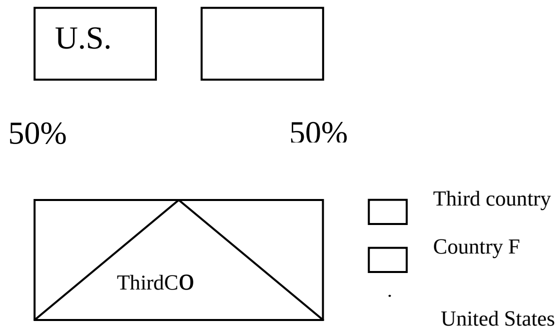
arise in the context of payments made through a hybrid entity.

Example 1: Payment arising in Country F (treaty partner) to LLC, a U.S. entity that is treated by the United States as fiscally transparent.

A limited liability company (LLC) organized in the United States and that is treated as fiscally transparent for U.S. tax purposes receives a dividend arising in the treaty partner, Country F. Country F treats LLC as a corporation under its domestic law. LLC is equally owned by two corporate members, one resident in the United States and the other resident in Country X. Because of the U.S. treatment of LLC, the U.S. member is taxed currently by the United States on its 50% share of the Country F dividend. This is the case even though Country F treats LLC as a corporation under its domestic law. It should follow that the U.S. member should be entitled to the benefits of the U.S.-F tax treaty (assuming that it satisfies any and all requirements set forth in the treaty). It should also follow that the portion of the dividend that flows through to the Country X member should not be entitled to the benefits of the U.S.-F tax treaty. However, as a policy matter, if Country X views LLC as fiscally transparent, the dividend should be entitled to the benefits of the tax treaty between Country F and XCo's state of residence.

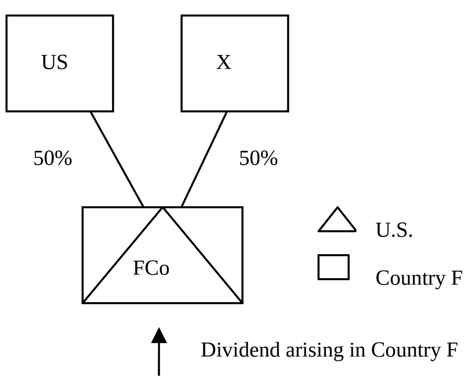
While these desired outcomes are consistent with the principles of the Partnership Report, countries may not apply their tax treaties in a manner that would reach these results absent an explicit treaty provision. Countries may argue, for instance, that since LLC is not taxed by the United States as a company, the dividend (which they see as being paid to LLC, is not entitled to treaty benefits because it is not being paid to a



Dividend arising in Country F

ThirdCo is an entity organized in a third country. Both Country F (the source State) and the third country view ThirdCo as a company, but the United States views ThirdCo as fiscally transparent. ThirdCo is equally owned by two corporate partners, one resident in the United States and one resident in Country X. Even though Country F and the third country view ThirdCo as a company, because the United States, as the residence State, views ThirdCo as fiscally transparent (and thus, the U.S. member is taxed currently by the United States on its 50% share of the Country F dividend), the U.S. member is treated as deriving 50% of the dividend received by ThirdCo. From a policy perspective, the same outcomes should be reached in this example as in Example 1.

<u>Example 3:</u> Payment arising in Country F to FCo, a Country F entity that is treated as fiscally transparent by the United States.



FCo, a company organized in Country F (the treaty partner) and that is treated as fiscally transparent for U.S. tax purposes receives a dividend arising in the treaty partner, Country F. Country F treats FCo as a corporation under its domestic law. FCo is equally owned by two corporate members, one resident in the United States and the other resident in Country X.

This example is distinguishable from the previous examples because from a Country F perspective, a country F company is receiving a dividend arising in Country F. It is therefore reasonable to assume that the U.S.-F. tax treaty should not have application, and that Country F should be able to tax the dividend in accordance with its domestic law. Nevertheless, treaty benefits should be available with respect to any future dividends paid by FCo to the U.S. member.

Example 4: Payment arising in Country F to ThirdCo, a third-country entity that is treated as fiscally transparent by the third country but as a company by the United States.

ThirdCo is an entity organized in a third country. Country F and the third country view ThirdCo as fiscally transparent, but the United States views ThirdCo as a company. ThirdCo is equally owned by two corporate partners, one resident in the United States and one resident in Country X. Because the United States, as the residence State, views ThirdCo as a company, the U.S. member is not taxed on a flow-through basis by the United States on its share of the Country F dividend. It should follow that the dividend arising in Country F should not be entitled to the benefits of the U.S.-F. tax treaty.

Treaty provision:

In order to provide clarity in such situations, the Committee may wish to consider adopting a rule into the U.N. Model. The following is text for possible consideration:

> **"For the purposes of this Convention, an item of income, profit or gain derived by or through an entity that is treated as wholly or partly fiscally transparent under the taxation laws of either Contracting State shall be considered to be derived by a resident of a Contracting State, but only 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."**

Additional treaty provisions:

In order to achieve the desired result in Example 3 above, it would be necessary to include in the Model, in addition to the draft provision above, a provision that grants a Contracting State the authority to tax its residents as if there were no Convention. Beyond achieving the desired result

ANNEX 1: U.S. Model Technical Explanation for corresponding tax treaty provisions

Paragraph 4

Paragraph 4 contains the traditional saving clause found in all U.S. income tax treaties. The Contracting States reserve their rights, except as provided in paragraph 5, to tax their residents and citizens as provided under their domestic laws, notwithstanding any provisions of the Convention to the contrary. For example, if a resident of the other Contracting State performs professional services in the United States and the income from the services is not attributable to a permanent establishment in the United States, Article 7 (Business Profits) would by its terms prevent the United States from taxing the income. If, however, the resident of the other Contracting State is also a citizen of the United States, the saving clause permits the United States to include the remuneration in the worldwide income of the citizen and subject it to tax under the normal Code rules (*i.e.*, without regard to Code section 894(a)). Subparagraph 5(a) of Article 1 also preserves the benefits of special foreign tax credit rules applicable to the U.S. taxation of certain U.S. income of its citizens resident in the other Contracting State. See paragraph 4 of Article 23 (Relief from Double Taxation).

For purposes of the saving clause, “residence” is determined under Article 4 (Resident). Thus, an individual who is a resident of the United States under the Code (but not a U.S. citizen) but who is determined to be a resident of the other Contracting State under the tie-breaker rules of Article 4 would be subject to U.S. tax only to the extent permitted by the Convention. The United States would not be permitted to apply its domestic law to that person to the extent that its law is inconsistent with the Convention.

However, the person would still be treated as a U.S. resident for U.S. tax purposes other than determining the individual’s U.S. tax liability. For example, in determining under Code section 957 whether a foreign corporation is a controlled foreign corporation, shares in that corporation held by the individual would be considered to be held by a U.S. resident. As a result, other U.S. citizens or residents might be deemed to be United States shareholders of a controlled foreign corporation subject to current inclusion of subpart F income recognized by the corporation. *See* Treas. Reg. section 301.7701(b)-7(a)(3).

Under paragraph 4, each Contracting State also reserves its right to tax former citizens and former long-term residents in accordance with domestic law. Thus, paragraph 4 allows the United States to tax former U.S. citizens and former U.S. long-term residents in accordance with Section 877 of the Code. Section 877 generally applies to a former citizen or long-term resident of the United States who relinquishes citizenship or terminates long-term residency before June 17, 2008 if he fails to certify that he has complied with U.S. tax laws during the 5 preceding years, or if either of the following criteria exceed established thresholds: (a) the average annual net income tax of such individual for the period of 5 taxable years ending before the date of the loss of status; or (b) the net worth of such individual as of the date of the loss of status.

The United States defines “long-term resident” as an individual (other than a U.S. citizen) who is a lawful permanent resident of the United States in at least 8 of the prior 15 taxable years. An individual is not treated as a lawful permanent resident for any taxable year in which the individual is treated as a resident of the other Contracting State under this Convention, or as a resident of any country other than the United States under the provisions of any other U.S. tax treaty, and the individual does not waive the benefits of the relevant tax treaty.

Paragraph 5

Paragraph 5 sets forth certain exceptions to the saving clause. The referenced provisions are intended to provide benefits to citizens and residents even if such benefits do not exist under domestic law.

Subparagraph 5(a) lists certain provisions of the Convention that are applicable to all citizens and residents of a Contracting State, despite the general saving clause rule of paragraph 4:

(1) Paragraph 2 of Article 9 (Associated Enterprises) grants the right to a correlative adjustment with respect to income tax due on profits reallocated under Article 9.

(2) Paragraph 7 of Article 13 (Gains) coordinates the tax systems of the Contracting States to avoid double taxation that could result from the imposition of an exit tax or similar regime on an individual who ceases to be treated as a resident (as determined under paragraph 1 of Article 4 (Resident)) of on Contracting State and becomes a resident of the other Contracting State.

(3) Subparagraph 1 (b), paragraphs 3 and 6 of Article 17 (Pensions, Social Security, Annuities, Alimony and Child Support) provide exemptions from source or residence State taxation for certain pension distributions, social security payments and child support.

(4) Paragraph 3 Article 18 (Pensions Funds) provides an exemption for certain investment income of pension funds located in the other Contracting State.

(5) Article 23 (Relief from Double Taxation) confirms to citizens and residents of one Contracting State the benefit of a credit for income taxes paid to the other or an exemption for income earned in the other State.

(6) Article 24 (Non-Discrimination) protects residents and nationals of one Contracting State against the adoption of certain discriminatory taxation practices in the other Contracting State.

(7) Article 25 (Mutual Agreement Procedure) confers certain benefits on citizens and residents of the Contracting States in order to reach and implement solutions to disputes between the two Contracting States. For example, the competent authorities are permitted to use a definition of a term that differs from an internal law definition.

The statute of limitations may be waived fo

Contracting State, creates a revocable trust in the United States and names persons resident in a third country as the beneficiaries of the trust. If, under the laws of the other Contracting State, X is treated as taking the trust's income into account for tax purposes, the trust's income would be regarded as being derived by a resident of the other Contracting Stat