.
holding company income of a foreign corporation under section 545 and the regulations thereunder. Moreover, the distributable net income of a foreign trust is determined without regard to section 894 and this paragraph, to the extent provided by section 643(a)(6)(B). Further, the compensating tax adjustment required by section 819(a)(3) in the case of a foreign life insurance company is to be determined without regard to section 894 and this paragraph, to the extent required by section 819(a)(3)(A). See §1.871-12 for the manner of determining the tax liability of a nonresident alien individual or foreign corporation whose gross income includes income on which the tax is reduced under a tax convention.

(b) Taxpayer treated as having no permanent establishment in the United States—(1) In general. A nonresident alien individual or a foreign corporation, that is engaged in trade or business in the United States through a permanent establishment located therein at any time during a taxable year beginning after December 31, 1966, shall be deemed not to have a permanent establishment in the United States at any time during that year for purposes of applying any exemption from, or reduction in the rate of, any tax under Subtitle A of the Code which is provided by any income tax convention with respect to income which is not effectively connected for that year with the conduct of a trade or business in the United States by the taxpayer. This paragraph applies to all treaties or conventions entered into by the United States, whether entered into before, on, or after November 13, 1966, the date of enactment of the Foreign Investors Tax Act of 1966 (80 Stat. 1539). This paragraph is not considered to be contrary to any obligation of the United States under an income tax convention to which it is a party. The benefit granted under section 894(b) and this paragraph applies only to those items of income derived from sources within the United States which are subject to the tax imposed by section 871(a) or 881(a), and section 1441, 1442, or 1451, on the noneffectively connected income received from sources within the United States by a nonresident alien individual or a foreign corporation.

The benefit does not apply to any income from real property in respect of which an election is in effect for the taxable year under §1.871-10 or in determining under section 877(b) the tax of a nonresident alien individual who has lost United States citizenship at any time after March 8, 1965. The benefit granted by section 894(b) and this paragraph is not elective.

(2) Illustrations. The application of this paragraph may be illustrated by the following examples:

Example 1. M, a corporation organized in foreign country X, uses the calendar year as the taxable year. The United States and country X are parties to an income tax convention which provides in part that dividends received from sources within the United States by a corporation of country X not having a permanent establishment in the United States are subject to tax under Chapter 1 of the Code at a rate not to exceed 15 percent. During 1967, M is engaged in business in the United States through a permanent establishment located therein and receives $100,000 in dividends from domestic corporation B, which under section 864(c)(2) and §1.864–4(c), the dividends received from B are not effectively connected with the conduct of a trade or business of country X in the United States by M. Although M has a permanent establishment in the United States during 1967, it is deemed, under section 894(b) and this paragraph, not to have a permanent establishment in the United States during that year with respect to the dividends. Accordingly, in accordance with paragraph (c)(3) of §1.871–12 the tax on the dividends is $15,000, that is, 15 percent of $100,000, determined without the allowance of any deductions.

Example 2. T, a corporation organized in foreign country X, uses the calendar year as the taxable year. The United States and country X are parties to an income tax convention which provides in part that an enterprise of country X is not subject to tax under chapter 1 of the Code in respect of its industrial or commercial profits unless it is engaged in trade or business in the United States during the taxable year through a permanent establishment located therein and that, if it is so engaged, the tax may be imposed upon the entire income of that enterprise from sources within the United States. The convention also provides that the tax imposed by Chapter 1 of the Code on dividends received from sources within the United States by a corporation of X which is not engaged in trade or business in the
United States through a permanent establishment located therein shall not exceed 15 percent of the dividend. During 1967, T is engaged in a business (business A) in the United States through a permanent establishment located therein; in addition, T is engaged in a business (business B) in the United States which is not carried on through a permanent establishment. During 1967, T receives from sources within the United States $50,000 in service fees through the operation of business A and $10,000 in dividends through the operation of business B, both of which amounts are, under section 864(c)(2)(B) and §1.864–4(c)(3), effectively connected for that year with the conduct of a trade or business in the United States by that corporation. The service fees are considered to be industrial or commercial profits under the tax convention with country X. Since T has no income for 1967 which is not effectively connected for that year with the conduct of a trade or business in the United States through a permanent establishment located therein, it is deemed, under section 894(b) and this paragraph, not to have a permanent establishment therein with respect to the $5,000 in dividends. Accordingly, in accordance with paragraph (c) of §1.871–12, for 1967 T's entire income of $70,000 from sources within the United States is subject to tax, after allowance of deductions, in accordance with section 882(a)(1) and paragraph (b)(2) of §1.882–1.

Example 3. S, a corporation organized in foreign country W, uses the calendar year as the taxable year. The United States and country W are parties to an income tax convention which provides in part that a corporation of country W is not subject to tax under Chapter 1 of the Code on dividends received from sources within the United States by a corporation of country W as are attributable to the permanent establishment in the United States; in addition, N holds shares of stock in a domestic corporation D which are not effectively connected with the permanent establishment. The tax convention also provides that if a corporation of country W is engaged in industrial or commercial activity in the United States through a permanent establishment in the United States, income tax may be imposed by the United States on so much of the dividends received from sources within the United States by a corporation of country W which, under section 864(c)(2)(A) and §1.864–4(c)(2), are effectively connected for that year with the conduct of a trade or business in the United States by S. The sales income is considered to be industrial or commercial profits under the tax convention with country X. During 1967, S is engaged in a business (business A) in the United States through a permanent establishment located therein and derives from sources within the United States $50,000 in service fees which, under section 864(c)(2)(B) and §1.864–4(c)(3), are effectively connected for that year with the conduct of a trade or business in the United States by S and which are considered to be industrial or commercial profits under the tax convention with country W. During 1967, S also derives from sources within the United States, through another business it carries on in foreign country X, $10,000 in sales income which, under section 864(c)(3) and §1.864–4(b), is effectively connected for that year with the conduct of a trade or business in the United States by S and $5,000 in dividends which, under section 864(c)(2)(A) and §1.864–4(c)(2), are not effectively connected for that year with the conduct of a trade or business in the United States by S. The sales income is considered to be industrial or commercial profits under the tax convention with country X. During 1967 through a permanent establishment located therein and derives from sources within the United States $60,000 in dividends which, under section 864(c)(2)(A) and §1.864–4(c)(2), are effectively connected for that year with the conduct of a trade or business in the United States by S. The sales income is considered to be industrial or commercial profits under the tax convention with country X. During 1967 T receives from sources within the United States $70,000 through the operation of business A and $10,000 in dividends through the operation of business B, both of which amounts are, under section 864(c)(2)(B) and §1.864–4(c)(3), effectively connected for that year with the conduct of a trade or business in the United States by that corporation. The service fees are considered to be industrial or commercial profits under the tax convention with country X. Since T has no income for 1967 which is not effectively connected for that year with the conduct of a trade or business in the United States through a permanent establishment located therein, it is deemed, under section 894(b) and this paragraph, not to have a permanent establishment therein with respect to the $5,000 in dividends. Accordingly, in accordance with paragraph (c) of §1.871–12, for 1967 T's entire income of $70,000 from sources within the United States is subject to tax, after allowance of deductions, in accordance with section 882(a)(1) and paragraph (b)(2) of §1.882–1.

Example 4. (a) N, a corporation organized in foreign country Z, uses the calendar year as the taxable year. The United States and country Z are parties to an income tax convention which provides in part that the tax imposed by Chapter 1 of the Code on dividends received from sources within the United States by a corporation of country Z shall not exceed 15 percent of the amount distributed if the recipient does not have a permanent establishment in the United States or, where the recipient does have a permanent establishment in the United States, if the shares giving rise to the dividends are not effectively connected with the permanent establishment. The tax convention also provides that if a corporation of country Z is engaged in industrial or commercial activity in the United States through a permanent establishment in the United States, income tax may be imposed by the United States on so much of the industrial or commercial profits of such corporation as are attributable to the permanent establishment in the United States.

(b) During 1967, N is engaged in a business (business A) in the United States which is not carried on through a permanent establishment in the United States. In addition, N has a permanent establishment in the United States through which it carries on another business (business B) in the United States. During 1967, N holds shares of stock in a domestic corporation D which are not effectively connected with N's permanent establishment in the United States. During 1967, N receives $100,000 in dividends from D which, pursuant to section 864(c)(2)(A) and §1.864–4(c)(2), are effectively connected for that year with the conduct of business A. Under section 864(c)(2)(A) these dividends are treated as income from sources within the United States; in addition, N receives from sources within the United States $150,000 in sales income which, pursuant to
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section 864(c)(3) and §1.894–4(b), is effectively connected with the conduct of a trade or business in the United States and which is considered to be industrial or commercial profits under the tax convention with country Z. Of these total profits, $70,000 is from business A and $30,000 is from business B. Only the $80,000 of industrial or commercial profits is attributable to N’s permanent establishment in the United States.

(c) Since N has no income for 1967 which is not effectively connected for that year with the conduct of a trade or business in the United States by that corporation, section 894(b) and this paragraph do not apply. However, N is entitled to the reduced rate of tax under the tax convention with country Z with respect to the dividends because the shares of stock are not effectively connected with N’s permanent establishment in the United States. Accordingly, assuming that there are no deductions connected with N’s industrial or commercial profits, the tax for 1967, determined as provided in paragraph (c) of §1.871–32, is $46,900 as follows:

<table>
<thead>
<tr>
<th>Amount</th>
<th>Taxable</th>
<th>Rate</th>
<th>Tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>$80,000−.48</td>
<td>$38,400</td>
<td>.26</td>
<td>$10,080</td>
</tr>
<tr>
<td>Less $25,000−.26</td>
<td>$15,000</td>
<td>.15</td>
<td>$4,275</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>$31,900</td>
</tr>
</tbody>
</table>

Example 5. M, a corporation organized in foreign country Z, uses the calendar year as the taxable year. The United States and country Z are parties to an income tax convention which provides in part that a corporation of country Z is not subject to tax under Chapter 1 of the Code in respect of its commercial and industrial profits except such profits as are allocable to its permanent establishment in the United States. The regulations in this chapter under the tax convention with country Z provide that a corporation of country Z having a permanent establishment in the United States is subject to U.S. tax upon its industrial and commercial profits from sources within the United States and that its industrial and commercial profits from such sources are deemed to be allocable to the permanent establishment in the United States. During 1967, M is engaged in a business (business A) in the United States which is carried on through a permanent establishment in the United States; in addition, M is engaged in a business (business B) in foreign country X and none of such business is carried on in the United States. During 1967, M receives from sources within the United States $60,000 in sales income through the operation of business A and $10,000 in sales income through the operation of business B, both of which amounts are, under section 864(c)(3) and §1.894–4(b), effectively connected for that year with the conduct of a trade or business in the United States by that corporation. The sales income is considered to be industrial and commercial profits under the tax convention with country Z. Since M has no income for 1967 which is not effectively connected for that year with the conduct of a trade or business in the United States by that corporation, section 894(b) and this paragraph do not apply. Accordingly, for 1967 M’s entire income of $50,000 from sources within the United States is subject to tax, after allowance of deductions, in accordance with section 882(a)(1) and paragraph (b)(2) of §1.882-1.

(c) Substitute interest and dividend payments. The provisions of an income tax convention dealing with interest or dividends paid to or derived by a foreign person include substitute interest or dividend payments that have the same character as interest or dividends under §1.864–5(b)(9)(ii), 1.871–7(b)(2) or 1.881–2(b)(2). The provisions of this paragraph (c) shall apply for purposes of securities lending transactions or sale-repurchase transactions as defined in §1.861–2(a)(7) and §1.861–3(a)(6).

(d) Special rule for items of income received by entities—(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 jurisdiction, as defined in paragraph (d)(9)(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 for items of income derived from such holder. 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 jurisdiction, as defined in paragraph (d)(9)(ii) of this section, with respect to the item of income.
transient 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.

(2) Application to domestic reverse hybrid entities—(i) In general. An income tax treaty may not apply to reduce the amount of federal income tax on U.S. source payments received by a domestic reverse hybrid entity. Further, notwithstanding paragraph (d)(1) of this section, the foreign interest holders of a domestic reverse hybrid entity are not entitled to the benefits of a reduction of U.S. income tax under an income tax treaty on items of income received from U.S. sources by such entity. A domestic reverse hybrid entity is a domestic entity that is treated as not fiscally transparent for U.S. tax purposes and as fiscally transparent under the laws of the interest holder’s jurisdiction, with respect to the item of income received by the domestic entity.

(ii) Payments by domestic reverse hybrid entities—(A) General rule. Except as otherwise provided in paragraph (d)(2)(ii)(B) of this section, an item of income paid by a domestic reverse hybrid entity to an interest holder in such entity shall have the character of such item of income under U.S. law and shall be considered to be derived by the interest holder, provided the interest holder is not fiscally transparent in its jurisdiction, as defined in paragraph (d)(3)(ii) of this section, with respect to the item of income. In determining whether the interest holder is fiscally transparent with respect to the item of income under this paragraph (d)(2)(ii)(A), the determination under paragraph (d)(3)(ii) of this section shall be made based on the treatment that would have resulted had the item of income been paid by an entity that is not fiscally transparent under the laws of the interest holder’s jurisdiction with respect to any item of income.

(B) Payment made to related foreign interest holder—(1) General rule. If—

(i) A domestic entity makes a payment to a related domestic reverse hybrid entity that is treated as a dividend under either the laws of the United States or the laws of the jurisdiction of a related foreign interest holder in the domestic reverse hybrid entity, and under the laws of the jurisdiction of the related foreign interest holder in the domestic reverse hybrid entity, the related foreign interest holder is treated as deriving its proportionate share of the payment under the principles of paragraph (d)(1) of this section; and

(ii) The domestic reverse hybrid entity makes a payment of a type that is deductible for U.S. tax purposes to the related foreign interest holder or to a person, wherever organized, the income and losses of which are available, under the laws of the jurisdiction of the related foreign interest holder, to offset the income and losses of the related foreign interest holder, and for which a reduction in U.S. withholding tax would be allowed under an applicable income tax treaty; then

(iii) To the extent the amount of the payment described in paragraph (d)(2)(ii)(B)(1)(i) of this section does not exceed the sum of the portion of the payment described in paragraph (d)(2)(ii)(B)(1)(i) of this section treated as derived by the related foreign interest holder and the portion of any other prior payments described in paragraph (d)(2)(ii)(B)(1)(i) of this section treated as derived by the related foreign interest holder, the amount of the payment described in (d)(2)(ii)(B)(1)(ii) of this section will be treated for all purposes of the Internal Revenue Code and any applicable income tax treaty as a distribution within the meaning of section 301(a) of the Internal Revenue Code, and the tax to be withheld from the payment described in paragraph (d)(2)(ii)(B)(1)(ii) of this section (assuming the payment is a dividend under section 301(o)(1) of the Internal Revenue Code) shall be determined based on the appropriate rate of withholding that would be applicable to dividends paid from the domestic reverse hybrid entity to the related foreign interest holder in accordance with the principles of paragraph (d)(2)(ii)(A) of this section.
§ 1.894–1 Determining amount to be re-characterized under paragraph (d)(2)(ii)(B)(1)(iii). For purposes of determining the amount to be re-characterized under paragraph (d)(2)(ii)(B)(1)(iii) of this section, the portion of the payment described in paragraph (d)(2)(ii)(B)(1)(i) of this section treated as derived by the related foreign interest holder shall be increased by the portion of the payment derived by any other person described in paragraph (d)(2)(ii)(B)(1)(ii), and shall be reduced by the amount of any prior section 301(c) distributions made by the domestic reverse hybrid entity to the related foreign interest holder or any other person described in paragraph (d)(2)(ii)(B)(1)(ii) and by the amount of any payments from the domestic reverse hybrid entity previously recharacterized under paragraph (d)(2)(ii)(B)(1)(iii) of this section.

(3) Tiered entities. The principles of this paragraph (d)(2)(ii)(B) also shall apply to payments referred to in this paragraph (d)(2)(ii)(B) made among related entities when there is more than one domestic reverse hybrid entity or other fiscally transparent entity involved.

(4) Definition of related. For purposes of this section, a person shall be treated as related to a domestic reverse hybrid entity if it is related by reason of the ownership requirements of section 267(b) or 707(b)(1), except that the language “at least 80 percent” applies instead of “more than 50 percent,” where applicable. For purposes of determining whether a person is related by reason of the ownership requirements of section 267(b) or 707(b)(1), the constructive ownership rules of section 318 shall apply, and the attribution rules of section 267(c) also shall apply to the extent they attribute ownership to persons to whom section 318 does not attribute ownership.

(C) Payments to persons not described in paragraph (d)(2)(ii)(B)(1)(i) — (1) Related persons. The Commissioner may treat a payment by a domestic reverse hybrid entity to a related person (who is neither the related foreign interest holder nor otherwise described in paragraph (d)(2)(ii)(B)(1)(ii) of this section), in whole or in part, as being made to a related foreign interest holder for purposes of applying paragraph (d)(2)(ii)(B) of this section, if—

(i) The payment to the related person is of a type that is deductible by the domestic reverse hybrid entity; and

(ii) The payment is made in connection with one or more transactions the effect of which is to avoid the application of paragraph (d)(2)(ii)(B) of this section.

(2) Unrelated persons. The Commissioner may treat a payment by a domestic reverse hybrid entity to an unrelated person, in whole or in part, as being made to a related foreign interest holder for purposes of applying paragraph (d)(2)(ii)(B) of this section, if—

(i) The payment to the unrelated person is of a type that is deductible by the domestic reverse hybrid entity;

(ii) The unrelated person (or other person (whether related or not) which receives a payment in a series of transactions that includes a transaction involving such unrelated person) makes a payment to the related foreign interest holder (or other person described in paragraph (d)(2)(ii)(B)(1)(ii));

(iii) The foregoing payments are made in connection with a series of transactions which constitute a financing arrangement, as defined in §1.881–3(a)(2)(i); and

(iv) The transactions have the effect of avoiding the application of paragraph (d)(2)(ii)(B) of this section.

(iii) Examples. The rules of this paragraph (d)(2) are illustrated by the following examples:

Example 1. Dividend paid by unrelated entity to domestic reverse hybrid entity. (i) Facts. Entity A is a domestic reverse hybrid entity, as defined in paragraph (d)(2)(i) of this section. With respect to the U.S. source dividends it receives from B, a domestic corporation to which A is not related within the meaning of paragraph (d)(2)(ii)(B)(4) of this section, A’s 85-percent shareholder, FC, is a corporation organized under the laws of Country X, which has an income tax treaty in effect with the United States. A’s remaining 15-percent shareholder is an unrelated domestic corporation. Under Country X law, FC is not fiscally transparent with respect to the dividend, as defined in paragraph (d)(3)(ii) of this section. In year 1, A receives $100 of dividend income from B. Under Country X law, FC is treated as deriving $85 of the $100 dividend payment received by A. The applicable rate of tax on dividends under the U.S.-Country X
income tax treaty is 5 percent with respect to a 10-percent or more corporate shareholder.

(ii) Analysis. Under paragraph (d)(2)(i) of this section, FC may not claim a reduced rate of taxation on its share of the dividend income received by A because the payment is made by B, a domestic corporation, to A, another domestic corporation. A remains fully taxable under the U.S. tax laws as a domestic corporation with regard to that item of income. Further, pursuant to paragraph (d)(2)(i) of this section, notwithstanding the fact that A is treated as fiscally transparent under the U.S.-Country X income tax treaty with respect to the dividend income under the laws of Country X, FC may not claim a reduced rate of taxation on its share of the U.S. source dividend income received by A.

Example 2. Interest paid by domestic reverse hybrid entity to related foreign interest holder where dividend is paid by unrelated entity. (i) Facts. The facts are the same as in Example 1. Both the United States and Country X characterize the payment by B in year 1 as a dividend. In addition, in year 2, A makes a payment of $25 to FC that is characterized under the Internal Revenue Code as interest. Accordingly, in year 2, A is entitled to an interest deduction with respect to that payment and FC is not entitled to an interest deduction with respect to that payment and FC is not entitled to claim the reduced rate of withholding applicable to interest.

(ii) Analysis. The analysis is the same as in Example 1 with respect to the $100 dividend payment from B to A. With respect to the $25 payment from A to FC, paragraph (d)(2)(i)(B) of this section will not apply because, although FC is a related foreign interest holder in A, A is not related to B, the payor of the dividend income it received. Under paragraph (d)(2)(i)(A) of this section, the $25 of interest paid by A to FC in year 2 is characterized under the laws of Country X as interest. Accordingly, in year 2, A is entitled to an interest deduction with respect to the $25 interest payment from A to FC, and FC is entitled to the reduced rate of withholding applicable to interest under the laws of Country X income tax treaty, assuming all other requirements for claiming treaty benefits are met.

Example 3. Interest paid by domestic reverse hybrid entity to related foreign interest holder where dividend is paid by an unrelated entity. (i) Facts. The facts are the same as in Example 3, except that A has two 50-percent shareholders, FC1 and FC2. In year 2, A makes an interest payment of $25 to both FC1 and FC2. FC1 is a corporation organized under the laws of Country X, which has an income tax treaty in effect with the United States. FC2 is a corporation organized under the laws of Country Y, which also has an income tax treaty in effect with the United States. FP owns 100-percent of both FC1 and FC2, and is organized under the laws of Country Y. Under Country X law, FC1 is not fiscally transparent with respect to the dividend, as defined in paragraph (d)(3)(i) of this section. Under Country X law, FC1 is treated as deriving 5 percent of the $100 dividend payment received by A because A is fiscally transparent under the laws of Country X, as determined under paragraph (d)(3)(i) of this section. The applicable rate of tax on dividends under the U.S.-Country X income tax treaty is 5 percent with respect to a 10-percent or more corporate shareholder. Under Country Y law, FC2 is not treated as deriving any of the $100 dividend payment received by A because, under the laws of Country Y, A is not a fiscally transparent entity.

(ii) Analysis. The analysis is the same as in Example 1 with respect to the $100 dividend payment from S to A. With respect to the $25 payment in year 2 by A to FC1, the payment will be treated as a dividend for all purposes of the Internal Revenue Code and the U.S.-Country X income tax treaty because FC1 is a related foreign interest holder as determined under paragraph (d)(3)(i) of this section. The applicable rate of tax on dividends under the U.S.-Country X income tax treaty is 5 percent with respect to a 10-percent or more corporate shareholder. Under the U.S.-Country X income tax treaty because FC1 is a related foreign interest holder as determined under paragraph (d)(3)(i) of this section, and because $25 does not exceed FC1’s share of the dividend payment made by S to A ($50), FC1 is a related foreign interest holder because FC1 is treated as owning the stock of A owned by FC2 under section 267(b)(3). Since FC1 is not fiscally transparent with respect to the payment as determined under paragraph (d)(3)(i)(A) of this section, FC1 is entitled to the 5-percent reduced rate applicable to dividends under the U.S.-Country X income tax treaty with respect to the $25 payment. Because the $25 payment in year 2 is recharacterized as a
dividend for all purposes of the Internal Revenue Code and the U.S.-Country X income tax treaty, A is not entitled to an interest deduction with respect to that payment. Even though A is related to FC, the interest holder, the $25 interest payment by A to FC in year 2 is not recharacterized because A is not fiscally transparent under the laws of Country X. A is not entitled to claim the reduced rate of withholding applicable to the payment because, although A is related to S, the payor of the dividend income it received, A is not related to FB under paragraph (d)(2)(i)(B)(4) of this section. Under paragraph (d)(2)(i)(A) of this section, the $25 interest payment made from A to FB in year 2 is characterized as interest under the Internal Revenue Code.

Example 7. Interest paid by domestic reverse hybrid entity to unrelated foreign bank. (i) Facts. The facts are the same as in Example 3, except that in year 2, A makes the interest payment of $25 to FB, a Country Y unrelated foreign bank, on a loan from FB to A.

(ii) Analysis. The analysis is the same as in Example 1 with respect to the $100 dividend payment from S to A. With respect to the $25 payment from A to FB, paragraph (d)(2)(i)(B) of this section will not apply because the payment is made in connection with a transaction that constitutes a financing arrangement within the meaning of paragraph (d)(2)(i)(C)(2) of this section, the payment may be treated by the Commissioner as being made directly to FC. If the Commissioner disregards FB, then the analysis is the same as in Example 3 with respect to the $25 interest payment in year 2 from A to FC.

Example 8. Interest paid by domestic reverse hybrid to an unrelated entity pursuant to a financing arrangement. (i) Facts. The facts are the same as in Example 7, except that in year 3, FB makes an interest payment of $25 to FC on a deposit made by FC with FB.

(ii) Analysis. The analysis is the same as in Example 1 with respect to the $100 dividend payment from S to A. With respect to the $25 payment from A to FB in year 2, because the payment is made in connection with a financing arrangement, the payment rate under the treaty is 10 percent and the interest rate is 0 percent.

Example 9. Royalty paid by related entity to domestic reverse hybrid entity. (i) Facts. The facts are the same as in Example 3, except the $100 income received by A from S in year 1 is a royalty payment under both the laws of the United States and the laws of Country X. The royalty rate under the treaty is 10 percent and the interest rate is 0 percent.

(ii) Analysis. The analysis as to the royalty payment from S to A is the same as in Example 1 with respect to the $100 dividend payment from S to A. With respect to the $25 payment from A to FC, paragraph (d)(2)(i)(B) of this section will not apply because the payment from S to A is not treated as a dividend under the Internal Revenue Code or the laws of Country X. Under paragraph (d)(2)(i)(A) of this section, the $25 of interest paid by A to FC in year 2 is characterized as interest under the Internal Revenue Code. Accordingly, in year 2, FC may obtain the reduced rate of withholding applicable to interest under the U.S.-Country X income tax treaty, assuming all other requirements for claiming treaty benefits are met.

(3) Definitions—(i) Entity. For purposes of this paragraph (d), the term entity shall mean any person that is...
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An entity will not be treated as fiscally transparent with respect to an item of income under the laws of the interest holder’s jurisdiction, however, if, under the laws of the interest holder’s jurisdiction, the interest holder is required to include in gross income a share of all or a part of the entity’s income on a current basis year under any type of anti-deferral or comparable mechanism. In determining whether an entity is fiscally transparent with respect to an item of income under the laws of an interest holder’s jurisdiction, it is irrelevant...
how the entity is treated under the laws of the entity’s jurisdiction.

(B) Special definitions. For purposes of this paragraph (d)(3)(iii), an interest holder’s jurisdiction is the jurisdiction where the interest holder is organized or incorporated or may otherwise be considered a resident under the laws of that jurisdiction. An interest holder will be treated as taking into account that person’s share of income paid to an entity on a current basis even if such amount is taken into account by such person in a taxable year other than the taxable year of the entity if the difference is due solely to differing taxable years.

(iv) Applicable treaty jurisdiction. The term applicable treaty jurisdiction means the jurisdiction whose income tax treaty with the United States is invoked for purposes of reducing the rate of tax imposed under sections 871(a), 881(a), 1461, and 4948(a).

(v) Resident. The term resident shall have the meaning assigned to such term in the applicable income tax treaty.

(4) Application to all income tax treaties. Unless otherwise explicitly agreed upon in the text of an income tax treaty, the rules contained in this paragraph (d) shall apply in respect of all income tax treaties to which the United States is a party. Notwithstanding the foregoing sentence, the competent authorities may agree on a mutual basis to depart from the rules contained in this paragraph (d) in appropriate circumstances. However, a reduced rate under a tax treaty for an item of U.S. source income paid will not be available irrespective of the provisions in this paragraph (d) to the extent that the applicable treaty jurisdiction would not grant a reduced rate under the tax treaty to a U.S. resident in similar circumstances, as evidenced by a mutual agreement between the relevant competent authorities or by a public notice of the treaty jurisdiction. The Internal Revenue Service shall announce the terms of any such mutual agreement or public notice of the treaty jurisdiction. Any denial of tax treaty benefits as a consequence of such a mutual agreement or notice shall affect only payment of U.S. source items of income made after announcement of the terms of the agreement or of the notice.

(5) Examples. This paragraph (d) is illustrated by the following examples:

Example 1. Treatment of entity treated as partnership by U.S. and country of organization. (i) Facts. Entity A is a business organization formed under the laws of Country X that has an income tax treaty in effect with the United States. A is treated as a partnership under the laws of Country X, and therefore Country X requires the interest holders in A to separately take into account on a current basis their respective shares of the items of income paid to A, whether or not distributed to the interest holders, and the character and source of the items in the hands of the interest holders are determined as if such items were realized directly from the source from which realized by A. A receives royalty income from U.S. sources that is not effectively connected with the conduct of a trade or business in the United States.

(ii) Analysis. A is fiscally transparent in its jurisdiction within the meaning of paragraph (d)(3)(ii) of this section with respect to the U.S. source royalty income in Country X and, thus, A does not derive such income for purposes of the U.S.-X income tax treaty.

Example 2. Treatment of interest holders in entity treated as partnership by U.S. and country of organization. (i) Facts. The facts are the same as under Example 1. A’s partners are M, a corporation organized under the laws of Country Y that has an income tax treaty in effect with the United States, and T, a corporation organized under the laws of Country Z that has an income tax treaty in effect with the United States. M and T are not fiscally transparent under the laws of their respective countries of incorporation. Country Y requires M to separately take into account on a current basis M’s respective share of the items of income paid to A, whether or not distributed to M, and the character and source of the items of income in M’s hands are determined as if such items were realized directly from the source from which realized by A. Country Z treats A as a corporation and does not require T to take its share of A’s income into account on a current basis whether or not distributed.

(ii) Analysis. M is treated as deriving its share of the U.S. source royalty income for purposes of the U.S.-Y income tax treaty because A is fiscally transparent under paragraph (d)(3)(ii) with respect to that income under the laws of Country Y. Under Country Z law, however, because T is not required to take into account its share of the U.S. source royalty income received by A on a current basis whether or not distributed, A is not treated as fiscally transparent. Accordingly, T is not treated as deriving its share.
of the U.S. source royalty income for purposes of the U.S.-Z income tax treaty.

Example 3. Dual benefits to entity and interest holder. (i) Facts. The facts are the same as under Example 2, except that M is taxable as a corporation under the laws of Country X. Article 12 of the U.S.-X income tax treaty provides for a source country reduced rate of tax on royalty income. Paragraph (d)(3)(ii) of this section reduces the royalty treaty reduced rate on royalties under the U.S.-Y income tax treaty provides that royalty income may only be taxed by the beneficial owner’s country of residence.

(ii) Analysis. A is treated as deriving the U.S. source royalty income for purposes of the U.S.-X income tax treaty because it is not fiscally transparent with respect to the item of income within the meaning of paragraph (d)(3)(ii) of this section in Country X. Its country of organization, M is also treated as deriving its share of the U.S. source royalty income for purposes of the U.S.-Y income tax treaty because A is fiscally transparent under paragraph (d)(3)(ii) of this section with respect to that income under the laws of Country Y. T is not treated as deriving the U.S. source royalty income for purposes of the U.S.-Z income tax treaty because A is fiscally transparent under paragraph (d)(3)(ii) of this section with respect to that income under the laws of Country Z.

Analysis. Assuming all other requirements for eligibility for treaty benefits have been satisfied, M is also entitled to a zero rate share of the royalty income of A. M is not required to take into account any of its income on a current basis, some distributions are made currently to M. There is no requirement under Country Y law that M take into account A’s income on a current basis whether or not distributed to him in that year. The resident of Country Y, although the character of the item of income in the hands of the interest holder is determined as if such item were realized directly from the source from which realized by A. Accordingly, upon a current distribution of interest income to M, the interest income retains its source as U.S. source income.

Example 5. Treatment of complex trust. (i) Facts. The facts are the same as in Example 4 except that M is treated as the owner of the trust only under U.S. tax law, after application of section 672(f), but not under the law of Country Y. Although the trust document governing A does not require that A distribute any of its income on a current basis, some distributions are made currently to M. There is no requirement under Country Y law that M take into account A’s income on a current basis whether or not distributed to him in that year. Under the laws of Country Y, with respect to current distributions, the character of the item of income in the hands of the interest holder is determined as if such item were realized directly from the source from which realized by A. Accordingly, upon a current distribution of interest income to M, the interest income retains its source as U.S. source income.

(ii) Analysis. M does not derive the U.S. source interest income because A is not fiscally transparent under paragraph (d)(3)(ii) of this section with respect to the U.S. source interest income under the laws of Country Y. Although the character of the interest in the hands of M is determined as if realized directly from the source from which realized by A, under the laws of Country Y, M is not required to take into account his share of A’s interest income on a current basis whether or not distributed. Accordingly, neither A nor M is entitled to claim treaty benefits, since A is a resident of a non-treaty jurisdiction and M does not derive the U.S. source interest income for purposes of the U.S.-Y income tax treaty.

Example 6. Treatment of interest holders required to include passive income under anti-deferral regime. (i) Facts. The facts are the same as under Example 2. However, Country Y does require T, who is treated as owning 50-percent of the stock of A, to take into account its respective share of the royalty income of A under an anti-deferral regime applicable to certain passive income of controlled foreign corporations.

(ii) Analysis. T is still not eligible to claim treaty benefits with respect to the royalty income. T is not treated as deriving the U.S. source royalty income for purposes of the U.S.-Z income tax treaty under paragraph (d)(3)(ii) of this section because T is only required to take into account its pro rata share of the U.S. source royalty income by reason of Country Z’s anti-deferral regime.

Example 7. Treatment of contractual arrangements operating as collective investment vehicles. (i) Facts. A is a contractual arrangement without legal personality for all purposes under the laws of Country X providing for joint ownership of securities. Country X has
an income tax treaty in effect with the United States. A is a collective investment fund which is of a type known as a Common Fund under Country X law. Because of the absence of legal personality in Country X of the arrangement, A is not liable to tax as a person at the entity level in Country X and is thus not a resident within the meaning of the income tax treaty. A is, however, a resident of Country X under the laws of Country X, however, investors in A only take into account their respective share of A’s income generated within Country X, and thus not a resident within the meaning of the income tax treaty. A is treated as a partnership for U.S. income tax purposes and receives U.S. source dividend income. Under the laws of Country X, however, investors in A only take into account their respective share of A’s income and, thus, the character and source of the income received by A when A distributes the income to its interest holders is not determined as if such income were realized directly from the source from which realized by A. Accordingly, A is treated as deriving the U.S. source dividends for purposes of the U.S.-Country X treaty.

Example 9. Treatment of investment company
when entity receives distribution deductions, and all distributions sourced by residence of entity. (i) Facts. Entity A is a business organization formed under the laws of Country X, which has an income tax treaty in effect with the United States. A is treated as a partnership for U.S. income tax purposes. Under the laws of Country X, A is an investment company taxable at the entity level and a resident of Country X. It is also entitled to a distribution deduction for amounts distributed to its interest holders on a current basis. A distributes all its net income on a current basis to its interest holders and, thus, in fact, has no income tax liability to Country X. A receives U.S. source dividend income. Under Country X law, all amounts distributed to interest holders of this type of business entity are treated as dividends from sources within Country X and Country X imposes a withholding tax on all payments by A to foreign persons. Under Country X laws, the interest holders in A do not have to separately take into account their respective shares of A’s income on a current basis as such income is not, in fact, distributed.

(ii) Analysis. A is not fiscally transparent under paragraph (d)(3)(ii) of this section with respect to the U.S. source dividend income because the interest holders in A are not required to take into account their respective shares of such income in the taxable year whether or not distributed. Because A is an arrangement without a legal personality that is not considered a person in Country X and thus not a resident of Country X under the Residence Article of the U.S.-X income tax treaty, however, A does not derive the income as a resident of Country X for purposes of the U.S.-X income tax treaty. Further, because A is not fiscally transparent under paragraph (d)(3)(ii) of this section with respect to the U.S. source dividend income, A’s interest holders that are residents of Country X do not derive the income as residents of Country X for purposes of the U.S.-X income tax treaty.

Example 10. Item by item determination of fiscal transparency. (i) Facts. Entity A is a business organization formed under the laws of Country X, which has an income tax treaty in effect with the United States. A is treated as a partnership for U.S. income tax purposes. Under the laws of Country X, A is an investment company taxable at the entity level and a resident of Country X. It is also entitled to a distribution deduction for amounts distributed to its interest holders on a current basis. A receives both U.S. source dividend income and interest income from U.S. sources that is neither portfolio interest nor effectively connected with the conduct of a trade or business in the United States. Country X law sources all distributions attributable to dividend income based on the residence of the investment company. In contrast, Country X law sources all distributions attributable to interest income based on the residence of the payor of the interest. No withholding applies with respect to distributions attributable to U.S. source interest and the character of the distributions attributable to the interest income remains the same in the hands of A’s interest holders.
Income derived by a foreign central bank of issue, or by Bank for International Settlements, from obligations of the United States or from bank deposits.

(a) In general. Income derived by a foreign central bank of issue from obligations of the United States or of any agency or instrumentality thereof, or from interest on deposits with persons carrying on the banking business, is excluded from the gross income of such bank and is exempt from income tax if