
US and Norwegian tax authorities address treaty eligibility for fiscally transparent entities

February 6, 2013

In brief

On January 31, 2013, the IRS announced the signing of a competent authority agreement between Norway and the United States addressing the circumstances in which an item of income paid to an entity that is fiscally transparent under the tax laws of either jurisdiction will be seen as received by a resident of one of the two countries. The agreement specifically identifies disregarded LLCs, subchapter S corporations, grantor trusts, and common trust funds as entities that are fiscally transparent for US tax purposes and details the procedures that each entity must follow in order to claim treaty benefits from Norway.

In detail

Treaty fiscal transparency rules

The Section 894 regulations

In late 1997, the IRS issued final regulations addressing the availability of treaty benefits for an item of US source income paid to an entity that was fiscally transparent under the laws of either the United States or the treaty partner. In brief, the regulations generally look to the treatment of the income item under the residence country's tax laws to determine whether, under those laws, either the entity or its owner(s) is treated as taxable on the income.

Example: Absent a specific treaty provision between a country (country R) and the

United States, if: (i) US source interest is paid to an entity that country R sees as fiscally transparent, (ii) tax residents of country R own the entity and (iii) because of the transparent treatment of the entity under country R's laws, the owners are treated as the taxable recipients of their allocable share of the income on a current basis (whether or not distributed), then the interest generally will be treated as derived by the owners and eligible for the benefits of the US/R income tax treaty (assuming all other criteria for treaty benefits are met). In contrast, if the entity is treated as non-transparent for purposes of country R tax laws and the entity is not a tax resident of country R (e.g., a US LLC), the treaty benefits will not be available, even though the

entity is owned by residents of country R who will be taxable on any subsequent distribution of that income to them.

Fiscal transparency rules contained in treaties

Since 1997, the United States has routinely (but not uniformly) included fiscal transparency rules similar to the section 894 regulations in income tax treaties and protocols. The key distinction between the treaty rules and the regulatory rule is that the application of the regulatory rule is expressly limited to fixed or determinable annual or periodic income (FDAP), whereas the treaty fiscal transparency rule applies to all items of income, profit, or gain.

Treatment of partnerships, estates, and trusts under the current treaty and other older treaties

Prior to 1997, US tax treaties typically addressed the treatment of partnerships, estates, and trusts in the residency article. The present US/Norway treaty follows this historic approach. Rather than looking through the partnership and treating the owners as the potential claimants of the treaty benefits, the residency article treats the partnership as a resident to the extent, under the tax law of the treaty partner, the income is treated as income of a resident. Hence, the partnership, and not the partners, is treated as the resident eligible to claim treaty benefits.

Observation: The timing of the competent authority agreement is interesting. US Treasury Department representatives have been stating that a new treaty with Norway is very close to signature. One would expect the post-1997 treaty fiscal transparency rule to be included in the new agreement. Hence, any guidance provided by the competent authority agreement may have very limited relevance.

Key aspects of the competent authority agreement

Under the competent authority agreement, the treaty partners agree to interpret the residency rule in the treaty as follows:

[I]ncome from sources within one of the Contracting States received by an entity, wherever organized, that is treated as fiscally transparent under the laws of either Contracting State will be treated as income derived by a resident of the other Contracting State to the extent that such income is subject to tax as the income of a resident of the other Contracting State.

Example: A Norwegian company eligible for the treaty benefits wholly owns a US LLC that is treated as a disregarded entity under US tax law. The US LLC earns interest income from US sources. Because Norway views an LLC as non-transparent, Norwegian tax law does not see the interest income as earned by a resident of Norway. As a result, the Norwegian company cannot claim the treaty exemption for US source interest. In the reverse situation — a US corporation, eligible for the benefits of the treaty, owning a disregarded US LLC that earns interest income from Norwegian sources — the treaty exemption for interest would be available because US tax law sees the interest as earned by a US resident eligible for the treaty benefits.

The agreement clarifies that, for an entity to be transparent, the income subject to tax in the resident's hands must have the same source and character as if the income were directly received by the resident and it is not relevant whether the entity is fiscally transparent in the other Contracting State or any third jurisdiction in which it is organized.

Observation: The application of treaty fiscal transparency rules to income derived through an entity organized in a third jurisdiction is standard US tax treaty policy. However, some US treaties, including the US tax treaties with France and Mexico, limit or deny the rule's application with respect to income derived through an entity organized in a third jurisdiction.

Under the agreement, the following US entities are fiscally transparent for US tax purposes: partnerships, disregarded entities, subchapter S corporations, grantor trusts, and common trust funds. The agreement then describes the procedures for

obtaining residency certificates from the IRS in order to claim a reduction in Norwegian taxation.

The takeaway

The agreement clarifies the application of the treaty fiscal transparency rules in a treaty that does not contain the revised fiscal transparency commonly found in treaties since 1997. US taxpayers that are the beneficial owners of Norwegian source income that is derived through fiscally transparent entities should become familiar with the residency certification filing requirements in order to claim the treaty benefits.

Observation: The full scope of the treaties' fiscal transparency rules is not clear. The Section 894 regulations stated that the purpose of the rule in the regulations was to determine who should be treated as deriving the income. That makes sense in the FDAP context because treaty reductions in source country taxation of dividends, interest, and royalties is expressly tied to the income being derived by, received by, or paid to a treaty resident. However, many treaty benefits are not couched in terms of who derives the income. For example, the treaty limitation on the branch profits tax (BPT) rate typically provides that the source country can impose its BPT on a resident of the treaty partner and then limits the tax rate. Hence, a treaty country resident that earns US effectively connected income through a disregarded US LLC should be able to claim the treaty limitation on the BPT even if the residence country treats the LLC as opaque and accordingly does not tax its income until distributed. For a more comprehensive discussion of the subject, see Applying Branch Profits Tax Treaty Limits to Hybrid Entities,

Oren Penn, Steve Nauheim, and Susan J. Conklin, Tax Notes Special Reports, November 21, 2011.

Let's talk

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