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Reflections on the Application of Income Tax Treaties to Hybrid Entities That Earn Non-FDAP Income

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Income tax treaties are designed, among other things, to prevent (or at least reduce) double taxation by allocating taxing jurisdiction between the two countries. This may be accomplished in different ways. For example, the treaty may cause an income item to be wholly exempt from tax in the source country, so that the only tax imposed is that of the residence country. Alternatively, the treaty may permit the source country to tax the income item, but reduce the potential for double taxation by requiring the residence country to grant a credit for the source country tax (subject to applicable limitations). The system does not prevent double taxation in all cases, but it is conceptually easy to apply when the same person is the taxpayer in both countries. Once hybrid entities are introduced, the real fun begins.[1]

Background of the Code Sec. 894 Rules

Treatment of Hybrids Under General U.S. Tax Principles

Generally, the foreign tax treatment of an entity is not relevant to the U.S. taxation of that entity and its owners. If an entity is characterized as a partnership under U.S. tax law, the partners are considered the taxpayers for U.S. tax purposes, even if the entity is characterized as a corporation under the tax laws of its country of residence. In the treaty context, however, unwarranted tax advantages (or disadvantages) may arise if the entity is a hybrid entity.

Abusive Hybrid Structures

In the 1990s, following promulgation of the "check the box regulations,"[2] observant cross-border tax planners discovered that hybrid entities could be used to secure treaty benefits that clearly seemed inappropriate as a matter of policy. For example, under one popular structure, a Canadian parent corporation would hold debt of its U.S. subsidiary through a wholly owned U.S. limited liability company (LLC). When the U.S. subsidiary paid interest to the LLC, the interest was treated, for U.S. tax purposes, as income of the Canadian parent corporation, and a reduced rate of withholding tax was claimed under Article XI (Interest) of the U.S.-Canadian Treaty, as then in effect.[3]

The allowance of treaty benefits seemed improper as a matter of treaty policy, because Canada considers the LLC to be a corporation and therefore did not consider the

Canadian parent corporation to have earned any interest income, so there was no current tax in Canada on the interest for which U.S. treaty benefits were being claimed. Moreover, there was not even a deferred tax in Canada. When the LLC later transferred funds to the Canadian parent, such transfers were characterized as dividends and excludable from income for Canadian tax purposes.[4]

Code Sec. 894(c) and the Treasury Regulations Thereunder

The Taxpayer Relief Act of 1997 added Code Sec. 894(c) to the Internal Revenue Code to combat such abuses.[5] Pursuant to Code Sec. 894(c)(1), treaty benefits are denied to a foreign person with respect to an item of income derived through a partnership (or other fiscally transparent entity), if the item is not treated by the foreign country as an item of income of such person, the treaty does not address the treatment of income derived through partnerships, and the foreign country does not tax the distribution of the income from the partnership to the foreign person. Since all three criteria are met by the Canadian example (Canadian tax laws did not tax the interest income received by the LLC, the U.S.-Canada tax treaty did not address income derived through fiscally transparent entities, and Canada did not tax the dividend payments from the LLC to the Canadian parent), the benefits of the U.S.-Canadian Treaty are denied to the Canadian parent's interest income from its U.S. subsidiary.

In addition, Code Sec. 894(c)(2) authorized the Treasury Department to promulgate regulations addressing certain hybrid structures to which Code Sec. 894(c)(1) does not apply.[6] Regulations under Code Sec. 894(c) were proposed in 1997[7] and ultimately finalized in July 2000.[8] The basic rule of the regulations is set forth in Reg. §1.894-1(d)(1), which provides as follows:[9]

> *(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.

The first sentence of the regulation makes clear that an item of non-business income (*i.e.*, FDAP income)[10] will be eligible for a reduced rate of withholding tax under an income tax treaty between the United States and another country only if such item of income is "derived" by a resident of such country, in addition to satisfying all other applicable requirements.[11]

The succeeding sentences of the regulation essentially provide that, in order for an item of income to be "derived" by a resident of a treaty country, that country must consider its resident to have earned the income under that country's tax laws. More precisely, the regulations provide that an item of income paid to an entity is considered to be derived by the entity if, and only if, the entity is not "fiscally transparent"[12] under the laws of its jurisdiction with respect to such item of income. Therefore, an entity that is a resident of a treaty jurisdiction, and otherwise satisfies all limitation-on-benefits (LOB) requirements, may claim treaty benefits for income paid to such entity, regardless of how it is characterized for U.S. federal tax purposes. For example, assume that an entity, HoldCo, is formed under the laws of Country X. HoldCo is characterized as a partnership under U.S. law but as a corporation (and a resident) under Country X law. Since HoldCo is subject to tax in its jurisdiction, HoldCo derives the income for purposes of the U.S.-X treaty, and may therefore qualify for any applicable provisions of the U.S.-X Income Tax Treaty that reduce or completely exempt U.S. withholding tax on FDAP income.[13]

The regulations similarly provide that an item of income paid to an entity is considered to be derived by the interest holder in the entity if, and only if, (1) the interest holder is not fiscally transparent in its jurisdiction with respect to the item of income and (2) the entity is considered to be fiscally transparent under the laws of the interest holder's jurisdiction with respect to the item of income. Therefore, an interest holder in an entity may claim treaty benefits for income paid to such entity if such interest holder is a resident of a treaty jurisdiction, and otherwise satisfies all LOB requirements, provided that the tax laws of such treaty jurisdiction view the entity as fiscally transparent with respect to such item of income. For example, if a HoldCo partner is a resident of Country Y, which treats HoldCo as fiscally-transparent, the partner would be required to take HoldCo's income into account on a current basis. The partner would be treated as deriving its share of HoldCo's income for purposes of the U.S.-Y Income Tax Treaty, allowing the partner to benefit from that treaty. Conversely, if a HoldCo partner is a resident of Country Z, and Country Z treats HoldCo as a corporation under its tax laws, that partner is not treated as deriving its share of HoldCo income for purposes of the U.S.-Z Income Tax Treaty with that country and cannot benefit from that treaty.[14]

When the hybrid entity is a resident of one treaty jurisdiction and its owners are residents of one or more other treaty jurisdictions, multiple U.S. tax treaties may potentially come into play. The analysis of the hybrid entity's eligibility for the treaty benefits of its jurisdiction is entirely distinct from the analyses of the eligibility of the hybrid entity's owners for the treaty benefits of their jurisdictions.

Reg. §1.894-1(d)(5), Example 3 is an example showing multiple treaties applying to a hybrid entity and its owners. An entity A, earning royalties in the United States, was formed under the laws of Country X, which has a treaty with the U.S. providing for a reduced five-percent withholding rate on royalty income. A is treated as a partnership for U.S. tax law purposes, but taxable as a corporation under the laws of Country X. A has a partner M based in Country Y, which has a treaty with the U.S. that exempts royalty income from U.S. withholding tax. Under the laws of Country Y, M is a resident and is required to take its share of A's income into account on a current basis, because Country Y treats A as a fiscally transparent entity. The example concludes that A is considered to derive its royalty income for purposes of the U.S.-X Income Tax Treaty, because A is not fiscally transparent under the laws of X. Furthermore, M is also treated as deriving its share of A's income for purposes of the U.S.-Y Income Tax Treaty, because A is fiscally transparent under the laws of Y. Thus, assuming all the other treaty benefit requirements are met, two treaties apply to M's share of A's income. A is entitled to the five-percent reduced rate on all of its royalty income under the U.S.-X Income Tax Treaty. M is also entitled to the zero-percent reduced rate under the U.S.-Y Income Tax Treaty with respect to its share of the income. The final result is that A's royalty income allocable to M is exempt from U.S. withholding, while the income allocable to other partners is subject to the five-percent rate.[15]

The above example confirms that, under the Code Sec. 894 regulations, an entity that is considered a partnership, or disregarded as separate from its owner, for U.S. federal tax purposes, may nevertheless claim treaty benefits. Since the partnership or disregarded entity is not a U.S. taxpayer for such purposes, this result is (or at least was) quite surprising. Prior to promulgation of the Code Sec. 894(c) regulations, few practitioners would have thought that a partnership or disregarded entity would be entitled to treaty benefits in its own right. Thus, the regulations taketh away, but they giveth as well.

It might be argued that allowing treaty benefits to the hybrid entity is meaningless as a technical matter, because the owner does not qualify for those treaty benefits and is required to pay any tax that is not collected (by withholding or otherwise) from the hybrid. For instance, in the example above, suppose that one of the other owners of an interest in entity A is N, a Cayman Islands corporation treated as a corporation for U.S. federal tax purposes. One might argue that Code Sec. 881 imposes a 30-percent tax on the U.S.-source royalty income earned by N (through entity A), regardless of what is going on with entity A. N must therefore file a U.S. income tax return and pay the additional 25-percent tax rate that the U.S. payor did not withhold on the portion of the royalty allocable to N. However, it seems clear that N is not required to file a return, nor to pay any additional U.S. tax, in the above example, though the regulations do not explain precisely why. Presumably, the treaty benefits conferred to a hybrid entity that derives the income in its country of residence are somehow passed along to the hybrid entity's owner situated in another country. It is not clear how N would claim treaty benefits for the U.S.-source royalty income if were required to report such income on a U.S. federal corporate income tax return, but the issue is moot in most circumstances since N would ordinarily not be required to file such a tax return.[16]

Limitations of the Code Sec. 894 Rules

With relatively immaterial exceptions, the Code Sec. 894 regulations apply solely to FDAP income, yet the same concerns regarding potential abuse of hybrid entities also applies to foreign taxpayers earning non-FDAP income.[17] For example, suppose that a French corporation wishes to conduct business in the United States, and is able to do so without creating a permanent establishment (PE). Pursuant to the Business Profits article of the U.S.-French Treaty, the French corporation would pay French tax but no U.S. federal income tax.[18]

Tax planners are notoriously greedy, however, and avoiding U.S. tax while still paying current French tax just is not enough to generate much excitement. The real “home run” is avoiding (or at least deferring) *all* taxes. With a view towards that objective, the French corporation may choose to conduct the same U.S. activities through a Cayman subsidiary that checks the box to be disregarded for U.S. tax purposes. For French purposes, the income is earned by a Cayman subsidiary and should thus be nontaxable in France (subject to any CFC or other anti-abuse rules that may apply). Under U.S. tax principles, the Cayman subsidiary is ignored and the French parent is viewed as doing business directly in the United States, which, at least on the surface, would exempt its income from U.S. federal income tax under the U.S.-French Treaty.[19]

For the same reasons as with the FDAP income discussed earlier, this result seems inappropriate. The Code Sec. 894 rules, however, clearly do not apply to business income. The IRS might attempt to disallow treaty benefits anyway, but would need to convince a court that the allowance of such treaty benefits is not only bad policy, but also inconsistent with some implied understanding that the non-FDAP income must be “seen” by the residence country to avoid tax in the source country.

Similar issues arise in the converse situation, *i.e.*, where a hybrid entity that earns business income is a qualified resident of the applicable treaty country, but the owners of the entity do not qualify for treaty benefits.[20] Suppose, for example, that a Cayman corporation owns a French SAS, which is taxed as a corporation in France but elects to be a disregarded entity for U.S. federal tax purposes. The SAS earns business income in the United States, but has no PE. From a policy perspective, it would make sense to allow treaty benefits for the SAS’s U.S. business income, which is liable to tax in France, but the Code Sec. 894 regulations only apply to FDAP. Under generally applicable U.S. tax principles, the “real” taxpayers are the non-qualifying owners, not the disregarded hybrid entity. Some treaties include provisions that may resolve this problem for non-FDAP income.

Treaty Provisions

Article 1(6) of the 2006 U.S. Model Treaty (the “2006 Model”) provides as follows:

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

Consistent with the principles underlying the Code Sec. 894(c) regulations, Article 1(6) of the 2006 Model looks to the tax principles of the country of residence to determine whether a resident of that country is considered to have earned the income for which treaty benefits are being claimed. Treaty benefits are available only to a resident when the income is subject to tax by its country of residence. As explained in the Treasury Department's Technical Explanation:

> The intention of paragraph 6 is to eliminate a number of technical problems that arguably would have prevented investors using such entities from claiming treaty benefits, even though such investors would be subject to tax on the income derived through such entities. The provision also prevents the use of such entities to claim treaty benefits in circumstances where the person investing through such an entity is not subject to tax on the income in its State of residence.[21]

As one example, the Technical Explanation provides that, "if a company that is a resident of the other Contracting State pays interest to an entity that is treated as fiscally transparent for U.S. tax purposes, the interest will be considered derived by a resident of the U.S. only to the extent that the taxation laws of the United States treats one or more U.S. residents (whose status as U.S. residents is determined, for this purpose, under U.S. tax law) as deriving the interest for U.S. tax purposes."[22] The Technical Explanation also confirms that the treatment of such entity under the tax laws of the source country or the country of which the entity is a resident is irrelevant.[23]

In contrast with the Code Sec. 894(c) regulations, the application of Article 1(6) of the 2006 Model is not (or at least not expressly) limited to withholding taxes. Under the 2006 Model, a treaty resident doing business in the United States through a hybrid entity formed in a nontreaty country should not be able to invoke the Business Profits article of the applicable U.S. tax treaty to escape U.S. federal income tax on any business profits not attributable to a U.S. PE. By the same token, however, treaty benefits under the Business Profits article of the 2006 Model should be available in such situation if the hybrid is a resident of a treaty jurisdiction that satisfies the applicable LOB requirements, even if some or all of its owners do not qualify for any treaty benefits.

Over the last several years, the United States has signed a number of treaties and protocols that include provisions comparable to Article 1(6) of the 2006 Model, *e.g.*, with Belgium, Iceland (pending), Finland, Germany, France, and Sweden. A comparable provision preceding the 2006 Model also appears in the 2001 treaty with the United Kingdom.

The first question is whether these treaties mean what their words say. Do the "hybrid" provisions apply to non-FDAP income? The authors understand that the IRS has expressed some reluctance to reach this conclusion, at least in one situation under the U.S.-French Treaty.[24]

A situation with the branch profits tax was informally presented to the IRS. As a broadly comparable example, assume that a French SAS has two owners: a Cayman Islands corporation and a U.S. corporation. In order to accommodate certain tax-planning objectives of the U.S. corporation,[25] the SAS elects to be characterized as a partnership for U.S. tax purposes. Nevertheless, the SAS is a corporation for French tax purposes and has an active trade or business in France, that, subject to any potential "hybrid" considerations, should normally entitle it to the benefits of the U.S.-French Treaty.[26]

In the absence of a "Code Sec. 894" provision, U.S. treaty benefits would likely be unavailable to the Cayman owner, because it is not a treaty resident, while the hybrid SAS is not a U.S. taxpayer.[27] Accordingly, the Cayman owner would seem to be subject to a 30-percent branch profits tax, in addition to the regular corporate tax, on its portion of the effectively connected income earned by the SAS.

Article 4(2)(b)(iv) of the U.S.-French Treaty, however, appears to extend the favorable (as well as the unfavorable) rules of the Code Sec. 894(c) regulations to all income, not just FDAP income, earned by the French SAS. The article provides in relevant part that, "[t]he term 'resident of a Contracting State' includes … a partnership or similar pass-through entity … whether or not organized or managed in one of the Contracting States, but only to the extent that the income derived by such partnership … is treated for taxation purposes in that Contracting State as the income of a resident, either in the hands of such partnership … or in the hands of its partners."[28] The provision is not by its terms limited to any particular types of income or any particular portions of the Internal Revenue Code.

Accordingly, it appears that the French SAS should be permitted to claim *all* treaty benefits for *all* of its income, including the benefits of the branch profits tax rule for the portion of its income that is allocable to its Cayman owner.[29] When asked informally about this type of structure, however, an individual at the IRS who deals with such matters was unwilling to provide any comfort that Article 4 of the U.S.-French Treaty applies for any purpose other than eliminating (or reducing) the U.S. withholding tax on FDAP income. In other words, the IRS is, at the very least, unconvinced that the "hybrid" provisions of the U.S.-French Treaty go any further than the Code Sec. 894 regulations.

From a policy perspective, this reluctance is difficult to understand. Since the income is subject to tax by France at the French SAS level, the allowance of treaty benefits to avoid double taxation seems entirely proper. Furthermore, from a theoretical perspective, the branch profits tax is conceptually equivalent to the dividend withholding tax that would have been applicable if the U.S. operations had been conducted through a U.S. corporate subsidiary that distributed dividends to its SAS parent; so the imposition of branch profits at a more burdensome rate than the dividend withholding tax for which it acts as a substitute seems particularly unjustifiable.[30]

The position of the IRS would be more understandable if Article 4(2)(iv) of the U.S.-French Treaty were narrowly drafted. As indicated above, however, that provision is not by its terms restricted to any particular types of income or any particular portions of the Internal Revenue Code. Moreover, the technical explanation to the U.S.-Canadian Treaty indicate that the "hybrid" provisions in that treaty should apply to business income not earned through a permanent establishment.[31] One example involves a hybrid U.S. LLC, which has a Canadian business but has no permanent establishment in Canada. Since the U.S. LLC is not a resident of the United States, it is not entitled to claim treaty benefits in its own right. A U.S. resident member of the LLC, however, is exempt from Canadian on his share of the LLC's Canadian business profits, because such member is considered to deriving that income for purposes of U.S. tax law and the treaty. Absent some principled reason for interpreting the "hybrid" provisions of the U.S.-Canadian Treaty more broadly than their counterparts in the U.S.-French Treaty, the 2006 Model, or other U.S. tax treaties, the above example suggests that reading of the latter provisions as restricted to FDAP income would be improper.

Perhaps one reason for the IRS's apparent overabundance of caution is a concern about the mechanics for claiming treaty benefits in circumstances where a hybrid entity earns non-FDAP income. In the case of FDAP, it appears to be implicit that the owner need not file a return (or anything else) to enjoy the treaty benefits to which the hybrid entity is technically entitled.[32] But outside the FDAP context, the owner clearly must file a return; and it is not at all clear what might be attached to such return to claim the treaty benefits to which the hybrid entity is entitled. It may also be that the hybrid entity itself should file a return of some kind, but what exactly would this filing look like?

The desire of the IRS to avoid these tough questions is understandable, but not a particularly good reason for construing the "hybrid" treaty provisions in an overly narrow manner. It may be hoped that the views of the IRS will change as it gives the matter further consideration. In particular, the IRS may become more inclined towards a broader reading when it reflects on the potential for a narrow reading to permit treaty abuse. Only time will tell.

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1 The term "hybrid" refers to an entity that is treated as fiscally transparent for U.S. federal tax purposes, but not for purposes of the tax laws in the applicable foreign jurisdiction. Where an entity is fiscally transparent for purposes of the tax laws in the applicable foreign jurisdiction, but not U.S. federal tax purposes, the term "reverse hybrid" is used.

2 See Reg. §§301.7701-2(a), 301.7701-3. Certain domestic and foreign business entities are characterized by default as disregarded entities (if they have only one owner) or partnerships (if they have more than one owner) for U.S. federal tax purposes, but can elect to be taxable as corporations under Reg. §301.7701-2(b)(2). Certain foreign business entities with respect to which all the owners have limited liability are characterized by default as corporations, but can elect to be characterized as disregarded entities or partnerships (depending on whether they have more than one owner).

3 The applicable rate was 15 percent for 1995 and earlier years, and 10 percent for 1996 and later years. Article XI of United States - Canada Income Tax Convention (1980) [*hereinafter* U.S.-Canadian Treaty]; Article XI(1) of Protocol Amending the Convention Between the United States and Canada With Respect to Income Taxes (1995).

4 H. REP. 105-148, 105th Cong. 1st Sess., at 550.

5 P.L. 105-34, §1054(a). Except as otherwise indicated, all "section" and "§" references herein are to the Internal Revenue Code of 1986, as amended.

6 Code Sec. 894(c)(2) authorizes the Treasury to issue "regulations as may be necessary or appropriate to determine the extent to which a taxpayer ... shall not be entitled to benefits under any income tax treaty of the United States with respect to any payment received by, or income attributable to any activities of, an entity organized in any jurisdiction (including the United States) that is treated as a partnership or is otherwise treated as fiscally transparent for purposes of this title ... and is treated as fiscally nontransparent for purposes of the tax laws of the jurisdiction of residence of the taxpayer."

7 62 FR 35673 (June 30, 1997).

8 T.D. 8889 (July 3, 2000). The final regulations were subsequently revised in 2002 by T.D. 8999 (June 11, 2002).

9 Special rules addressing payments by U.S. "reverse hybrid" entities are set forth in Reg. §1.894-1(d)(2). The validity of these rules is doubtful, however, since Code Sec. 894(c)(2) applies by its terms only to certain payments " received by, or income attributable to any activities of, an entity … that is treated as a partnership or

is otherwise treated as fiscally transparent for purposes of this title ... and is treated as fiscally nontransparent for purposes of the tax laws of the jurisdiction of residence of the taxpayer." These words do not seem broad enough to cover reverse hybrid entities.

[10] FDAP income is "fixed or determinable annual or periodic gains, profits, and income" as defined in Code Secs. 871(a)(1)(A) and 881(a)(1), such as interest, dividends, rents, and wages. In the absence of a statutory or treaty exemption, FDAP income is subject to a tax of 30 percent on gross income.

[11] The disallowance of treaty benefits under the Code Sec. 894(c) regulations may be viewed as a treaty override. If that view is taken, the propriety of such unilateral treaty override by the United States is open to question.

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

[13] *See* Reg. §1.894-1(d)(5) Example 1.

[14] *See* Reg. §1.894-1(d)(5) Example 2.

[15] Note that A might take steps to ensure that none of the burdens of the five-percent U.S. withholding tax is allocated to M.

[16] Reg. §1.6012-1(b)(2)(i) provides that a nonresident alien individual is not required to file a return if his tax liability is fully satisfied by withholding and he did not engage in a U.S. trade or business at any time during the tax year. A similar rule applies to foreign corporations under Reg. §1.6012-2(g)(2)(i). Of course, the applicability of this rule presupposes that there is no substantive tax liability in excess of the amount, if any, that was withheld.

[17] Code Sec. 894 applies to taxes imposed under Code Sec. 871(a) (FDAP income of nonresident individuals) and Code Sec. 881(a) (FDAP income of foreign corporations). It also applies to taxes imposed under Code Sec. 1443 (unrelated business taxable income of foreign tax-exempt organizations), Code Sec. 1461 (tax liability of withholding agents), and Code Sec. 4948(a) (tax on private foundations). Reg. §1.894-1(d)(1).

[18] Article 7, Convention between the Government of the United States of America and the Government of the French Republic for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital (1994) [*hereinafter* U.S.-French Treaty].

[19] State or local taxes, however, might potentially apply.

[20] The owners might, for example, be residents of non-treaty countries, or they might fail to satisfy the LOB provisions of the income tax treaties between the United States and their countries of residence.

[21] United States Model Technical Explanation Accompanying the United States Model Income Tax Convention of November 15, 2006 [*hereinafter* Technical Explanation], at 5. Note that whether or not the State of residence actually taxes the income is not relevant. The income may still be "subject to tax" (or, in other treaties, "liable to tax") even if some exemption applies.

[22] Id. at 6.

[23] "The same result obtains even if the entity were viewed differently under the tax laws of the other Contracting State (*e.g.*, as not fiscally transparent in the first example above where the entity is treated as a partnership for U.S. tax purposes). Similarly, the characterization of the entity in a third country is also irrelevant, even if the entity is organized in that third country." Id. One key exception is that the "savings clause" of the applicable treaty generally would allow the source country to tax its own residents as if such treaty were not in effect.

[24] Pursuant to Article 10(7) of the U.S.-French Treaty, a French resident that earns business income in the United States qualifies for a reduction in the rate of branch profits tax to five percent.

[25] The interest to be owned by the U.S. corporation in the SAS would not have been sufficient to qualify for a 100-percent dividends received deduction.

[26] The U.S. trade or business is conducted either directly or through entities that are fiscally transparent for French tax purposes.

[27] Treaty benefits would not be relevant to the U.S. owner, which would simply be taxed on a "flow-through basis" under generally applicable Subchapter K principles.

[28] Article 4(2)(b)(iv) was added to the U.S.-French Treaty by Article I(2) of the Protocol Amending the Convention between the Government of the United States of America and the Government of the French Republic for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital. The protocol was signed on December 8, 2004, and entered into force on December 21, 2006.

[29] A exemption for any business profits not attributable to a U.S. PE would also seem appropriate, but on the facts presented to the IRS, it was assumed that all of the income generated within the U.S. would be attributable to a U.S. PE.

[30] There appears to be no question that the Code Sec. 894 regulations (as well as Article 4(2)(iv) of the U.S.-French Treaty) would allow a reduced dividend withholding tax to a hybrid SAS that receives dividends from a U.S. subsidiary, provided that all LOB and other treaty requirements are satisfied.

[31] Department of the Treasury Technical Explanation of the Protocol Done at Chelsea on September 21, 2007 Amending the Convention Between the United States of America and Canada With Respect to Taxes on Income and on Capital Done at Washington on September 26, 1980, as Amended by the Protocols Done on June 14, 1983, March 28, 1994, March 17, 1995, and July 29, 1997, at 5-6.

[32] As indicated above, a foreign taxpayer has no filing obligation where it is not engaged in a U.S. trade or business and its U.S. tax, if any, is fully satisfied by the amount withheld. *See* supra, note 16.