Section 894(a).—Income Affected by Treaty

26 CFR 1.894–1(a): Income affected by treaty. (Also sections 894(c); 1.894–1(d))

"Liable to Tax" treaty residence standard. Guidance is provided on the "liable to tax" standard for residence under U.S. income tax treaties.

Rev. Rul. 2000–59

This revenue ruling provides guidance on whether certain entities will be considered liable to tax under the laws of a foreign country for purposes of determining if such entities are residents within the meaning of the relevant Treaty. In order to obtain treaty benefits a person must be a resident of the applicable treaty jurisdiction and must meet all other applicable requirements for obtaining treaty benefits, including any applicable limitation on benefits provision and, in the case of an entity that is fiscally transparent under the laws of the United States or the entity's jurisdiction, the requirement that the entity derive the item of income for which treaty benefits are sought within the meaning of Treas. Reg. § 1.894–1(d).

FACTS

Situation 1

Entity A is a business organization in Country X, which has an income tax treaty in effect with the United States that is identical to the 1996 United States Model Income Tax Treaty (1996 U.S. Model). Under the laws of Country X, Entity A is an investment company taxable on income from all sources at the entity level by reason of being incorporated in Country X. Similar to other domestic corporations, distributions from a Country X investment company are generally treated as dividends and do not retain the character or source of the underlying income. However, net capital gains and, in some cases, tax exempt interest, retain their character when they are distributed to the investment company's interest holders. Further, a Country X investment company may deduct distributions of current income to its interest holders in computing taxable income. Entity A distributes its net income and capital gains on a current basis to its interest holders so that it will not actually bear a tax. Country X imposes a withholding tax on Entity A's dividend distributions to its foreign interest holders regardless of the source of Entity A's underlying income. If Entity A did not distribute such amounts, Entity A would be taxed by Country X on such amounts. Entity A receives dividend income from the United States.

Country X has not announced by public notice that investment companies such as Entity A are not residents of Country X, and there is no competent authority agreement providing that such entities are not residents of Country X. Further, the U.S. competent authority has not issued a public notice indicating that treaty benefits to such entities are being denied because, and to the extent that, Country X will not grant treaty benefits to similar U.S. entities.

Situation 2

Entity B is an investment company organized in Country Y, which has an income tax treaty in effect with the United States that is identical to the 1996 U.S. Model. Under the laws of Country Y, corporations organized in Country Y are generally taxable on income from all sources at the entity level by reason of being incorporated in Country Y. A specific provision in Country Y law, however, exempts the income of investment companies such as Entity B from taxation. Under Country Y law, the character and source of distributions from Entity B to all its interest holders are determined based on the distributions themselves rather than on the character and source of Entity B's underlying income. Further, Country Y imposes a withholding tax on distributions to its foreign interest holders regardless of the source of the underlying income. Entity B receives dividend income from the United States.

Country Y has not announced by public notice that investment companies such as Entity B are not residents of Country Y, and there is no competent authority agreement providing that such entities are not residents of Country Y. Further, the U.S. competent authority has not issued a public notice indicating that treaty benefits to such entities are being denied because, and to the extent that, Country Y will not grant treaty benefits to similar U.S. entities.

Situation 3

Entity C is a trust established and administered in Country Z, which has an in-

come tax treaty with the United States identical to the 1981 U.S. Model Income Tax treaty (1981 U.S. Model). The trust exclusively provides pension benefits. Entity C's trustee is a resident of Country Z. Under the laws of Country Z, because Entity C's trustee is a resident of Country Z, Entity C is treated as a resident trust taxable at the entity level. However, because Entity C is established and operated exclusively to provide pension benefits, a provision of Country Z law exempts Entity C from Country Z income tax. Entity C receives dividend income from the United States.

Country Z has not announced by public notice that entities such as Entity C are not residents of Country Z, and there is no competent authority agreement providing that such entities are not residents of Country Z. Further, the U.S. competent authority has not issued a public notice indicating that treaty benefits to such entities are being denied because, and to the extent that, Country Z will not grant treaty benefits to similar U.S. entities.

LAW AND ANALYSIS

Article 4 of the 1996 U.S. Model provides in relevant part:

> 1. Except as provided in this paragraph, for the purposes of this Convention, the term "resident of a Contracting State" means any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, citizenship, place of management, place of incorporation, or any other criterion of a similar nature.
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> a) The term "resident of a Contracting State" does not include any person who is liable to tax in that state in respect only of income from sources in that State or of profits attributable to a permanent establishment.
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> b) A legal person organized under the laws of a Contracting State and that is generally exempt from tax in that State and is established and maintained in that State either:
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> i) exclusively for a religious, charitable, educational, scientific, or other similar purpose; or
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> ii) to provide pension or other similar benefits to employees pursuant to a plan

is to be treated as a resident of the Contracting State where it is established.

The analogous portion of Article 4 of the 1981 U.S. Model provides:

> 1. For the purposes of this Convention, the term "resident of a Contracting State" means any person who under the laws of the State, is liable to tax therein by reason of his domicile, residence, citizenship, place of management, place of incorporation, or any other criterion of a similar nature, provided, however, that
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> (a) this term does not include any person who is liable to tax in that State in respect only of income from sources within that State or capital situated therein;

The phrase "liable to tax" as used in the above articles does not require actual taxation. Thus, the fact that a person is only nominally taxable does not preclude that person from meeting the applicable "liable to tax" standard of these residence articles. This is consistent with the position taken in the 1996 U.S. Model Technical Explanation to Article 4(1), which provides: "[c]ertain entities that are nominally subject to tax but that in practice rarely pay tax also would generally be treated as residents and therefore accorded treaty benefits. For example, RICs, REITs, and REMICs, are all residents of the United States for purposes of the treaty."

For purposes of these residence articles, whether a person will be liable to tax in, and thus a resident of, a jurisdiction depends on the facts and circumstances. However, in the context of a bilateral income tax treaty, a person will not be considered a resident of a contracting state if (1) the treaty partner has announced by public notice that such persons are not residents of that state; (2) there is a competent authority agreement or separate specific treaty provision providing that such persons are not residents of that state; or (3) the treaty partner would not treat similar U.S. persons as residents of the United States, and the Internal Revenue Service has issued a public notice indicating that treaty benefits to such entities are consequently being denied. Conversely, a person may be treated as a resident of a contracting state if there is a competent authority agreement or separate specific treaty provision providing that such persons are residents of that state. The Internal Revenue Service shall announce the terms of any relevant competent authority agreement or treaty partner's position.

Situation 1

Under the facts of Situation 1, notwithstanding that Entity A is only nominally taxable in Country X, Entity A is "liable to tax in [Country X] by reason of its place of incorporation," within the meaning of the U.S.- Country X treaty, because of the following factors. First, as a corporation incorporated in Country X, Entity A may be taxed by Country X on its worldwide income. Second, but for the deduction regime, Country X would have imposed a tax on Entity A as it would any corporation incorporated in Country X. Third, the character and source of certain distributions by Entity A are determined independent of the character and source of Entity A's income, and Country X imposes a withholding tax on such distributions by Entity A to its foreign interest holders regardless of the source of Entity A's underlying income.

Finally, Country X has not announced by public notice that persons such as Entity A are not residents of Country X; there is no competent authority agreement providing that such persons are not residents of Country X; and the U.S. competent authority has not issued a public notice indicating that treaty benefits to such persons are being denied because Country X will not grant treaty benefits to similar U.S. persons.

Accordingly, Entity A is liable to tax in Country X by reason of its place of incorporation within the meaning of Article 4 (1) of the U.S.-Country X treaty, and thus is a resident of Country X for purposes of the U.S.-Country X treaty. In order to obtain treaty benefits, however, Entity A must still meet all other applicable requirements for such benefits, including the applicable limitation on benefits provision and, if Entity A is viewed as fiscally transparent under the laws of either the United States or Country X, those provisions of Treas. Reg. § 1.894–1(d).

Situation 2

Under the facts of Situation 2, notwithstanding that Entity B is only nominally liable to tax in Country Y, Entity B is liable to tax by reason of its place of incorporation, within the meaning of the U.S.-Country Y treaty, because of the follow-

ing factors. First, as a corporation incorporated in Country Y, Entity B may be taxed by Country Y on its worldwide income. Second, but for the specific exemption in Country Y law, Country Y would have imposed a tax on Entity B as it would any corporation incorporated in Country Y. Third, the character and source of distributions by Entity B are determined independent of the character and source of the Entity B's underlying income, and Country Y imposes a withholding tax on distributions by Entity B to its foreign interest holders regardless of the source of Entity B's underlying income.

Finally, Country Y has not announced by public notice that persons such as Entity A are not residents of Country Y; there is no competent authority agreement providing that such persons are not residents of Country Y; and the U.S. competent authority has not issued a public notice indicating that treaty benefits to such persons are being denied because Country Y will not grant treaty benefits to similar U.S. persons.

Accordingly, Entity B is liable to tax in Country Y by reason of its place of incorporation within the meaning of Article 4 (1) of the U.S.-Country Y treaty, and thus B is a resident of Country Y for purposes of the U.S.-Country Y treaty. In order to obtain treaty benefits, however, Entity B must still meet all other applicable requirements for such benefits, including the applicable limitation on benefits provision and, if Entity B is viewed as fiscally transparent under the laws of either the United States or Country Y, those provisions of Treas. Reg. § 1.894–1(d).

Situation 3

Under the facts of Situation 3, notwithstanding that Entity C is only nominally taxable in Country Z, Entity C is liable to tax within the meaning of the U.S.-Country Z treaty because of the following. But for the exemption from tax for Country Z entities that provide pension benefits, Entity C would be taxable by Country Z at the entity level as a resident trust in Country Z. While the 1981 U.S. Model does not specifically provide that persons organized under the laws of a state that are generally exempt from tax and established and maintained exclusively to provide pension or other similar benefits are residents of that state (and the 1996 U.S. Model does so provide), the Treasury Department's Technical Explanation to the 1996 U.S. Model confirms that the specific provision in the 1996 U.S. Model merely clarifies the generally accepted practice that these entities are residents even though they may be entitled to a complete or partial exemption from tax.

Further, Country Z has not announced by public notice that persons such as Entity A are not residents of Country Z; there is no competent authority agreement providing that such persons are not residents of Country Z; and the U.S. competent authority has not issued a public notice indicating that treaty benefits to such persons are being denied because Country Z will not grant treaty benefits to similar U.S. persons.

Accordingly, Entity C is liable to tax in Country Z within the meaning of Article 4(1) of the Treaty, and thus is a resident of Country Z for purposes of the Treaty. In order to obtain treaty benefits, however, Entity C must still meet all other applicable requirements for such benefits, including the applicable limitation on benefits provision and, if Entity C is viewed as fiscally transparent under the laws of either the United States or Country Z, those provisions of Treas. Reg. § 1.894–1(d).

DRAFTING INFORMATION

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