

and Nationality Act. For examples of exemptions which are not affected by the Immigration and Nationality Act, see article X of the income tax convention between the United States and the United Kingdom (60 Stat. 1383); article IX, section 9(b), of the Articles of Agreement of the International Monetary Fund (60 Stat. 1414); and article VII, section 9(b), of the Articles of Agreement of the International Bank for Reconstruction and Development (60 Stat. 1458).

§ 1.894-1 Income affected by treaty.

(a) *Income exempt under treaty.* Income of any kind is not included in gross income and is exempt from tax under Subtitle A (relating to income taxes), to the extent required by any income tax convention to which the United States is a party. However, unless otherwise provided by an income tax convention, the exclusion from gross income under section 894(a) and this paragraph does not apply in determining the accumulated taxable income of a foreign corporation under section 535 and the regulations thereunder or the undistributed personal holding company income of a foreign corporation under section 545 and the regulations thereunder. Moreover, the distributable net income of a foreign trust is determined without regard to section 894 and this paragraph, to the extent provided by section 643(a)(6)(B). Further, the compensating tax adjustment required by section 819(a)(3) in the case of a foreign life insurance company is to be determined without regard to section 894 and this paragraph, to the extent required by section 819(a)(3)(A). See §1.871-12 for the manner of determining the tax liability of a nonresident alien individual or foreign corporation whose gross income includes income on which the tax is reduced under a tax convention.

(b) *Taxpayer treated as having no permanent establishment in the United States—(1) In general.* A nonresident alien individual or a foreign corporation, that is engaged in trade or business in the United States through a permanent establishment located therein at any time during a taxable year beginning after December 31, 1966, shall be deemed not to have a perma-

nent establishment in the United States at any time during that year for purposes of applying any exemption from, or reduction in the rate of, any tax under Subtitle A of the Code which is provided by any income tax convention with respect to income which is not effectively connected for that year with the conduct of a trade or business in the United States by the taxpayer. This paragraph applies to all treaties or conventions entered into by the United States, whether entered into before, on, or after November 13, 1966, the date of enactment of the Foreign Investors Tax Act of 1966 (80 Stat. 1539). This paragraph is not considered to be contrary to any obligation of the United States under an income tax convention to which it is a party. The benefit granted under section 894(b) and this paragraph applies only to those items of income derived from sources within the United States which are subject to the tax imposed by section 871(a) or 881(a), and section 1441, 1442, or 1451, on the noneffectively connected income received from sources within the United States by a nonresident alien individual or a foreign corporation. The benefit does not apply to any income from real property in respect of which an election is in effect for the taxable year under §1.871-10 or in determining under section 877(b) the tax of a nonresident alien individual who has lost United States citizenship at any time after March 8, 1965. The benefit granted by section 894(b) and this paragraph is not elective.

(2) *Illustrations.* The application of this paragraph may be illustrated by the following examples:

Example 1. M, a corporation organized in foreign country X, uses the calendar year as the taxable year. The United States and country X are parties to an income tax convention which provides in part that dividends received from sources within the United States by a corporation of country X not having a permanent establishment in the United States are subject to tax under Chapter 1 of the Code at a rate not to exceed 15 percent. During 1967, M is engaged in business in the United States through a permanent establishment located therein and receives \$100,000 in dividends from domestic corporation B, which under section 861(a)(2)(A) constitute income from sources within the United States. Under section

864(c)(2) and §1.864-4(c), the dividends received from B are not effectively connected for 1967 with the conduct of a trade or business in the United States by M. Although M has a permanent establishment in the United States during 1967, it is deemed, under section 894(b) and this paragraph, not to have a permanent establishment in the United States during that year with respect to the dividends. Accordingly, in accordance with paragraph (c)(3) of §1.871-12 the tax on the dividends is \$15,000, that is, 15 percent of \$100,000, determined without the allowance of any deductions.

Example 2. T, a corporation organized in foreign country X, uses the calendar year as the taxable year. The United States and country X are parties to an income tax convention which provides in part that an enterprise of country X is not subject to tax under chapter 1 of the Code in respect of its industrial or commercial profits unless it is engaged in trade or business in the United States during the taxable year through a permanent establishment located therein and that, if it is so engaged, the tax may be imposed upon the entire income of that enterprise from sources within the United States. The convention also provides that the tax imposed by Chapter 1 of the Code on dividends received from sources within the United States by a corporation of X which is not engaged in trade or business in the United States through a permanent establishment located therein shall not exceed 15 percent of the dividend. During 1967, T is engaged in a business (business A) in the United States which is carried on through a permanent establishment in the United States; in addition, T is engaged in a business (business B) in the United States which is not carried on through a permanent establishment. During 1967, T receives from sources within the United States \$60,000 in service fees through the operation of business A and \$10,000 in dividends through the operation of business B, both of which amounts are, under section 864(c)(2)(B) and §1.864-4(c)(3), effectively connected for that year with the conduct of a trade or business in the United States by that corporation. The service fees are considered to be industrial or commercial profits under the tax convention with country X. Since T has no income for 1967 which is not effectively connected for that year with the conduct of a trade or business in the United States by that corporation, section 894(b), this paragraph, and §1.871-12 do not apply. Accordingly, for 1967 T's entire income of \$70,000 from sources within the United States is subject to tax, after allowance of deductions, in accordance with section 882(a)(1) and paragraph (b)(2) of §1.882-1.

Example 3. S, a corporation organized in foreign country W, uses the calendar year as the taxable year. The United States and

country W are parties to an income tax convention which provides in part that a corporation of country W is not subject to tax under Chapter 1 of the Code in respect of its industrial or commercial profits unless it is engaged in trade or business in the United States during the taxable year through a permanent establishment located therein and that, if it is so engaged, the tax may be imposed upon the entire income of that corporation from sources within the United States. The convention also provides that the tax imposed by Chapter 1 of the Code on dividends received from sources within the United States by a corporation of country W which is not engaged in trade or business in the United States through a permanent establishment located therein shall not exceed 15 percent of the dividend. During 1967, S is engaged in business in the United States through a permanent establishment located therein and derives from sources within the United States \$100,000 in service fees which, under section 864(c)(2)(B) and §1.864-4(c)(3), are effectively connected for that year with the conduct of a trade or business in the United States by S and which are considered to be industrial or commercial profits under the tax convention with country W. During 1967, S also derives from sources within the United States, through another business it carries on in foreign country X, \$10,000 in sales income which, under section 864(c)(3) and §1.864-4(b), is effectively connected for that year with the conduct of a trade or business in the United States by S and \$5,000 in dividends which, under section 864(c)(2)(A) and §1.864-4(c)(2), are not effectively connected for that year with the conduct of a trade or business in the United States by S. The sales income is considered to be industrial or commercial profits under the tax convention with country W. Although S is engaged in a trade or business in the United States during 1967 through a permanent establishment located therein, it is deemed, under section 894(b) and this paragraph, not to have a permanent establishment therein with respect to the \$5,000 in dividends. Accordingly, in accordance with paragraph (c) of §1.871-12, for 1967 S is subject to a tax of \$750 on the dividends ($\$5,000 \times .15$) and a tax, determined under section 882(a) and §1.882-1, on its \$110,000 industrial or commercial profits.

Example 4. (a) N, a corporation organized in foreign country Z, uses the calendar year as the taxable year. The United States and country Z are parties to an income tax convention which provides in part that the tax imposed by Chapter 1 of the Code on dividends received from sources within the United States by a corporation of country Z shall not exceed 15 percent of the amount distributed if the recipient does not have a permanent establishment in the United States or, where the recipient does have a

permanent establishment in the United States, if the shares giving rise to the dividends are not effectively connected with the permanent establishment. The tax convention also provides that if a corporation of country Z is engaged in industrial or commercial activity in the United States through a permanent establishment in the United States, income tax may be imposed by the United States on so much of the industrial or commercial profits of such corporation as are attributable to the permanent establishment in the United States.

(b) During 1967, N is engaged in a business (business A) in the United States which is not carried on through a permanent establishment in the United States. In addition, N has a permanent establishment in the United States through which it carries on another business (business B) in the United States. During 1967, N holds shares of stock in domestic corporation D which are not effectively connected with N's permanent establishment in the United States. During 1967, N receives \$100,000 in dividends from D which, pursuant to section 864(c)(2)(A) and §1.864-4(c)(2), are effectively connected for that year with the conduct of business A. Under section 861(a)(2)(A) these dividends are treated as income from sources within the United States. In addition, during 1967, N receives from sources within the United States \$150,000 in sales income which, pursuant to section 864(c)(3) and §1.864-4(b), is effectively connected with the conduct of a trade or business in the United States and which is considered to be industrial or commercial profits under the tax convention with country Z. Of these total profits, \$70,000 is from business A and \$80,000 is from business B. Only the \$80,000 of industrial or commercial profits is attributable to N's permanent establishment in the United States.

(c) Since N has no income for 1967 which is not effectively connected for that year with the conduct of a trade or business in the United States by that corporation, section 894(b) and this paragraph do not apply. However, N is entitled to the reduced rate of tax under the tax convention with country Z with respect to the dividends because the shares of stock are not effectively connected with N's permanent establishment in the United States. Accordingly, assuming that there are no deductions connected with N's industrial or commercial profits, the tax for 1967, determined as provided in paragraph (c) of §1.871-12, is \$46,900 as follows:

Tax on nontreaty income:	
\$80,000×.48	\$38,400
Less \$25,000×.26	6,500
	31,900
Tax on treaty income:	
\$100,000 (gross dividends)×.15	15,000
Total tax	46,900

Example 5. M, a corporation organized in foreign country Z, uses the calendar year as the taxable year. The United States and country Z are parties to an income tax convention which provides in part that a corporation of country Z is not subject to tax under Chapter 1 of the Code in respect of its commercial and industrial profits except such profits as are allocable to its permanent establishment in the United States. The regulations in this chapter under the tax convention with country Z provide that a corporation of country Z having a permanent establishment in the United States is subject to U.S. tax upon its industrial and commercial profits from sources within the United States and that its industrial and commercial profits from such sources are deemed to be allocable to the permanent establishment in the United States. During 1967, M is engaged in a business (business A) in the United States which is carried on through a permanent establishment in the United States; in addition, M is engaged in a business (business B) in foreign country X and none of such business is carried on in the United States. During 1967, M receives from sources within the United States \$40,000 in sales income through the operation of business A and \$10,000 in sales income through the operation of business B, both of which amounts are, under section 864(c)(3) and §1.864-4(b), effectively connected for that year with the conduct of a trade or business in the United States by that corporation. The sales income is considered to be industrial and commercial profits under the tax convention with country Z. Since M has no income for 1967 which is not effectively connected for that year with the conduct of a trade or business in the United States by that corporation, section 894(b) and this paragraph do not apply. Accordingly, for 1967 M's entire income of \$50,000 from sources within the United States is subject to tax, after allowance of deductions, in accordance with section 882(a)(1) and paragraph (b)(2) of §1.882-1.

(c) *Substitute interest and dividend payments.* The provisions of an income tax convention dealing with interest or dividends paid to or derived by a foreign person include substitute interest or dividend payments that have the same character as interest or dividends under §1.864-5(b)(92)(ii), 1.871-7(b)(2) or 1.881-2(b)(2). The provisions of this paragraph (c) shall apply for purposes of securities lending transactions or sale-repurchase transactions as defined in §1.861-2(a)(7) and §1.861-3(a)(6).

(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 juris-

diction, 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 en-

tity'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 be-

cause 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 re-

quired 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 in Country X of the arrangement, A is not liable to tax as a person at the entity level in Country X and is thus 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 person in Country X and thus not a resident of Country X under the Residence Article of the U.S.-X income tax treaty, however, A does not derive the income as a resident of Country X 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 taxed 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.

(i) *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.

(e) *Effective Date.* Paragraphs (a) and (b) of this section apply for taxable years beginning after December 31, 1966. For corresponding rules applicable to taxable years beginning before January 1, 1967, (see 26 CFR part 1 revised April 1, 1971). Paragraph (c) of this section is applicable to payments made after November 1, 1997. See paragraph (d)(6) of this section for applicability dates for paragraph (d) of this section.

[T.D. 7293, 38 FR 32800, Nov. 28, 1973, as amended by T.D. 8735, 62 FR 53502, Oct. 14, 1997; T.D. 8889, 65 FR 40997, July 3, 2000; T.D. 8889, 65 FR 76932, Dec. 8, 2000]

§ 1.895-1 Income derived by a foreign central bank of issue, or by Bank for International Settlements, from obligations of the United States or from bank deposits.

(a) *In general.* Income derived by a foreign central bank of issue from obligations of the United States or of any agency or instrumentality thereof, or from interest on deposits with persons carrying on the banking business, is excluded from the gross income of such bank and is exempt from income tax if

the bank is the owner of the obligations or deposits and does not hold the obligations or deposits for, or use them in connection with, the conduct of a commercial banking function or other commercial activity by such bank. For purposes of this section and paragraph (i) of § 1.1441-4, obligations of the United States or of any agency or instrumentality thereof include beneficial interests, participations, and other instruments issued under section 302(c) of the Federal National Mortgage Association Charter Act (12 U.S.C. 1717). See 24 CFR part 1600 *et seq.*

(b) *Foreign central bank of issue.* (1) A foreign central bank of issue is a bank which is by law or government sanction the principal authority, other than the government itself, issuing instruments intended to circulate as currency. Such a bank is generally the custodian of the banking reserves of the country under whose law it is organized. See also paragraph (b)(5) of § 1.861-2.

(2) The exclusion granted by section 895 applies to an instrumentality that is separate from a foreign government, whether or not owned in whole or in part by a foreign government. For example, foreign banks organized along the lines of, and performing functions similar to, the Federal Reserve System qualify as foreign central banks of issue for purposes of this section.

(3) The Bank for International Settlements shall be treated as though it were a foreign central bank of issue for purposes of obtaining the exclusion granted by section 895.

(c) *Ownership of United States obligations or bank deposits.* The exclusion does not apply if the obligations or bank deposits from which the income is derived are not owned by the foreign central bank of issue. Obligations held, or deposits made, by a foreign central bank of issue as agent, custodian, trustee, or in any other fiduciary capacity, shall be considered as not owned by such bank for purposes of this section.

(d) *Commercial banking function or other commercial activity.* The exclusion applies only to obligations of the United States or of any agency or instrumentality thereof, or to bank deposits, held for, or used in connection