

of the Commission, nor are they published as bearing the Commission's official approval. They represent interpretations and practices followed by the Division of Corporation Finance and the Office of the Chief Accountant in administering the disclosure requirements of the Federal securities laws.

Dated: June 26, 2000.

Margaret H. McFarland,
Deputy Secretary.

PART 211—[AMENDED]

Accordingly, Part 211 of Title 17 of the Code of Federal Regulations is amended by adding Staff Accounting Bulletin No. 101B to the table found in Subpart B.

Staff Accounting Bulletin No. 101B

[The text of Staff Accounting Bulletin No. 101B will not appear in the Code of Federal Regulations.]

The staff hereby amends Question 2 of Section B of Topic 13 of the Staff Accounting Bulletin Series.

Topic 13: Revenue Recognition

* * * * *

B. Disclosures

Question 1

* * * * *

Question 2

Question: Will the staff expect retroactive changes by registrants to comply with the accounting described in this bulletin?

Interpretive Response: All registrants are expected to apply the accounting and disclosures described in this bulletin. The staff, however, will not object if registrants that have not applied this accounting do not restate prior financial statements provided they report a change in accounting principle in accordance with APB Opinion No. 20, *Accounting Changes*, and FASB Statement No. 3, *Reporting Accounting Changes in Interim Financial Statements*, no later than the fourth fiscal quarter of the fiscal year beginning after December 15, 1999. In periods subsequent to transition, registrants should disclose the amount of revenue (if material to income before income taxes) recognized in those periods that was included in the cumulative effect adjustment. If a registrant files financial statements with the Commission before applying the guidance in this bulletin, disclosures similar to those described in Staff Accounting Bulletin Topic 11—M, *Disclosure of the Impact that Recently Issued Accounting Standards Will Have on the Financial Statements of a Registrant When Adopted in a Future Period*, should be provided. With regard to question 10 of Topic 13—A and Topic 8—A regarding income statement presentation, the staff would normally expect retroactive application to all periods presented unless the effect of applying the guidance herein is immaterial.

However, if registrants have not previously complied with generally accepted accounting principles, for example, by recording revenue for products prior to delivery that did not comply with the applicable bill-and-hold guidance, those registrants should apply the guidance in APB Opinion No. 20 for the correction of an error.¹ In addition, registrants should be aware that the Commission may take enforcement action where a registrant in prior financial statements has violated the antifraud or disclosure provisions of the securities laws with respect to revenue recognition.

[FR Doc. 00-16580 Filed 6-30-00; 8:45 am]

BILLING CODE 8010-01-P

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[TD 8889]

RIN 1545-AV10

Guidance Regarding Claims for Certain Income Tax Convention Benefits

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations relating to treaty withholding rates for items of income received by entities that are fiscally transparent in the United States and/or a foreign jurisdiction. The regulations affect the determination of tax treaty benefits available to foreign persons with respect to such items of income.

DATES: *Effective Dates:* These regulations are effective June 30, 2000.

Applicability Dates: These regulations apply to items of income paid on or after June 30, 2000.

FOR FURTHER INFORMATION CONTACT: Shawn R. Pringle, (202) 622-3850 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

This document contains final regulations relating to the Income Tax Regulations (CFR part 1) under section 894 of the Internal Revenue Code

¹ APB Opinion No. 20, ¶ 13 and ¶ 36-37 describe and provide the accounting and disclosure requirements applicable to the correction of an error in previously issued financial statements. Because the term "error" as used in APB Opinion No. 20 includes "oversight or misuse of facts that existed at the time that the financial statements were prepared," that term includes both unintentional errors as well as intentional fraudulent financial reporting and misappropriation of assets as described in Statement on Auditing Standards No. 82, *Consideration of Fraud in a Financial Statement Audit*.

(Code). On June 30, 1997, the IRS and Treasury issued temporary regulations (TD 8722 [1997-2 C.B. 81]) in the **Federal Register** (62 FR 35673, as corrected at 62 FR 46876, 46877) under section 894 of the Code relating to eligibility for benefits under income tax treaties for payments to entities. A notice of proposed rulemaking ([1997-2 C.B. 646]) cross-referencing the temporary regulations was also published in the same issue of the **Federal Register** (62 FR 35755).

Need for Changes

Since the publication of TD 8722 and proposed regulation § 1.894(d)(REG-104893-97, 62 FR 35755), the IRS and Treasury have received numerous comments. This Treasury decision contains changes made in response to some of those comments.

Explanation of Provisions

I. General

These final section 894 regulations clarify the availability of treaty benefits with respect to an item of U.S. source income paid to an entity that is treated as fiscally transparent under the laws of one or more jurisdictions (including the United States) with respect to that item of income. An entity that is treated as fiscally transparent in one jurisdiction but not another is referred to as a hybrid entity. If an item of U.S. source income is paid to a hybrid entity, the United States may regard the entity as fiscally transparent with respect to the item of income and the foreign treaty jurisdiction may regard the entity as deriving the item of income. Alternatively, the United States may regard the entity as deriving the item of income under U.S. tax principles, but a foreign treaty jurisdiction may regard the entity as fiscally transparent and may therefore regard the interest holders as deriving the item of income. This dual classification may give rise to inappropriate and unintended results under tax treaties, such as double non-taxation or double taxation of the item of income, unless the tax treaties are interpreted to resolve the conflict of laws.

These final regulations clarify how to apply U.S. treaties when the entity classification law of the United States and a foreign treaty jurisdiction conflict by providing that a reduced treaty rate for an item of U.S. source income is available only if the income is derived by a foreign recipient resident in the applicable treaty jurisdiction. This general rule, which has been simplified but not substantially changed from the rule contained in the temporary and

proposed section 894 regulations, is discussed in greater detail below.

These final regulations are fully consistent with existing U.S. treaties. They rely on the basic principle that tax treaties are intended to relieve double taxation or excessive taxation.

Accordingly, the United States and its treaty partners agree to cede part or all of their taxation rights on income arising from sources within their respective borders on the mutual understanding that the other party is asserting tax jurisdiction over the items of income. This objective is generally achieved through treaty provisions that limit or eliminate the tax that the source state may impose on income arising within its borders to the extent that the income is considered to be derived by a resident of the other jurisdiction. In general, an item of income will be considered derived by a resident for treaty purposes only when the residence country is asserting taxing jurisdiction over the item of income. However, the source state does not necessarily require, as a condition for ceding its taxing jurisdiction, that the income actually be taxed in the residence state or taxed at a rate commensurate with the rate imposed in the source state. The source state and the residence state may come to different conclusions regarding the appropriate taxation principles that apply to a particular type of taxpayer or a particular type of income. Such differences reflect how each state has decided to assert its taxing jurisdiction over that taxpayer or item of income and may or may not affect the source state's willingness to forego its taxing rights in whole or in part during the treaty negotiation process.

The approach adopted in these final regulations is consistent with the evolving multilateral consensus among the member countries of the Organization for Economic Cooperation and Development (OECD) on the appropriate method for source countries to follow to determine if they should provide treaty benefits on items of income paid to fiscally transparent entities, particularly when an entity classification conflict exists between the source and residence states. This evolving multilateral consensus is described in greater detail in the OECD report, "The Application of the OECD Model Tax Convention to Partnerships" (OECD Partnership Report). The report generally provides that a source state is required to grant treaty benefits on income paid to an entity only if the income is considered to be derived by a resident of a treaty partner for purposes of the treaty partner's tax laws. IRS and Treasury will continue to

coordinate these issues with U.S. tax treaty partners both bilaterally and multilaterally to resolve substantive issues arising from application of the principles set forth in the section 894 regulations and the OECD Partnership Report.

These regulations apply with respect to all U.S. income tax treaties regardless of whether such treaties contain partnership provisions, unless the competent authorities agree otherwise. As with the proposed and temporary regulations, the final regulations address only the treatment of U.S. source income that is not effectively connected with the conduct of a U.S. trade or business. The IRS and Treasury may issue additional regulations addressing the availability of other tax treaty benefits, such as the application of business profits provisions, with respect to the income of fiscally transparent entities, particularly where a conflict in entity classification exists.

II. Objective Versus Subjective Regulatory Approach

The temporary and proposed section 894 regulations adopted an objective approach to determining whether the United States should grant treaty benefits on U.S. source items of income paid to entities. Application of the regulations did not turn on whether there existed a tax avoidance motive for choosing a particular transaction or structure.

Commentators recommended a narrower approach that would deny treaty benefits on items of income paid to an entity only if the entity served a tax avoidance purpose. As part of this approach, commentators requested implementation of a ruling procedure that could be used to claim treaty benefits by rebutting any deemed tax avoidance motive for the items of income paid to an entity. This suggestion was not adopted. These final regulations are intended to provide objective rules regarding eligibility for treaty benefits on certain items of U.S. source income paid to entities. Although a ruling procedure was not adopted, taxpayers may still invoke the Mutual Agreement Procedures under an applicable treaty in appropriate circumstances.

III. Simplified Standard for Determining When U.S. Source Income Is Derived by a Treaty Resident

The proposed and temporary regulations provided that the tax imposed by sections 871(a), 881(a), 1461, and 4948(a) on an item of income received by an entity is eligible for reduction under the terms of an income

tax treaty to which the United States is a party if such item of income is treated as derived by a resident of an applicable treaty jurisdiction, such resident is a beneficial owner of the item of income, and all other applicable requirements for benefits under the treaty are satisfied. The proposed and temporary regulations further provided that an item of income received by an entity is treated as derived by a resident only to the extent the item of income is subject to tax in the hands of a resident of such jurisdiction. Numerous comments were received stating that this general rule needed clarification. As a result, the IRS and Treasury are eliminating the use of the terms beneficial ownership and subject to tax from the general rule, as described in greater detail below.

A. Beneficial Ownership

Commentators requested clarification regarding the relationship between beneficial owner and the § 1.881-3 anti-conduit regulations issued under the authority of section 7701(l). The anti-conduit rules under section 7701(l) are incorporated into the U.S. determination of beneficial owner. They are not separate additional requirements.

The concept of beneficial owner was included in the proposed regulations to explain the circumstances under which a hybrid entity may beneficially own an item of income for purposes of an income tax treaty, in light of the then proposed withholding regulations under § 1.1441-1(c)(6)(ii)(B). However, the definition of beneficial owner in § 1.1441-1(c)(6) of the amended final regulations (TD 8881 [2000-23 I.R.B. 1158]) does not apply to claims for reduced withholding under an income tax treaty. Accordingly, because there is no longer a need to clarify the meaning of the term under the section 1441 regulations in the treaty context, these final regulations no longer provide specific rules for this determination. The concept of beneficial owner nevertheless remains an important condition for claiming tax treaty benefits that is determined under U.S. tax principles, including the anti-conduit rules.

B. Subject to Tax

Commentators suggested that the term subject to tax in the proposed and temporary regulations was ambiguous and could be misinterpreted. Commentators suggested that the term subject to tax could be interpreted as requiring that an actual tax be paid rather than requiring an exercise of taxing jurisdiction by the applicable treaty jurisdiction, whether or not there

is an actual tax paid. Commentators suggested that such an interpretation would lead to anomalous results, for example, in cases when the applicable treaty jurisdiction provides an exemption from income for U.S. source dividends under its tax laws.

The IRS and Treasury agree that the term subject to tax could cause unintentional confusion and that a more direct and simpler way of ensuring that an item of income is subject to the taxing jurisdiction of the residence country is to determine if the item of income is derived by a resident of a treaty jurisdiction. The concept of derived by a resident is a more useful surrogate for the concept of subject to the taxing jurisdiction of the residence state, the necessary prerequisite for the grant of treaty benefits on an item of income.

C. New General Rule Based on "Derived By" Standard

The regulations now provide three specific situations in which income is derived by a resident of a treaty jurisdiction, and thus considered subject to the taxing jurisdiction of the residence jurisdiction and eligible for treaty benefits.

In the first situation, an item of income paid to an entity is considered to be derived by the entity if the entity is not fiscally transparent with respect to the item of income under the laws of the entity's jurisdiction. The entity's jurisdiction is generally the place of the entity's organization, although it may be the place of management and control of the entity if it is a resident in a jurisdiction by reason of such factors.

In the second situation, regardless of whether the entity is found to be fiscally transparent with respect to the item of income under the laws of the entity's jurisdiction, an interest holder in the entity may derive the item of income if that interest holder can establish that, under the laws of the jurisdiction in which the interest holder is a resident, the entity is fiscally transparent with respect to the item of income. Under this test, the interest holder itself must not be considered fiscally transparent with respect to the item of income under the laws of its jurisdiction in order to claim the treaty benefit of that jurisdiction.

In the third situation, an item of income paid to a type of entity specifically listed in a treaty as a resident of that treaty jurisdiction is treated as derived by a resident of that jurisdiction. The reason for this rule is that the two treaty partners reached an explicit agreement on the appropriate treatment of that entity and treaty

benefits accordingly should be provided on items of income paid to it.

In some circumstances, both the entity and the interest holders in the entity will be treated as deriving the item of income under the foregoing tests. In that event, both the interest holder and the entity may be entitled to treaty benefits if all other conditions are satisfied. See § 1.1441-6(b)(2) for procedures for dual rate claims under separate income tax treaties.

IV. Determining Fiscal Transparency

A. Generally

The concept of fiscally transparent therefore is critical to the determination of whether an item of income is derived by an entity or an interest holder in an entity. Paragraph (d)(4)(ii) of the proposed and temporary regulations provided that an entity is treated as fiscally transparent by a jurisdiction to the extent the jurisdiction requires interest holders in the entity to take into account separately on a current basis their respective shares of the items of income paid to the entity and to determine the character of such item as if such items were realized directly from the source from which realized by the entity for purposes of the tax laws of the jurisdiction. The proposed and temporary regulations further provided that entities that are fiscally transparent for U.S. federal income tax purposes include partnerships, common trust funds described under section 584, simple trusts, grantor trusts, as well as certain other entities (including entities that have a single interest holder) that are treated as partnerships or as disregarded entities for U.S. federal income tax purposes.

The IRS and Treasury received numerous comments regarding the definition of fiscally transparent under the proposed regulations. The comments stated that it is unclear, in situations when multiple foreign jurisdictions are involved, which jurisdiction's laws apply in determining whether an entity is fiscally transparent. The comments further stated that the requirement that all items of income be separately stated is not consistent with the U.S. tax rules regarding partnerships, which permit partners not to state separately certain items if the outcome is the same whether or not the item is separately stated. Commentators also suggested that the regulations were unclear as to whether fiscal transparency is an item by item determination or a determination made with respect to the entity as a whole.

In response to the comments, several simplifying and clarifying changes were

made to the regulations. When an entity is invoking the treaty, paragraph (d)(3)(ii) of the final regulations provides a definition for purposes of determining whether the entity will be treated as fiscally transparent under the laws of the entity's jurisdiction with respect to an item of income received by the entity. When an interest holder in an entity is invoking the treaty, paragraph (d)(3)(iii) of the final regulations provides a definition for purposes of determining whether the entity will be fiscally transparent under the laws of the interest holder's jurisdiction. This clarifies which jurisdiction's laws apply in determining fiscal transparency in cases in which multiple foreign jurisdictions are involved.

Paragraphs (d)(3)(ii) and (iii) of the final regulations generally retain the definition of fiscally transparent as provided by the proposed and temporary regulations, with certain clarifications and modifications. They provide that an entity will be fiscally transparent only if inclusion by the interest holders in the entity is required whether or not an item of income is distributed to such interest holders and, generally, the character and source of the item in the hands of the interest holder are determined as if such item were realized directly from the source from which realized by the entity. They also provide that fiscal transparency is determined on an item of income by item of income basis. Accordingly, for example, an entity can be fiscally transparent with respect to interest income, but not with respect to dividend income. The regulations further provide, however, that if an item of income is not separately taken into account by its interest holders, the entity may still be fiscally transparent with respect to that item of income if failure to take the item of income into account separately does not result in a treatment under the tax laws of the applicable treaty jurisdiction different from that which would be required if the interest holder did separately take the share of such item into account. This is consistent with the U.S. tax provisions with respect to partnerships.

Because the final regulations adopt an item by item determination of fiscal transparency, the provision in the proposed regulations stating that partnerships, common trust funds described in section 584, simple trusts, grantor trusts and certain other entities are fiscally transparent for U.S. federal income tax purposes has been deleted from the final regulations. The foregoing language implied that fiscal transparency is determined with respect to the entity as a whole. Although the

final regulations remove this language, it is anticipated that such entities ordinarily will be fiscally transparent for federal income tax purposes with regard to all items of income received by them.

B. Investment Vehicles

Commentators also requested clarification regarding the treatment of investment vehicles that may be allowed an exclusion or deduction from income for amounts distributed to interest holders. The final regulations clarify that if an entity such as an investment company is not otherwise fiscally transparent as defined in paragraphs (d)(3)(ii) and (iii) of the final regulations, it will not be deemed to be fiscally transparent merely because it is allowed to exclude or deduct from income amounts distributed to interest holders. Examples provide further guidance with respect to foreign investment vehicles, most of which will not be fiscally transparent under the final regulations.

C. Treatment of Tax Exempt Organizations

In addition to the foregoing, several commentators suggested that the regulations undermine reciprocal treaty exemptions for pension funds and other tax exempt organizations by, for example, denying treaty benefits under circumstances when the fund or organization invests in U.S. LLCs that are treated as partnerships for purposes of U.S. tax law and as corporations under the laws of the applicable treaty jurisdiction. Treasury does not believe that the regulations conflict with U.S. treaty obligations to provide reduced treaty rates to pension funds and other tax exempt organizations investing in the United States. In most cases, the denial of benefits described by commentators can be avoided by ensuring that the pension fund or tax exempt organization invests directly or through an entity treated as fiscally transparent under the laws of the jurisdiction of the fund or organization, with the result that the fund or organization will still be able to claim exemptions under the applicable treaty. In addition, treaties may be negotiated that permit pensions and other tax exempt organizations to invest in the United States through nonfiscally transparent entities and still obtain reduced treaty rates. (See for example paragraph 2(b) of Article XXI of the U.S.-Canada treaty, with respect to pension funds). Further, paragraph (d)(4) gives the competent authorities the flexibility, in appropriate circumstances, to enter into a mutual

reciprocal understanding that would depart from the rules of paragraph (d) with respect to certain classes of entities.

D. Treatment of Complex Trusts

The proposed and temporary regulations did not specifically address the treatment of section 661 trusts that are permitted to accumulate income from year to year. Commentators suggested that they should be treated as fiscally transparent for U.S. tax purposes because, under section 662, the distributable net income of such trusts retains its character in the hands of the beneficiaries if it is distributed in the current year and not accumulated. The definitions of fiscally transparent as set forth in the final regulations provide that, in order for the entity to be fiscally transparent with respect to an item of income, the interest holder must be required to take that item of income into account in a taxable year whether or not the item is distributed, and generally the character and source of the item in the hands of the interest holder are determined as if such item were realized directly from the source from which realized by the entity.

Thus, to the extent the beneficiaries of a trust are required under section 662 to take an item of the trust's income into account in a taxable year, whether or not the item is distributed, and the character and source of the item in the hands of the beneficiaries are determined as if such item were realized directly from the source from which realized by the entity, the trust will be treated as fiscally transparent for U.S. tax purposes with respect to that item of income. If inclusion by the interest holders is not required whether or not such item of income is distributed, or the character and source of the item in the hands of the interest holder are determined as if such item were realized directly from the source from which realized by the entity, the trust will not be treated as fiscally transparent for U.S. tax purposes. In determining whether a trust, or any other entity, is fiscally transparent with respect to an item of income under the laws of any other jurisdiction, the treatment of that item of income under the laws of that jurisdiction controls, not the treatment under U.S. laws.

E. Effect of Anti-Deferral Regimes

Commentators also argued that controlled foreign corporations should be treated as fiscally transparent to the extent interest holders are required to account for the controlled foreign corporation's net passive income on a current basis. This suggestion was

rejected because the nature of an inclusion under an anti-deferral regime is that of a deemed distribution of after-tax profits of the controlled foreign corporation, while an inclusion because an entity is fiscally transparent is in the nature of a share of the item of income itself, as if the interest holder realized the income directly. This follows from the definition of fiscal transparency contained in paragraph (d)(3)(iii), relating to whether an entity is fiscally transparent under the laws of the interest holder's jurisdiction.

V. Treatment of Payments To and From Domestic Reverse Hybrid Entities

Section 1.894-1T(d)(3) provided guidance on the appropriate treatment of items of income paid to an entity that is treated as a domestic corporation for U.S. tax purposes but is treated as fiscally transparent under the laws of an interest holder's jurisdiction (a "domestic reverse hybrid" entity). That section provided that § 1.894-1T(d)(1) may not be applied to reduce the amount of federal income tax on U.S. source income received by a domestic reverse hybrid entity through application of an income tax treaty. Commentators expressed concern that this rule did not provide sufficient guidance and could lead to inappropriate results, noting that an item of income paid by a domestic reverse hybrid entity could be viewed as neither "received by" the interest holder nor "subject to tax" because the interest holder's jurisdiction would treat the domestic reverse hybrid entity as fiscally transparent. Thus, the interest holder's jurisdiction would view the interest holder as "receiving" the items of income paid to the domestic reverse hybrid entity and as being "subject to tax" on those items of income on an immediate basis, but may not recognize the items of income paid by the domestic reverse hybrid entity to the interest holder.

The IRS and Treasury are also aware of certain abusive structures involving domestic reverse hybrid entities, which are designed to manipulate differences in U.S. and foreign entity classification rules to produce inappropriate reductions in U.S. tax. These transactions give rise to some of the same concerns that led to the promulgation of the temporary and proposed regulations and caused Congress to enact section 894(c). Treasury and the IRS expect to issue guidance shortly regarding payments by domestic reverse hybrid entities to their interest holders in a separate regulation package. Thus, these final regulations reserve on the question of eligibility for

treaty benefits with respect to payments by domestic reverse hybrid entities.

Effective Date

The final regulations apply to items of income paid on or after June 30, 2000. Withholding agents should consider the effect of these regulations on their withholding obligations, including the need to obtain a new withholding certificate to confirm claims of treaty benefits for items of income paid on or after the effective date.

Special Analyses

It has been determined that this treasury decision not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations and, because these regulations do not impose on small entities a collection of information requirement, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Therefore, a Regulatory Flexibility Analysis is not required.

Drafting Information: The principal author of these regulations is Shawn R. Pringle of the Office of Associate Chief Counsel (International). However, other personnel from the IRS and Treasury participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Adoption of Amendments to the Regulations

Accordingly, CFR 26 part 1 is amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority for part 1 is amended by revising the entry for section 1.894-1 to read in part as follows:

Authority: 26 U.S.C. 7805. * * * Section 1.894-1 also issued under 26 U.S.C. 894 and 7701(l). * * *

Par. 2. In § 1.894-1, paragraph (d) is revised to read as follows:

§ 1.894-1 Income affected by treaty.

* * * * *

(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)(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.

(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.* [Reserved].

(3) *Definitions*—(i) *Entity.* For purposes of this paragraph (d), the term *entity* shall mean any person that is treated by the United States or the applicable treaty jurisdiction as other than an individual. The term *entity* includes disregarded entities, including single member disregarded entities with individual owners.

(ii) *Fiscally transparent under the law of the entity's jurisdiction*—(A) *General rule.* For purposes of this paragraph (d), an entity is fiscally transparent under the laws of the entity's jurisdiction with

respect to an item of income to the extent that the laws of that jurisdiction require the interest holder in the entity, wherever resident, to separately take into account on a current basis the interest holder's respective share of the item of income paid to the entity, whether or not distributed to the interest holder, and the character and source of the item in the hands of the interest holder are determined as if such item were realized directly from the source from which realized by the entity. However, the entity will be fiscally transparent with respect to the item of income even if the item of income is not separately taken into account by the interest holder, provided the item of income, if separately taken into account by the interest holder, would not result in an income tax liability for that interest holder different from that which would result if the interest holder did not take the item into account separately, and provided the interest holder is required to take into account on a current basis the interest holder's share of all such nonseparately stated items of income paid to the entity, whether or not distributed to the interest holder. In determining whether an entity is fiscally transparent with respect to an item of income in the entity's jurisdiction, it is irrelevant that, under the laws of the entity's jurisdiction, the entity is permitted to exclude such item from gross income or that the entity is required to include such item in gross income but is entitled to a deduction for distributions to its interest holders.

(B) *Special definitions.* For purposes of this paragraph (d)(3)(ii), an entity's jurisdiction is the jurisdiction where the entity 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 the interest holder in a taxable year other than the taxable year of the entity if the difference is due solely to differing taxable years.

(iii) *Fiscally transparent under the law of an interest holder's jurisdiction*—(A) *General rule.* For purposes of this paragraph (d), an entity is treated as fiscally transparent under the law of an interest holder's jurisdiction with respect to an item of income to the extent that the laws of the interest holder's jurisdiction require the interest holder resident in that jurisdiction to separately take into account on a current basis the interest holder's respective share of the item of income paid to the

entity, whether or not distributed to the interest holder, and the character and source of the item in the hands of the interest holder are determined as if such item were realized directly from the source from which realized by the entity. However, an entity will be fiscally transparent with respect to the item of income even if the item of income is not separately taken into account by the interest holder, provided the item of income, if separately taken into account by the interest holder, would not result in an income tax liability for that interest holder different from that which would result if the interest holder did not take the item into account separately, and provided the interest holder is required to take into account on a current basis the interest holder's share of all such nonseparately stated items of income paid to the entity, whether or not distributed to the interest holder. 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 in the entity 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 for U.S. federal income tax purposes. A is also 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)(iii) 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 A 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 taxation on royalties of 5-percent. Article 12 of 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)(iii) 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 under Country Z law A is not fiscally transparent. Assuming all other requirements for eligibility for treaty benefits have been satisfied, A is entitled to the 5-percent treaty reduced rate on royalties under the U.S.-X income tax treaty with respect to the entire royalty payment. Assuming all other requirements for treaty benefits have been satisfied, M is also entitled to a zero rate under the U.S.-Y income tax treaty with respect to its share of the royalty income.

Example 4. Treatment of grantor trust. (i) *Facts.* Entity A is a trust organized under the laws of Country X, which does not have an income tax treaty in effect with the United States. M, the grantor and owner of A for U.S. income tax purposes, is a resident of Country Y, which has an income tax treaty in effect with the United States. M is also treated as the grantor and owner of the trust under the laws of Country Y. Thus, Country Y requires M to take into account all items of A's income in the taxable year, whether or not distributed to M, and determines the character of each item in M's hands as if such item was realized directly from the source

from which realized by A. Country X does not treat M as the owner of A and does not require M to account for A's income on a current basis whether or not distributed to M. A receives 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.

(ii) *Analysis.* A is not fiscally transparent under the laws of Country X within the meaning of paragraph (d)(3)(ii) of this section with respect to the U.S. source interest income, but A may not claim treaty benefits because there is no U.S.-X income tax treaty. M, however, does derive the income for purposes of the U.S.-Y income tax treaty because under the laws of Country Y, A is fiscally transparent.

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 Z does require T, who is treated as owning 60-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)(iii) 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 of the arrangement, A is not liable to tax at the entity level in Country X and is not a resident within the meaning of the Residence Article of the U.S.-X 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 upon distribution from the Common Fund. Some of A's interest holders are residents of Country X and some of Country Y. Country Y has no income tax treaty in effect with the United States.

(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 resident of Country X under the Residence Article of the U.S.-X income tax treaty, however, A does not derive the income for purposes of the U.S.-X income tax treaty. Further, because A is not fiscally transparent under paragraph (d)(3)(iii) 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 8. Treatment of person specifically listed as resident in applicable treaty. (i) *Facts.* The facts are the same as in *Example 7* except that A (the Common Fund) is organized in Country Z and the Residence Article of the U.S.-Z income tax treaty provides that "the term 'resident of a Contracting State' includes, in the case of Country Z, Common Funds.* * *

(ii) *Analysis.* A is treated, for purposes of the U.S.-Z income tax treaty as deriving the dividend income as a resident of Country Z under paragraph (d)(1) of this section because the item of income is paid directly to A. A is a Common Fund under the laws of Country Z, and Common Funds are specifically identified as residents of Country Z in the U.S.-Z treaty. There is no need to determine whether A meets the definition of fiscally transparent under paragraph (d)(3)(ii) of this section.

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 if 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 dividends because the interest holders in A do not have to take into account their respective share of the U.S. source dividends on a current basis whether or not distributed. A is also not fiscally transparent under paragraph (d)(3)(ii) of this section because there is a change in source of the income received by A when A distributes the income to its interest holders and, thus, the character and source of the income in the hands of A's interest holder are 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 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 as if such items were realized directly from the source from which realized by A. However, under Country X law the interest holders in A do not have to take into account their respective share of the interest income received by A on a current basis whether or not distributed.

(ii) *Analysis.* An item by item analysis is required under paragraph (d) of this section. The analysis is the same as *Example 9* with respect to the dividend income. A is also not fiscally transparent under paragraph (d)(3)(ii) of this section with respect to the interest income because, although the character of the

distributions attributable to the interest income in the hands of A's interest holders is determined as if realized directly from the source from which realized by A, under Country X law the interest holders in A do not have to take into account their respective share of the interest income received by A on a current basis whether or not distributed. Accordingly, A derives the U.S. source interest income for purpose of the U.S.-X treaty.

Example 11. Treatment of charitable organizations. (i) *Facts.* Entity A is a corporation organized under the laws of Country X that has an income tax treaty in effect with the United States. Entity A is established and operated exclusively for religious, charitable, scientific, artistic, cultural, or educational purposes. Entity A receives U.S. source dividend income from U.S. sources. A provision of Country X law generally exempts Entity A's income from Country X tax due to the fact that Entity A is established and operated exclusively for religious, charitable, scientific, artistic, cultural, or educational purposes. But for such provision, Entity A's income would be subject to tax by Country X.

(ii) *Analysis.* Entity A is not fiscally transparent under paragraph (d)(3)(ii) of this section with respect to the U.S. source dividend income because, under Country X law, the dividend income is treated as an item of income of A and no other persons are required to take into account their respective share of the item of income on a current basis, whether or not distributed. Accordingly, Entity A is treated as deriving the U.S. source dividend income.

Example 12. Treatment of pension trusts. (i) *Facts.* Entity A is a trust established and operated in Country X exclusively to provide pension or other similar benefits to employees pursuant to a plan. Entity A receives U.S. source dividend income. A provision of Country X law generally exempts Entity A's income from Country X tax due to the fact that Entity A is established and operated exclusively to provide pension or other similar benefits to employees pursuant to a plan. Under the laws of Country X, the beneficiaries of the trust are not required to take into account their respective share of A's income on a current basis, whether or not distributed and the character and source of the income in the hands of A's interest holders are not determined as if realized directly from the source from which realized by A.

(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 under the laws of Country X, the beneficiaries of A are not required to take into account their respective share of A's income on a current basis, whether or not distributed. A is also not fiscally transparent under paragraph (d)(3)(ii) of this section with respect to the U.S. source dividend income because under the laws of Country X, the character and source of the income in the hands of A's interest holders are not determined as if realized directly from the source from which realized by A. Accordingly, A derives the U.S. source dividend income for purposes of the U.S.-X income tax treaty.

(6) *Effective date.* This paragraph (d) applies to items of income paid on or after June 30, 2000.

Robert E. Wenzel,
Deputy Commissioner of Internal Revenue.

Approved: June 28, 2000.

Jonathan Talisman,
Deputy Assistant Secretary of the Treasury (Tax Policy).
[FR Doc. 00-16761 Filed 6-30-00; 8:45 am]
BILLING CODE 4830-01-P

DEPARTMENT OF THE INTERIOR

Minerals Management Service

30 CFR Part 250

RIN 1010-AC-73

Oil and Gas and Sulphur Operations in the Outer Continental Shelf— Production Measurement Document Incorporated by Reference

AGENCY: Minerals Management Service (MMS), Interior.

ACTION: Final rule.

SUMMARY: MMS is adding a production measurement document incorporated by reference to the regulations governing oil, gas, and sulphur operations in the Outer Continental Shelf (OCS). The document will continue to ensure that lessees are able to use the best available and most accurate technologies while operating in the OCS. The document is from the American Petroleum Institute's Manual of Petroleum Measurement Standards.

DATES: This rule is effective August 2, 2000. The incorporation by reference of publications listed in the regulation is approved by the Director of the Federal Register as of August 2, 2000.

FOR FURTHER INFORMATION CONTACT: Sharon Buffington, Engineering and Research Branch, at (703) 787-1147.

SUPPLEMENTARY INFORMATION: MMS uses standards, specifications, and recommended practices developed by standard-setting organizations and the oil and gas industry as a means of establishing requirements for activities in the OCS. This practice, known as incorporation by reference, allows MMS to incorporate the requirements of technical documents into the regulations without increasing the volume of the Code of Federal Regulations (CFR). MMS currently incorporates by reference approximately 85 documents into the offshore operating regulations.

The regulations found at 1 CFR part 51 govern how MMS and other Federal

agencies incorporate various documents by reference. Agencies can only incorporate by reference through publication in the **Federal Register**. Agencies must also gain approval from the Director of the Federal Register for each publication incorporated by reference.

Incorporation by reference of a document or publication is limited to the edition of the document or publication cited in the regulations. This means that newer editions, amendments, or revisions to documents already incorporated by reference in regulations are not part of MMS's regulations.

This rule adds the following API document to those currently incorporated by reference into MMS regulations:

- API Manual of Petroleum Measurement Standards (MPMS), Chapter 10, Section 9, Standard Test Method for Water in Crude Oils by Coulometric Karl Fischer Titration, First Edition, November 1993.

MMS has reviewed this document and has determined that it must be incorporated into regulations to ensure that industry is able to use the best available and most accurate technologies. Our review shows that the option to use this standard will not impose additional costs on the offshore oil and gas industry. In fact, industry will still have the option to use the other procedures in current documents incorporated, as approved. Therefore, MMS is including this document via a final rule. MMS has determined under the Administrative Procedure Act (5 U.S.C. 553(b)(3)(B)) that publishing this rule as a notice of proposed rulemaking would be contrary to the public interest. The regulations found at 30 CFR 250.198(a)(2) allow updating documents without opportunity to comment when MMS determines that the revisions to a document result in safety improvements or represent new industry standard technology and do not impose undue costs on the affected parties.

A summary of MMS's review of the document is provided below:

API MPMS Chapter 10, Section 9, Standard Test Method for Water in Crude Oils by Coulometric Karl Fischer Titration, First Edition, November, 1993.

This document lists the method for directly determining water in crude oils by volume and weight. It represents an industry standard that would be newly used in the OCS. The MMS will retain the documents from MPMS, Chapter 10, Sediment and Water, that describe the other methods of determining water in crude oils.