[JOINT COMMITTEE PRINT]

EXPLANATION OF PROPOSED INCOME TAX TREATY BETWEEN THE UNITED STATES AND THE REPUBLIC OF CYPRUS

SCHEDULED FOR A HEARING

BEFORE THE

COMMITTEE ON FOREIGN RELATIONS
UNITED STATES SENATE

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I. SUMMARY

In general

The principal purposes of the proposed income tax treaty between the United States and the Republic of Cyprus ("Cyprus") are to reduce or eliminate double taxation of income earned by citizens and residents of either country from sources within the other country, and to prevent avoidance or evasion of the income taxes of the two countries. The proposed treaty is intended to promote close economic cooperation between the two countries and to eliminate possible barriers to trade caused by overlapping taxing jurisdictions of the two countries. It is intended to enable the countries to cooperate in preventing avoidance and evasion of taxes.

As in other U.S. tax treaties, these objectives are principally achieved by each country agreeing to limit, in certain specified situations, its right to tax income derived from its territory by residents of the other. For example, the treaty provides that neither country will tax business income derived from sources within that country by residents of the other unless the business activities in the taxing country are substantial enough to constitute a permanent establishment or fixed base (Articles 8 and 17). Similarly, the treaty contains "commercial visitor" exemptions under which residents of one country performing personal services in the other will not be required to pay tax in the other unless their contact with the other exceeds specified minimums (Articles 17 through 21). The proposed treaty provides that gains (except from the disposition of real property interests) and royalties derived by a resident of either country from sources within the other generally may be taxed by the residence country only and not by the source country (Articles 14 and 16), and that dividends and interest received by a resident of either country from sources within the other generally are to be taxed by the source country on a restricted basis (Articles 12 and 13).

In situations where the country of source retains the right under the proposed treaty to tax income derived by residents of the other country, the treaty generally provides for the relief of the potential double taxation by the country of residence allowing a foreign tax credit (Article 5).

Like other U.S. tax treaties, the proposed treaty contains a "saving clause." Under this provision, each country retains the right to tax its citizens and residents as if the treaty had not come into effect (Article 4). In addition, the treaty contains the standard provision that the treaty will not be applied to deny any taxpayer any benefits he would be entitled to under the domestic law of the country or under any other agreement between the two countries (Article 4); that is, the treaty will only be applied to the benefit of taxpayers.

The treaty also contains a non-discrimination provision and provides for exchange of information and administrative cooperation between the tax authorities of the two countries to avoid double taxation and to prevent fiscal evasion with respect to income taxes.

Difference in proposed treaty and model treaties

The proposed treaty differs in certain respects from other U.S. income tax treaties and from the U.S. model treaty. Some of these differences are as follows:

(1) U.S. citizens who are not also U.S. residents are generally covered by the treaty. While the U.S. model covers nonresident U.S. citizens, the United States frequently has been unable to negotiate coverage for them in its income tax treaties.

(2) The U.S. excise tax on insurance premiums paid to a foreign insurer is generally covered by the treaty. This is a departure from older U.S. tax treaties. The U.S. model and some recent U.S. treaties, such as the treaties with the United Kingdom, France, and Hungary, generally cover this excise tax.

(3) The proposed treaty allows the source country to tax any income not otherwise specifically dealt with in the treaty. The U.S. model treaty, by contrast, gives the residence country the sole right to tax income not otherwise specifically dealt with under the treaty, unless the income is attributable to a permanent establishment or a fixed base in the other country. The rule of the proposed treaty is contained in a number of existing U.S. income tax treatie

(4) The proposed treaty contains a comprehensive set of source rules. These rules are used in applying the treaty's source basis taxation provisions and in determining the appropriate foreign tax credit for U.S. and Cypriot taxes. The U.S. model contains source rules for the interest and foreign tax credit provisions only; local law determines the source of income in other cases. Some U.S. income tax treaties contain similar comprehensive sets of source rules.

(5) Under the U.S. model treaty, dividends, interest, and royalties arising in the United States that are paid to a resident of the other country may be taxed by the United States on a net basis, at the regular graduated U.S. rates (that is, without regard to the treaty limitations on source country gross withholding taxes), either if the resident of the other country is an individual and the investment income is attributable to a U.S. fixed base of that individual, or if the resident of the other country is an enterprise and the income is attributable to a U.S. permanent establishment of that enterprise. By contrast, under the proposed treaty, such dividends, interest, and royalties may be taxed by the United States on a net basis only if the recipient is an enterprise and the property or rights giving rise to the income are effectively connected with a U.S. permanent establishment of that enterprise. A number of older U.S. income tax treaties contain a similar rule.

(6) The definition of a permanent establishment in the proposed treaty is broader in one important respect than that in the U.S. model and in many existing U.S. treaties. The proposed treaty treats as a permanent establishment a building site, construction or installation project, or installation, drilling rig, or ship used for

the exploration or exploitation of natural resources that lasts for more than six months (rather than the U.S. model's 12 months). Similar provisions are found in a number of U.S. tax treaties.

(7) The dividends article of the proposed treaty generally limits the Cypriot tax on dividends derived by U.S. residents from Cypriot companies and provides such U.S. shareholders with a credit against the Cypriot tax. Under this article, U.S. shareholders will not be liable for any Cypriot tax on Cypriot source dividends beyond that owed by the distributing company on the profits out of which the dividends are paid.

This provision reflects Cyprus's partial integration of its corporate and individual income taxes. Under Cypriot law, Cypriot resident shareholders generally receive a tax credit with respect to dividends from Cypriot resident companies. The credit equals the Cypriot corporate tax deducted (paid) by the distributing company on the profits out of which the dividends are paid. The credit is applied against a Cypriot resident shareholder's income tax liability. If the credit exceeds that liability, the excess is refunded to the shareholder. (The Cypriot corporate tax rate generally is 42.5 percent. It is reduced to 25 percent for the first 10 years of a Cypriot public company's existence, to 4.25 percent for foreign source income of a Cypriot company registered as an overseas company, owned by foreign persons, and managed and controlled in Cyprus, and to zero for foreign source income of a branch of a similar company managed outside Cyprus. The Cypriot personal income tax is progressive with rates ranging from 10 to 60 percent.) Nonresident shareholders also generally receive a credit for the corporate tax paid; however, in the absence of a treaty, a nonresident of Cyprus generally is taxed on Cypriot source dividends at the top Cypriot corporate rate of 42.5 percent rather than at the rate otherwise applicable to the nonresident under Cypriot law. Nonresidents may not receive a refund of corporate tax paid with respect to a Cypriot source dividend.

Under the proposed treaty, Cypriot source dividends derived by U.S. shareholders generally may not be subjected to Cypriot tax in excess of the Cypriot corporate tax imposed on the profits or earnings from which the dividends are paid. U.S. shareholders generally receive a credit against their Cypriot tax liability for the amount of the Cypriot corporate tax paid on those profits or earnings.

The treaty provides U.S. resident individuals with a refund of any Cypriot corporate tax imposed on the profits or earnings out of which a dividend is paid that exceeds the individuals' Cypriot personal income tax liability. Under the treaty, Cypriot source dividends of U.S. resident individuals generally are subject to tax at the Cypriot personal income tax rates applicable to income of Cypriot resident individuals. However, the dividends are subject to a maximum Cypriot tax (at current Cypriot rates) of 42.5 percent (instead of 60 percent). Also, U.S. resident individuals have only their Cypriot source income counted in determining the applicable marginal rate. Thus, U.S. individual shareholders are generally treated more favorably under the treaty than they would be in its absence and are sometimes treated more favorably by virtue of the treaty than their Cypriot counterparts are.

U.S. corporate shareholders are also treated more favorably under the treaty then they would be in its absence: The treaty lowers the Cypriot tax rate applicable to their Cypriot source dividends from the top corporate rate of 42.5 percent that is otherwise generally applicable to the rate applicable to the profits or earnings from which the dividends are paid. However, U.S. corporate shareholders apparently may be treated less favorably than their Cypriot counterparts are in some cases: As indicated above, Cypriot corporate shareholders are subject to tax on Cypriot source dividends at the rates otherwise applicable to them as Cypriot corporations rather than at the rates applicable to the profits or earnings out of which the dividends are paid. Since Cyprus subjects some nonresident corporations to lower tax rates than resident corporations, nonresident corporate shareholders in Cypriot resident companies may be better off (in the aggregate) with the rule applicable to Cypriot corporate shareholders. Under U.S. income tax treaties currently in force, however, no country with a partially integrated system except the United Kingdom provides substantial U.S. corporate investors *any* portion of the credit provided its own residents. The U.S. treaty with the United Kingdom provides substantial U.S. corporate investors with a credit equal to one-half of the credit that a U.K. resident would be entitled to were he the recipient of the dividend.

(8) Like the U.S. model treaty, the proposed treaty generally limits to five and 15 percent, respectively, the rates of tax that the United States may impose on dividends paid to "direct" investors (that is, substantial corporate investors) and "portfolio" investors (that is, investors other than direct investors) resident in the other country. To qualify for the five-percent rate under the proposed treaty, a corporate investor must own 10 percent or more of the payor corporation's voting stock, and not more than 25 percent of the payor corporation's income may be from interest or dividends of certain kinds. To qualify for the five-percent rate under the U.S. model, only the 10-percent stock ownership test must be satisfied.

(9) The proposed treaty generally limits the tax at source on gross interest to 10 percent. Exempt from source country tax is interest beneficially derived by the countries and their tax-exempt instrumentalities, residents of the countries on debt obligations guaranteed by their countries, banks and other financial institutions, and residents of the countries on debt obligations arising in connection with the sale of property or the performance of services. Under the U.S. model, all interest, by contrast, generally is exempt from source country tax. The U.S. model position is rarely achieved.

Because of the recent repeal (in the Tax Reform Act of 1984) of the U.S. gross withholding tax on interest paid on portfolio indebtedness held by foreign persons, Cypriot residents generally will receive U.S. source interest on portfolio indebtedness free of U.S. tax in any event. However, U.S. residents generally will be subject to Cypriot tax (limited to 10 percent by the treaty) on Cypriot source interest on similar indebtedness.

(10) Under the U.S. model treaty, dividends, interest, and royalties derived by a resident of one country from sources in the other are not eligible for the treaty's reduced rates of source country tax

unless the beneficial owner of such investment income is a resident of the first-mentioned country. This beneficial owner limitation prevents a third-country investor from obtaining the reduced rates with respect to investment income earned in the second-mentioned country by appointing a resident nominee in the first-mentioned country to collect that income. Like a number of older U.S. income tax treaties, the proposed treaty does not expressly impose the beneficial owner limitation (except with respect to interest exempted from source country tax). However, the Treasury Department intends that the treaty be interpreted to contain the limitation.

(11) The proposed treaty allows source country taxation of income from independent personal services on the basis of presence in the source country for more than 183 days in a taxable year. The U.S. model treaty does not allow taxation of such income on the basis of days of presence. Under the U.S. model, independent personal services income of a nonresident is taxable only if the nonresident has available a fixed base in the source country.

(12) Under the proposed treaty, income from services performed as an employee in one country (the source country) by a resident of the other country will not be taxable in the source country if three requirements are met: (a) the employee is present in the source country for less than 183 days during the taxable year; (b) the employee's employer is not a resident of the source country; and (c) the compensation is not borne by a permanent establishment, a fixed base, or a trade or business which the employer has in the source country. Under the U.S. model, the third requirement for source country tax exemption is less stringent: if the employer has a trade or business in the source country, but it does not rise to the level of a permanent establishment or fixed base there, the exemption will not be lost as a result of that business' bearing the employee's compensation.

(13) Under the proposed treaty, remuneration from employment as a member of the regular complement of a ship or aircraft operated internationally by a resident of one country is taxable in that country as well as in the country of which the employee is a resident. By contrast, under the U.S. model treaty, such remuneration is taxable only in the country of which the employee is a resident.

(14) The proposed treaty allows the source country to tax entertainers and athletes who earn more than a total of $5,000 there during a taxable year or more than $500 there per day. The comparable annual total in the U.S. model treaty is $20,000; the model does not apply a daily threshold. Most U.S. income tax treaties follow the U.S. model rule, but use a lower annual income threshold.

(15) The proposed treaty allows directors' fees paid by a corporation of one country to a resident of the other country to be taxed in the first country, notwithstanding the general treaty limits on source country taxation of personal services income, to the extent that the directors' fees exceed a reasonable fixed amount. The U.S. model treaty does not contain this rule.

(16) The exemption from source country taxation provided to visiting students and trainees is broader than that provided in the U.S. model. The U.S. model exemption applies only to payments received from outside the source country for maintenance, education,

study, research, or training. The proposed treaty exemption extends to, among other things, $2,000 per year of personal services income in the case of a student, and $7,500 per year of personal services income in the case of a trainee. The proposed treaty exemption is similar to that incorporated in a number of older U.S. income tax treaties.

(17) The proposed treaty does not limit taxation of child support payments. The U.S. model treaty allows taxation of child support payments only in the country of residence of the payor.

(18) The proposed treaty contains the standard provision that, as a general rule, exempts wages of employees of one of the countries from tax in the other country. However, the proposed treaty provision does not apply, as the corresponding U.S. model provision does, to wages paid by political subdivisions and local authorities of the countries.

(19) The anti-treaty shopping provisions of the proposed treaty follow closely those of the U.S. model. However, certain of the provisions found in the proposed treaty and in the U.S. model do not apply to individuals. (All of the anti-treaty shopping provisions of the proposed Barbados treaty apply to individuals.) Cyprus may be called a "tax haven" country: Special tax provisions enacted in the 1970's that substantially reduce Cypriot taxes on income derived from certain offshore investments and activities encourage third-country residents to channel certain investments through Cyprus. It is possible, therefore, that the absence of full treaty shopping coverage for individuals might lead to treaty shopping abuses. (See discussion under "Issues" below.)

(20) The proposed treaty's exchange of information article differs from that of the U.S. model in specifically empowering the competent authorities of the two countries to secure within their respective countries whatever information may be necessary to comply with the treaty's exchange of information requirements. Notes exchanged when the proposed treaty was signed indicate that, without such modification by the treaty, Cypriot law may not empower the Cypriot competent authority to obtain all of the information required to be exchanged. The notes state that the treaty will provide Cyprus with the necessary authority to implement the treaty's exchange of information rules; the notes specify certain types of information which the treaty will authorize Cyprus to provide.

The proposed treaty, like the U.S. model, makes it clear that the appropriate Congressional committees and the General Accounting Office are to have access to information exchanged under the treaty where appropriate.

(21) The notes exchanged when the proposed treaty was signed also contain U.S. assurances that, when circumstances permit, the United States would be prepared to resume discussions with a view to incorporating provisions in the treaty, consistent with U.S. income tax policies regarding other developing countries, that would minimize the interference of the U.S. tax system with investment incentives offered by the Cypriot Government. These assurances are similar to those offered by the United States to certain other developing countries.

II. ISSUES

The proposed treaty presents the following specific issues:

(1) Treaty shopping

The proposed treaty, like a number of U.S. income tax treaties, generally limits source country withholding tax on interest paid to residents of the other country. Although this treaty tax reduction (like other reductions and tax exemptions provided in the proposed treaty) is intended to benefit residents of Cyprus and the United States only, residents of third countries sometimes attempt to use a treaty to obtain treaty benefits. This is known as treaty shopping. Investors from countries that do not have tax treaties with the United States, or from countries that have not agreed in their tax treaties with the United States to limit source country taxation of interest to the same extent that it is limited in another treaty may, for example, attempt to secure a lower rate of U.S. tax on interest by lending money to a U.S. person indirectly through a country whose treaty with the United States provides for a lower rate. The third-country investor may do this by establishing a subsidiary, trust, or other investing entity in that treaty country, which then makes the loan to the U.S. persons and claims the treaty reduction for the interest it receives. The third-country investor also may do this by hiring an individual resident of the treaty country to make the loan to the U.S. person. Under this arrangement, the individual resident enters into a separate loan agreement with the third-country investor; the individual resident claims the treaty reduction for the interest it receives on the loan to the U.S. person and routes this income to the third-country investor by making interest payments on the loan taken from the third-country investor.

By repealing the U.S. gross withholding tax on interest paid to foreigners on certain portfolio indebtedness, the Tax Reform Act of 1984 limited treaty shopping incentives dramatically. Opportunities for treaty shopping remain, however, where the United States still imposes tax on interest paid to foreigners. The United States taxes interest paid to parties related to the payor, interest on pre-July 19, 1984 debt, and certain interest paid to banks.

The anti-treaty shopping provisions of the proposed treaty follow closely those of the current (1981) U.S. model treaty. However, certain of the anti-treaty shopping provisions found in the proposed treaty (those in paragraphs 1 and 2 of Article 26), like the corresponding provisions of the U.S. model (paragraphs 1 and 2 of Article 16), do not apply to *individuals* resident in one of the treaty countries who claim treaty benefits. The proposed treaty would make it difficult, for example, for a third-country investor to obtain a reduced rate of U.S. tax on interest under the treaty by channeling a U.S. loan through an investing entity established in Cyprus. However, the treaty would not deny treaty benefits if, for example, a third-country investor lent money to U.S. persons pursuant to a "back-to-back" loan arrangement utilizing a Cypriot individual as the intermediary and the intermediary's U.S. income on the transaction were subject to full Cypriot tax. This raises the issue of whether coverage of individuals under all of the anti-treaty shopping provisions is needed to forestall effectively treaty shopping abuses.

As already indicated, certain of the U.S. model treaty's anti-treaty shopping provisions do not apply to individuals. The same is true with respect to the corresponding provisions of U.S. treaties currently in force. However, as indicated above, there is some potential for treaty shopping using an individual intermediary. That potential is of particular concern in the case of a "tax haven" country such as Cyprus that encourages third-country residents to channel investment income through it by reducing its taxes on income derived from certain offshore investments and providing other tax and non-tax incentives to attract foreign investors. Even without individual coverage, the anti-treaty shopping provisions of the proposed treaty are stricter than those included in most existing U.S. income tax treaties. This reflects the negotiators' recognition of the potential for treaty shopping problems posed by a treaty between the United States and a country that is arguably a tax haven. All of the anti-treaty shopping provisions included in the proposed treaty with Barbados, another country with tax haven characteristics, *do* apply to individuals.

On the other hand, there are provisions of the treaty and Cypriot law that reduce considerably the treaty's vulnerability to treaty shopping using a Cypriot individual as an intermediary. At present, Cyprus generally imposes a 42.5-percent withholding tax on interest payments to nonresidents. The proposed treaty does deny treaty benefits to income earned in one country by a resident of the other when the residence country substantially reduces the tax on such income as compared with similar domestic income (Article 4). According to the Treasury Department, the reduced rates of source country tax provided by the treaty for dividends, interests, and royalties do not apply if the recipient is a nominee for a third-country resident. In addition, the principles of a recent IRS ruling, if extended to individuals, could limit treaty shopping possibilities using an individual intermediary (Rev. Rul. 84-152, 1984-2 C.B. 381). At the same time, it is important to keep in mind that the Cypriot withholding tax on interest paid to nonresidents is substantially reduced or eliminated under a number of Cypriot income tax treaties. In addition, there is no guarantee that existing impediments to the use of the proposed treaty by third-country investors will continue. Cyprus substantially revised its tax laws in the 1970s to attract foreign investment. The possibility that Cyprus may make further tax law changes in the future to remove impediments to foreign investment cannot be discounted. Experience has shown that if treaty shopping abuses develop after a treaty is ratified, it is very difficult to negotiate solutions.

The United States arguably should maintain its policy of limiting treaty shopping opportunities whenever possible. Because individuals are not fully covered under the proposed treaty's anti-treaty shopping provisions, those provisions may not prevent all unintended uses of the proposed treaty by third-country investors.

(2) Developing country concessions

The proposed treaty contains a number of developing country concessions. A number of these concessions are found in other U.S. income tax treaties with developing countries.

"First," the proposed treaty departs from the U.S. and OECD model treaties in providing for relatively broad source basis taxation. The proposed treaty's permanent establishment clause, for example, permits the country in which business activities are carried on to tax the activities sooner, in certain cases, than it would be able to under the model treaties. Under the proposed treaty, a building site or construction or installation project will create a permanent establishment if it lasts in a country for more than six months; under the U.S. model, a building site, etc., must last for at least one year. Thus, under the proposed treaty, business profits attributable to an installation project, for example, in Cyprus will be taxable by Cyprus if the project lasts for more than six months. Similarly, under the proposed treaty, the use of a drilling rig in a country for more than six months creates a permanent establishment there; under the U.S. model, drilling rigs must be present for at least one year.

The staff understands that the present level of direct investment by U.S. firms in Cyprus is not significant. However, one purpose of the treaty is to promote such investment. The practical effect of these permanent establishment rules could be greater Cypriot taxation of future construction activities of U.S. firms in Cyprus than would be the case under the model treaty rules.

Other concessions to source basis taxation in the proposed treaty include a maximum rate of source country tax on interest that is higher than that provided in the U.S. model treaty; taxing jurisdiction on the part of the source country as well as the residence country with respect to income not otherwise specifically dealt with by the treaty; and broader source country taxation of personal services income, directors' fees, and entertainers' income than that allowed by the U.S. model.

In addition to allowing relatively broad source basis taxation, the proposed treaty contains some other types of developing country concessions. For example, in notes exchanged when the proposed treaty was signed, the United States agreed to resume discussions (when it is in a position to do so), with a view to incorporating provisions in the treaty that will minimize the interference of the U.S. tax system with investment incentives offered by Cyprus and that will be consistent with U.S. income tax policies regarding other developing countries.

The issue is whether these developing country concessions are appropriate U.S. treaty policy and, if so, whether Cyprus is an appropriate recipient of these concessions. There is a risk that the inclusion of these concessions in the proposed treaty could result in additional pressure on the United States to include them in future treaties negotiated with developing countries. However, a number of existing U.S. treaties with developing countries already include developing country concessions. Such concessions are arguably necessary in order to obtain treaties with developing countries such as Cyprus. Tax treaties with developing countries can be in the interest of the United States because they provide tax relief for U.S. investors and a framework within which the taxation of U.S. investors will take place. On the other hand, tax treaties with "tax haven" countries like Cyprus may not be in the interest of the United States to the same extent that tax treaties with some other developing countries are.

(3) Resourcing rule of the Tax Reform Act of 1984

The Tax Reform Act of 1984 amended the foreign tax credit limitation rules to prevent U.S. persons from treating as foreign source income dividends, interest, and certain other income that they derived through a foreign corporation a significant part of whose income arose in the United States. The proposed treaty provides that the United States need credit taxes paid to Cyprus only "[i]n accordance with and subject to the limitations of the law of the United States (as it may be amended from time to time without changing the principles hereof)" (Article 5, paragraph 1). The proposed treaty also provides that, "in applying the United States credit in relation to taxes paid to Cyprus," special treaty source rules apply (*id.*). Among other things, these source rules provide that dividends will be treated as income from sources within a country only if paid by a corporation of that country, and interest will be treated as income from sources within a country only if it is paid by the country or by a resident of the country (Article 6, paragraphs 1 and 2). Items of income not covered by the treaty source rules generally are to be sourced by each country under its own law (Article 6, paragraph 9).

The issue is whether the proposed treaty allows the 1984 change to the foreign tax credit limitation rules to operate as Congress intended. If the 1984 change is a limitation on the foreign tax credit (for the purpose of the treaty provisions listed above), then paragraph 1 of Article 5 would control. In that case, the proposed treaty would not prevent operation of the change since the treaty credit is allowed only "subject to the limitations" of U.S. law. A strong argument for this view is that the 1984 Act amended a Code section (904) that deals only with the foreign tax credit limitation. However, if instead the 1984 change is read as a source rule amendment for purposes of the proposed treaty, then Article 6 arguably would control. In that case the proposed treaty arguably would prevent operation of the change since Article 6 provides foreign sourcing of certain income that would be treated as U.S. source income under the 1984 Act rule. The argument for this latter view is that the Article 6 source rules would have limited meaning if they did not obligate the United States to credit taxes on income that these rules treat as foreign source income.

Thus, the proposed treaty might make payments from an Cypriot corporation to a U.S. person Cypriot source, even if the Cypriot corporation derived all its income from the United States. That result, if it obtains, would defeat the purpose of the 1984 Code amendment. The Treasury Department interprets the proposed treaty not to override the 1984 amendment. The issue for the Committee is to insure that Committee report language and Treasury's technical explanation clarity the retention of the 1984 change to the Code.

(4) Branch-level tax

The United States does not now impose a branch-level tax, but the Administration's May 1985 tax reform proposal asks Congress to enact one. The proposed treaty does not expressly prohibit the United States from imposing a branch-level-type tax. Many argue, however, that the nondiscrimination rule protecting permanent establishments that is found in the proposed treaty and in most U.S. income tax treaties forbids the imposition of a branch-level-type tax on permanent establishments. The Administration has responded to this argument by proposing that treaties not be overriden. On enactment, the Administration would seek to renegotiate treaties to allow the United States to impose the branch-level tax that Congress enacted as a general rule in particular countries where current treaties prohibit its imposition. The issue is whether the sequence of actions that the Administration asks Congress in general and the Senate in particular to take makes sense. If the Senate agrees to a treaty with Cyprus, for example, and then Congress enacts a branch-level tax that the treaty arguably prevents Cypriot corporations from paying, it is unclear why Cyprus would agree to allow the United States to impose that tax. Cyprus could unilaterally concede the issue, but Cyprus could instead ask for a quid pro quo from the United States, or Cyprus could instead not yield on this point. Previous experience indicates that, in general, renegotiation of treaties, once ratified, is difficult.

The Committee might address this issue in one of three ways. First, the Committee could follow the Administration's request and recommend that the Senate consent to the treaty notwithstanding this branch-level tax issue. It is not clear if or when Congress will enact a branch-level tax; if Congress does not do so, then there will have been no need for the Committee to take notice of this issue. Similarly, if Congress overrides treaties in enacting a branch-level tax, there is no need for current adverse Committee action. Overriding the treaty so soon after approval could disappoint Cyprus' legitimate expectations, however. Second, the Committee could seek a reservation allowing the United States to impose a branch-level tax if it decides to do so. This course, while it could allow the United States to collect the tax if it is enacted, could also present a condition that the Cypriot Government finds unacceptable. Therefore, this course could delay or prevent the benefits of the treaty. Third, the Committee could delay action on the treaty while it awaits legislative progress on the Administration proposals for tax reform.

III. OVERVIEW OF UNITED STATES TAXATION OF INTERNATIONAL TRADE AND INVESTMENT AND TAX TREATIES

This overview contains two parts. The first part describes the U.S. tax rules relating to foreign income and foreign persons that apply in the absence of a U.S. tax treaty. The second part discusses the objectives of U.S. tax treaties and describes some of the modifications they make in U.S. tax rules.

A. United States Tax Rules

The United States taxes U.S. citizens, U.S. residents, and U.S. corporations on their worldwide income. The United States taxes nonresident alien individuals and foreign corporations on their U.S. source income that is not effectively connected with the conduct of a trade or business in the United States (sometimes referred to as "noneffectively connected income"). They are also taxed on their U.S. source income and certain limited classes of foreign source income that is effectively connected with the conduct of a trade or business in the United States (sometimes referred to as "effectively connected income.")

Income of a nonresident alien or foreign corporation that is effectively connected with the conduct of a trade or business in the United States is subject to tax at the normal graduated rates on the basis of net taxable income. Deductions are allowed in computing effectively connected taxable income, but only if and to the extent that they are related to income that is effectively connected.

U.S. source fixed or determinable annual or periodical income of a nonresident alien or foreign corporation (including generally interest, dividends, rents, salaries, wages, premiums, and annuities) that is not effectively connected with the conduct of a U.S. trade or business is subject to tax at a rate of 30 percent of the amount paid. This tax is often reduced or eliminated in the case of payments to residents of countries with which the United States has an income tax treaty. The 30-percent (or lower treaty rate) tax imposed on U.S. source noneffectively connected income paid to foreign persons is collected by means of withholding (hence these taxes are often called withholding taxes).

Certain exemptions from the 30-percent tax are provided. Bank account interest is defined as foreign source interest and, therefore, is exempt. Exemptions are provided for certain original issue discount and for income of a foreign government from investments in U.S. securities. Under the Tax Reform Act of 1984, certain interest paid on portfolio obligations issued after July 18, 1984 (the 1984 Act's date of enactment) is exempt from the 30-percent tax. U.S. treaties also provide for exemption from tax in certain cases.

U.S. source noneffectively connected capital gains of nonresident individuals and foreign corporations are generally exempt from

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U.S. tax, with two exceptions: (1) gains realized by a nonresident alien who is present in the United States for at least 183 days during the taxable year, and (2) certain gains from the sale of interests in U.S. real estate.

The source of income received by nonresident aliens and foreign corporations is determined under rules contained in the Internal Revenue Code. Interest and dividends paid by a U.S. citizen or resident or by a U.S. corporation are generally considered U.S. source income. However, if a U.S. corporation derives more than 80 percent of its gross income from foreign sources, then dividends and interest paid by that corporation will be foreign source rather than U.S. source. Conversely, dividends and interest paid by a foreign corporation, at least 50 percent of the income of which is effectively connected income, are U.S. source to the extent of the ratio of its effectively connected income to total income.

Rents and royalties paid for the use of property in the United States are considered U.S. source income. The property used can be either tangible property or intangible property (e.g., patents, secret processes and formulas, franchises and other like property).

Since the United States taxes U.S. persons on their worldwide income, double taxation of income can arise because income earned abroad by a U.S. person may be taxed by the country in which the income is earned and also by the United States. The United States seeks to mitigate this double taxation by generally allowing U.S. persons to credit their foreign income taxes against the U.S. tax imposed on their foreign source income. A fundamental premise of the foreign tax credit is that it may not offset the U.S. tax on U.S. source income. Therefore, the foreign tax credit provisions contain a limitation that ensures that the foreign tax credit offsets only the U.S. tax on foreign source income. The foreign tax credit limitation generally is computed on a worldwide consolidated (overall) basis. Hence, all income taxes paid to all foreign countries are combined to offset U.S. taxes on all foreign income.

Prior to the Tax Reform Act of 1984, a U.S. person could convert U.S. source income to foreign source income, thereby circumventing the foreign tax credit limitation, by routing the income through a foreign corporation. The 1984 Act added to the foreign tax credit provisions special rules that prevent U.S. persons from converting U.S. source income into foreign source income through the use of an intermediate foreign payee. These rules apply to 50-percent U.S.-owned foreign corporations only.

A U.S. corporation that owns 10 percent or more of the voting stock of a foreign corporation may credit foreign income taxes paid or deemed paid by that corporation on earnings that are received as dividends. These deemed paid taxes are included in total foreign taxes paid for the year the dividend is received and go into the general pool of taxes to be credited.

Separate foreign tax credit limitations are provided for DISC dividends, FSC dividends, taxable income of a FSC attributable to foreign trade income, and certain interest, respectively. Also, a special limitation applies to the credit for taxes imposed on oil and gas extraction income. The Code sometimes disregards intermediate entities to apply these limitations correctly.

B. United States Tax Treaties—In General

The traditional objectives of U.S. tax treaties have been the avoidance of international double taxation and the prevention of tax avoidance and evasion. To a large extent, the treaty provisions designed to carry out these objectives supplement Code provisions having the same objectives; the treaty provisions modify the generally applicable statutory rules with provisions that take into account the particular tax system of the treaty country. Given the diversity of tax systems, it would be very difficult to develop in the Code rules that unilaterally would achieve these objectives for all countries.

Notwithstanding the unilateral relief measures of the United States and its treaty partners, double taxation might arise because of differences in source rules between the United States and the other country. Likewise, if both countries consider the same deduction allocable to foreign sources, double taxation can result. Problems sometimes arise in the determination of whether a foreign tax qualifies for the U.S. foreign tax credit. Also, double taxation may arise in those limited situations where a corporation or individual may be treated as a resident of both countries and be taxed on a worldwide basis by both.

In addition, there may be significant problems involving "excess" taxation—situations where either country taxes income received by nonresidents at rates that exceed the rates imposed on residents. This is most likely to occur in the case of income taxed at a flat rate on a gross basis. (Most countries, like the United States, generally tax domestic source income on a gross basis when it is received by nonresidents who are not engaged in business in the country.) In many situations the gross income tax exceeds the tax that would have been paid under the net income tax system applicable to residents.

Another related objective of U.S. tax treaties is the removal of barriers to trade, capital flows, and commercial travel caused by overlapping tax jurisdictions and the burdens of complying with the tax laws of a jurisdiction when a person's contacts with, and income derived from, that jurisdiction are minimal.

The objective of limiting double taxation is generally accomplished in treaties by the agreement of each country to limit, in certain specified situations, its right to tax income earned from its territory by residents of the other country. For the most part, the various rate reductions and exemptions by the source country provided in the treaties are premised on the assumption that the country of residence will tax the income in any event at levels comparable to those imposed by the source country on its residents. The treaties also provide for the elimination of double taxation by requiring the residence country to allow a credit for taxes that the source country retains the right to impose under the treaty. In some cases, the treaties may provide for exemption by the residence country of income taxed by the source country pursuant to the treaty.

Treaties first seek to eliminate double taxation by defining the term "resident" so that an individual or corporation generally will not be subject to primary taxing jurisdiction as a resident by each of the two countries. Treaties also provide that neither country will tax business income derived by residents of the other country unless the business activities in the taxing jurisdiction are substantial enough to constitute a branch or other permanent establishment or fixed base. The treaties contain commercial visitation exemptions under which individual residents of one country performing personal services in the other will not be required to pay tax in that other country unless their contacts exceed certain specified minimums, for example, presence for a set number of days or earnings of over a certain amount.

Treaties deal with passive income such as dividends, interest, and royalties from sources within one country derived by residents of the other country by either providing that they are taxed only in the country of residence or by providing that the source country's withholding tax generally imposed on those payments is reduced. As described above, the United States generally imposes a 30-percent tax and seeks to reduce this tax (on some income to zero) in its tax treaties, in return for reciprocal treatment by its treaty partner.

In its treaties, the United States, as a matter of policy, generally retains the right to tax its citizens and residents on their worldwide income as if the treaty had not come into effect, and provides this in the treaties in the so-called "saving clause". Double taxation can also still arise because most countries will not exempt passive income from tax at the source.

This double taxation is further mitigated either by granting a credit for income taxes paid to the other country, or, in the case of some U.S. treaty partners, by providing that income will be exempt from tax in the country of residence. The United States provides in its treaties that it will allow a credit against U.S. tax for income taxes paid to the treaty partners, subject to the limitations of U.S. law.

The objective of preventing tax avoidance and evasion is generally accomplished in treaties by the agreement of each country to exchange tax-related information. The treaties generally provide for the exchange of information between the tax authorities of the two countries when such information is necessary for carrying out the provisions of the treaty or of their domestic tax laws. The obligation to exchange information under the treaties typically does not require either country to carry out measures contrary to its laws or administrative practices or to supply information not obtainable under its laws or in the normal course of its administration, or to supply information that would disclose trade secrets or other information the disclosure of which would be contrary to public policy. The provisions generally result in an exchange of routine information, such as the names of U.S. residents receiving investment income. The Internal Revenue Service (and the treaty partner's tax authorities) also can request specific tax information from a treaty partner. This can include information to be used in a criminal investigation or prosecution.

Administrative cooperation between the countries is further assured under the treaties by the inclusion of a competent authority mechanism to resolve double taxation problems arising in individual cases and, more generally, to facilitate consultation between tax officials of the two governments.

At times, residents of countries without income tax treaties with the United States attempt to use a treaty to avoid U.S. tax. To prevent third-country residents from obtaining treaty benefits intended for treaty country residents only, the treaties generally contain an "anti-treaty shopping" provision that is designed to limit treaty benefits to bona fide residents of the two countries.

The treaties generally provide that neither country may subject nationals of the other country (or permanent establishments of enterprises of the other country) to taxation more burdensome than that which it imposes on its own nationals (or on its own enterprises). Similarly, in general, neither country may discriminate against its enterprises owned by residents of the other country.

IV. EXPLANATION OF PROPOSED TAX TREATY

Set forth below is a detailed, article-by-article explanation of the proposed income tax treaty between the United States and the Republic of Cyprus ("Cyprus"), followed by an explanation of the notes exchanged when the proposed treaty was signed.

Article 1. Taxes Covered

In the case of the United States, the proposed treaty applies to the Federal income taxes imposed under the Internal Revenue Code (the "Code") and to the excise taxes imposed on insurance premiums paid to foreign insurers and with respect to private foundations. However, it does not apply to the accumulated earnings tax, the personal holding company tax, or the social security taxes. The excise tax imposed on insurance premiums paid to foreign insurers is covered by the treaty only to the extent that the foreign insurer does not reinsure the risks with a person not entitled to exemption from the tax under this or another U.S. tax treaty. Therefore, under the business profits article (Article 8), income of a Cypriot insurer from the insurance of U.S. risks will not be subject to the insurance excise tax (except in situations where the risk is reinsured with a company not entitled to the exemption) if that insurance income is not attributable to a U.S. permanent establishment maintained by the Cypriot insurer. Some recent U.S. income tax treaties, for example, the treaties with France and Hungary, also cover the insurance excise tax. It is a covered tax under the U.S. model treaty.

The insurance excise tax will continue to apply notwithstanding the proposed treaty in situations where a Cypriot insurer with no U.S. trade or business reinsures a policy it has written on a U.S. risk with a foreign insurer other than a resident of Cyprus or another insurer entitled to exemption under a different tax treaty (such as the U.S.-French treaty). For example, a Cypriot company not engaged in a U.S. trade or business insures a U.S. casualty risk and receives a premium of $200. The company reinsures part of the risk with a German insurance company (not currently entitled to exemption from the excise tax) and pays that German company a premium of $100. The four-percent excise tax on casualty insurance applies to the premium paid to the Cypriot insurance company to the extent of the $100 reinsurance premium. Thus, the U.S. insured is liable for an excise tax of $4, which is four percent of the portion of its premium to the Cypriot insurer which was used by the Cypriot insurer to reinsure the risk. It is the responsibility of the U.S. insured to determine to what, if any, extent the risk is to be reinsured with a nonexempt person.

In the case of Cyprus, the treaty applies to the income tax, the capital gains tax, and the special contribution tax.

The proposed treaty contains a provision generally found in U.S. income tax treaties to the effect that it also will apply to substantially similar taxes that either country may subsequently impose.

Additionally, the non-discrimination provisions of the proposed treaty (Article 7) apply to all taxes of every kind imposed at the national, state, or local level by the United States or Cyprus. The exchange of information provisions of the treaty (Article 28) apply to all taxes of every kind imposed by the two countries at the national level.

Article 2. General Definitions

The proposed treaty contains certain of the standard definitions found in most U.S. income tax treaties.

The "United States" means the United States of America, but does not include Puerto Rico, the Virgin Islands, Guam or any other U.S. possession or territory. When used in a geographical sense, the term includes the fifty States, the District of Columbia, the territorial waters of the United States, and any area which, in accordance with international law and the laws of the United States, is an area within which the rights of the United States with respect to the natural resources of the seabed and subsoil may be exercised. The definition is intended to cover the U.S. continental shelf consistent with the definition of continental shelf contained in section 638 of the Code.

The term "Cyprus" means the Republic of Cyprus. The term also includes, when used in a geographical sense, the territorial waters of Cyprus and any area outside Cyprus which, in accordance with international law and the laws of Cyprus, is an area within which the rights of Cyprus with respect to the natural resources of the seabed and subsoil may be exercised.

The term "Contracting State" means the United States or Cyprus, as the context requires.

The term "person" is defined to include an individual, a partnership, a corporation, an estate, a trust, or any other body of persons.

A "United States corporation" is a corporation which is created or organized under the laws of the United States or any State thereof or of the District of Columbia, or any unincorporated entity treated as a U.S. corporation for U.S. tax purposes.

A "Cypriot corporation" is an entity (other than a United States corporation) treated as a body corporate for tax purposes under the laws of Cyprus, which is resident in Cyprus for the purposes of Cypriot tax.

The U.S. competent authority is the Secretary of the Treasury or his authorized representative. In fact, the U.S. competent authority function has been delegated to the Commissioner of Internal Revenue, who has redelegated the authority to the Associate Commissioner (Operations). The Assistant Commissioner (Examination) has been delegated the authority to administer programs for simultaneous, spontaneous, and industry-wide exchange of information. The Director, Foreign Operations District, has been delegated the authority to administer programs for routine and specific exchanges of information and mutual assistance in collection.

The Cypriot competent authority is the Minister of Finance, or his authorized representative.

The proposed treaty defines "international traffic" as any transport by a ship or aircraft except where the transport is solely between places in the other country. Accordingly, with respect to a Cypriot enterprise, purely domestic transport in the United States is excluded.

The term "State" means any national state; it is not limited to the United States and Cyprus.

The treaty provides that any term not defined in the treaty is to have the meaning it has under the applicable law of the country applying the treaty, unless the context otherwise requires. If the meaning of an undefined term under one country's law is different from its meaning under the other country's law, or is not readily determinable under either country's law, the competent authorities of the two countries may establish a common meaning for the undefined term.

Article 3. Fiscal Residence

The assignment of a country of residence is important because the benefits of the proposed treaty generally are available only to a resident of one of the countries as the term is defined in the treaty. Furthermore, double taxation is often avoided by the treaty assigning one of the countries as the country of residence where, under the laws of the countries, a person is a resident of both.

Under U.S. law, residence of an individual is important because a resident alien is taxed on his worldwide income, while a nonresident alien is taxed only on U.S. source income and on his income that is effectively connected with a U.S. trade or business. A company is a resident of the United States if it is organized in the United States. Prior to the Tax Reform Act of 1984, the Code did not provide standards for determining whether an alien individual was a resident. Under U.S. Treasury regulations, an alien was a resident of the United States if he was actually present in the United States and was not a mere transient or sojourner. Whether he was a transient was determined by his intentions as to the length and nature of his stay. (See Treas. Reg. sec. 1.871-2(b).) Under the standards for determining residence provided in the 1984 Act (which were generally effective on January 1, 1985), an individual who spends substantial time in the United States in any year or over a three-year period generally is a U.S. resident. A permanent resident for immigration purposes also is a U.S. resident. The standards for determining residence provided in the 1984 Act do not apply in determining the residence of a U.S. citizen for the purpose of any U.S. tax treaty (such as a treaty that benefits residents, rather than citizens, of the United States).

Under the proposed treaty, a U.S. corporation and a Cypriot corporation (both as defined in Article 2) are treated as residents of their respective countries. A U.S. citizen is treated as a resident of the United States. Any person (other than a corporation) that is resident in one of the countries for purposes of its tax is treated as a resident of that country. However, a partnership, estate, or trust is considered to be a resident of either country only to the extent that the income it derives is subject to tax, either in its hands or in the hands of its partners or beneficiaries, as the income of a resident of the country. For example, if the share of Cypriot beneficiaries in the income of a Cypriot trust is only one-half, the United States would have to reduce its withholding tax on only one-half of the U.S. source income paid to the trust.

This provision of the proposed treaty is generally based on the residence article of the U.S. model treaty. Under this provision, U.S. citizenship alone may establish U.S. residency for treaty purposes. As a result, U.S. citizens residing overseas (in countries other than Cyprus) are entitled to the benefits of the treaty as U.S. residents. The proposed treaty is one of the few U.S. income tax treaties in which the United States has been able to negotiate coverage for nonresident U.S. citizens.

The article also provides a set of "tie-breaker" rules to determine residence in the case of an individual who, under the basic residence rules, would be considered a resident of both countries. These rules are similar to those contained in the U.S. model treaty. In the case of a dual residence individual, the individual will be deemed for all purposes of the treaty to be a resident only of the country in which he has his permanent home (where an individual dwells with his family), his center of vital interests (his closest economic and personal relations), his habitual abode, or his citizenship. If the residence of an individual cannot be determined by these tests, applied in the order stated, the competent authorities of the countries will settle the question of residence by mutual agreement.

The possibility of a dual residence corporation under the proposed treaty is precluded by the Article 2 definitions of a U.S. corporation and a Cypriot corporation. The Article 2 definition of a Cypriot corporation excludes a corporation treated as a U.S. resident corporation under U.S. internal tax rules.

In the case of a dual residence person other than an individual or corporation (e.g., a dual residence partnership, trust, or estate), residence for treaty purposes and the mode of application of the treaty will be determined by the competent authorities.

Article 4. General Rules of Taxation

The proposed treaty provides that a resident of one of the countries may be taxed by the other on any income from sources within that other country, and only on such income, subject to any limitations set forth in the treaty. For this purpose, the rules set forth in Article 6 (Source of Income) are to be applied to determine the source of the income. The proposed treaty contains detailed rules for the taxation of most types of income, which generally limit taxation at source, so this general provision will not determine taxing jurisdiction in most cases. Nevertheless, it does differ from the corresponding provisions of the U.S. and OECD model treaties, which generally provide that income not otherwise dealt with in the treaty may be taxed only by the country of residence.

The proposed treaty also contains the rule found in other U.S. tax treaties that its provisions will not restrict in any manner any exclusion, exemption, deduction, credit, or other allowance otherwise accorded by the domestic laws of either country or any other agreement between the two countries. Thus, the treaty will apply only where it benefits taxpayers.

Like all U.S. income tax treaties, the proposed treaty contains a "saving clause." Under this clause, with exceptions described below, the United States reserves the right to tax its citizens and residents and Cyprus reserves the right to tax its citizens and residents, notwithstanding any provision of the treaty. By reason of the saving clause, the United States generally will continue to tax its citizens who are residents of Cyprus as if the treaty were not in force. "Residents," for purposes of the treaty (and thus for purposes of the saving clause), include corporations and other entities as well as individuals (Article 3 (Fiscal Residence)). Under Section 877 of the Code, a former U.S. citizen whose loss of citizenship had as one of its principal purposes the avoidance of U.S. income, estate, or gift taxes, will, in certain cases, be subject to tax for a period of 10 years following the loss of citizenship. The treaty contains the standard provision found in the U.S. model and most recent treaties specifically reserving the United States' right to tax former citizens. (Even absent a specific provision the Internal Revenue Service takes the position that the United States retains the right to tax former citizens resident in the treaty partner (Rev. Rul. 79-152, 1979-1 C.B. 237).)

Exceptions to the saving clause are provided for the benefits conferred by the articles dealing with relief from double taxation (Article 5), non-discrimination (Article 7), social security payments (Article 24), and mutual agreement procedures (Article 27). The benefits of those articles will be conferred by each country on its own citizens and residents as well as the citizens and residents of the other country. In addition, the benefits conferred by the articles dealing with the taxation of income received by students and trainees (Article 21) and government employees (Article 22) are to be provided by each country to its residents who are neither citizens of, nor have immigrant status in, the country. A person has "immigrant status" in the United States if he has been admitted to the United States as a permanent resident under U.S. immigration laws (that is, he holds a "green card").

Other than under these exceptions to the saving clause, U.S. citizens and residents benefit under the treaty only as the result of the agreement by Cyprus to reduce its rate of tax on their income or exempt their income from tax; they do not benefit under the treaty from reductions in tax or tax exemptions granted by the United States. Even in the case of the Cypriot tax reductions and exemptions, if the tax that is foregone by Cyprus could have otherwise been claimed in full by the U.S. taxpayers as a foreign tax credit, the real beneficiary of the reduction or elimination of the Cypriot tax could, as a practical matter, be the U.S. Treasury rather than the U.S. taxpayer. Similarly, except as noted above, Cypriot citizens and residents benefit under the treaty only as the result of the agreement by the United States to reduce its rate of tax on their income or exempt their income from tax.

This article also contains two rules intended to prevent the application of the treaty in situations where Cyprus is used as a tax haven. Under the first rule, which is contained in the 1977 U.S. model treaty, when, pursuant to the treaty, one country reduces the rate of tax on, or exempts from tax, income of a resident of the other country and, under the law in force in that other country, the resident is subject to tax only on that part of the income which is remitted to or received in that other country, then the treaty reduction or exemption will apply only to so much of the income as is actually remitted to or received in that other country during the calendar year the income is paid or the next succeeding calendar year.

Under the second anti-haven rule, when, under the proposed treaty, one country reduces the rate of tax on, or exempts from tax, income of a resident of the other country and, under the law in force in that other country, the income is subject to a rate of tax or tax burden which is substantially less than the tax which generally would be imposed by that country on the income if derived from sources within that country, then the treaty reduction or exemption will not apply. A rate of tax that is less than 50 percent of the rate normally applicable will be considered to be "substantially less than" the tax generally imposed. Cyprus law provides substantially reduced tax rates for certain foreign source income. For example, foreign source income of certain companies registered in Cyprus as overseas companies that are owned by nonresidents of Cyprus generally is taxed at a rate of 4.25 percent instead of at the normal corporate rate of 42.5 percent.

Under the proposed treaty rule, dividends arising in the United States, for example, that would otherwise be taxed at a maximum U.S. rate of 15 percent under the treaty, will be taxed at the U.S. statutory rate of 30 percent instead if derived by a company registered in Cyprus as an overseas company that is subject to Cypriot tax on the dividends at the reduced 4.25 percent rate. Because the U.S. excise tax on insurance premiums paid to foreign insurers is, in the context of the treaty, treated as a substitute for an income tax, the rule will apply to U.S. source income of Cypriot insurers to the extent taxed in Cyprus at substantially less than the general rate. The proposed treaty rule has applicability with respect to U.S. tax rules favoring foreign source income too. For example, that portion of a U.S. person's foreign earned income exempt from U.S. tax under Code section 911 that is derived in Cyprus will be subject to the rule and, thus, will not be eligible for any otherwise applicable treaty reductions in Cypriot tax. The rule does not apply to pensions described in Article 23(1). Thus, the source country exemption for pensions provided by that provision will apply regardless of whether the pension is taxed by the payee's country of residence at substantially reduced rates.

This anti-haven rule is designed (in conjunction with the anti-treaty shopping rules of Article 26) to limit the treaty's benefits to bona fide residents, that is, to prevent third-country residents from establishing entities in one of the countries to derive treaty-benefited income from the other. The rule also reflects the principle that source country tax reductions are justified only to avoid double taxation; that justification does not exist if the residence country, under its internal law, exempts from tax or subjects to substantially reduced tax income received from the other country. The rule is discussed further under Article 26. A similar rule is contained in the anti-treaty shopping article of the U.S. model treaty.

Article 5. Relief from Double Taxation

Background

One of the two principal purposes for entering into an income tax treaty is to limit double taxation of income earned by a resident of one of the countries that may be taxed by the other country. The United States seeks unilaterally to mitigate double taxation by generally allowing U.S. taxpayers to credit the foreign income taxes that they pay against the U.S. tax imposed on their foreign source income. A fundamental premise of the foreign tax credit is that it may not offset the U.S. tax on U.S. source income. Therefore, the foreign tax credit provisions contain a limitation that ensures that the foreign tax credit offsets U.S. tax on foreign source income only. This limitation is generally computed on a worldwide consolidated basis. Hence, all income taxes paid to all foreign countries are combined to offset U.S. taxes on all foreign income. Separate limitations on the foreign tax credit are provided for oil and gas extraction income, DISC dividends, FSC dividends, taxable income of a FSC attributable to foreign trade income, and certain interest.

A U.S. corporation that owns 10 percent or more of the voting stock of a foreign corporation may credit foreign taxes paid or deemed paid by that foreign corporation on earnings that are received as dividends (deemed paid credit) (Code sec. 902). These deemed paid taxes are included in the U.S. shareholder's total foreign taxes paid for the year the dividend is received and go into the general pool of taxes to be credited.

Unilateral efforts to limit double taxation are imperfect. Because of differences in rules as to when a person may be taxed on business income, a business may be taxed by two countries as if it were engaged in business in both countries. Also, a corporation or individual may be treated as a resident of more than one country and be taxed on a worldwide basis by both.

Part of the double tax problem is dealt with in other articles that limit the right of a source country to tax income and that coordinate the source rules. This article provides further relief where both Cyprus and the United States will still tax the same item of income. This article is not subject to the saving clause, so that the country of citizenship or residence waives its overriding taxing jurisdiction to the extent that the article applies.

The proposed treaty provides separate rules for relief from double taxation for the United States and Cyprus.

United States

Under the proposed treaty, the United States will provide its citizens and residents with a foreign tax credit against their U.S. income tax for the appropriate amount of the Cypriot tax. The credit is to be computed in accordance with the provisions and subject to the limitations of U.S. law applicable to the year in question. The proposed treaty also provides that a deemed paid foreign tax credit will be made available to a U.S. company with respect to dividends from a Cypriot corporation in which the U.S. company owns, directly or indirectly, at least 10 percent of the voting stock. In this case, a credit will be allowed for the appropriate amount of the Cypriot tax paid by the Cypriot corporation on the profits out of which the dividend was paid. In either case, the credit may not exceed the limitations provided by U.S. law for the taxable year. All Cypriot taxes covered by the treaty are eligible for the regular and deemed paid U.S. foreign tax credits.

Cyprus

The proposed treaty provides that, in accordance with and subject to the limitations of Cypriot law for the year, Cyprus will allow its citizens and residents a credit against their Cypriot tax for the appropriate amount of taxes paid to the United States. Cyprus also will provide an indirect credit in the case of a dividend paid by a U.S. corporation in which a Cypriot corporation has at least 10 percent of the voting power. The amount of such credit will be based on the U.S. tax on the profits out of which the dividend was paid, but will be limited to that portion of the Cypriot tax, as computed before the credit is given, which is applicable to the dividend. All U.S. taxes covered by the treaty are eligible for the regular and indirect Cypriot foreign tax credits.

For purposes of applying both the U.S. and Cypriot credits under the treaty, the treaty source rules (Article 6) apply.

Article 6. Source of Income

The proposed treaty contains a comprehensive set of rules, similar to rules found in certain other U.S. tax treaties, to determine the proper source of income. Source rules are provided for eight different types of income. These rules are relevant to determine whether one of the countries may assert jurisdiction to tax the income on the basis that the income arose within that country. The rules are also relevant to a determination of the appropriate foreign tax credit to be allowed under the treaty (Article 5). The U.S. model treaty contains source rules for the foreign tax credit and interest provisions only; local law determines the source of income in other cases under the model.

Under the proposed treaty, dividends paid by a U.S. corporation generally are U.S. source, and dividends paid by a Cypriot corporation generally are Cypriot source. However, dividends paid by a Cypriot or third-country corporation that derives 50 percent or more of its total gross income from one or more permanent establishments in the United States will be U.S. source. Coupled with the treaty dividend rules (Article 12), the latter rule enables the United States to continue to tax dividends paid by foreign corporations doing substantial business in the United States. However, the Code's "second tier" withholding tax is not preserved in all cases because the permanent establishment concept is more limited than the U.S. trade or business concept utilized in the Code rules governing the second tier withholding tax. (See Code sec. 861(a)(2)(B) and discussion in Article 8 (Business Profits).)

Interest paid by a government authority or resident of one of the countries generally is sourced in that country. However, if the interest expense is borne by a permanent establishment in a different country, the interest is sourced in the country in which the permanent establishment is located. Interest paid by a Cypriot corporation that derives 50 percent or more of its total gross income from one or more permanent establishments in the United States is sourced in the United States, whether or not borne by such permanent establishments. Coupled with the treaty interest rules (Article 13), the latter rule enables the United States to tax interest paid by Cypriot corporations doing substantial business in the United States, subject to the same limitations applicable to the second tier withholding tax on dividends discussed in the preceding paragraph.

Rentals from tangible personal (movable) property and royalties (other than royalties relating to real property) (Article 14(2)) are sourced in the country where the property producing the income is used. Income from real property (Article 15) is sourced in the country where the property is located.

Income (including pensions) from personal services generally is sourced in the country where the services are performed. However, income from personal services performed aboard ships or aircraft operated by a resident of one country in international traffic is treated as income from sources within that country if rendered by a member of the regular complement of the ship or aircraft. Remuneration of government employees (Article 22) and social security payments (Article 24) are sourced within a country only if paid by or from public funds of a government authority of that country. To the extent that directors' fees may be taxed by a country (Article 20), they are sourced in that country.

Income from the purchase and sale of tangible or intangible personal property generally is sourced in the country in which it is sold. Income from the purchase and sale of a real property interest is sourced in the country in which the real property is located or deemed to be located.

All of the foregoing source rules are overridden if the income consists of industrial or commercial profits which are attributable to a permanent establishment which the recipient, a resident of one of the countries, has in the other country. Such income is sourced in the country in which the permanent establishment is located. This source rule will apply to income from real property, dividends, interest, royalties, and gains, as well as to other industrial and commercial profits, but only, in each case, if the property or rights giving rise to the income are effectively connected with the permanent establishment. Article 8 (Business Profits) sets forth factors to be taken into account in determining whether property or rights giving rise to income are "effectively connected" with a permanent establishment for treaty purposes.

Some of the treaty source rules differ somewhat from those of the Code. As indicated under Article 4 (General Rules of Taxation), the treaty may only be applied to benefit taxpayers; thus, a taxpayer is not required to apply a treaty source rule in determining its U.S. tax liability if the corresponding Code source rule would produce a more favorable result. However, a taxpayer may not make inconsistent choices between the Code and treaty source rules. *See* Rev. Rul. 84-17, 1984-1 C.B. 308 (applying a similar rule under the Polish income tax treaty).

If the source of any item of income is not covered by the treaty rules, each country will determine the source according to its own law. However, if the two countries apply different rules or if the source is not readily determinable under the laws of one country, the competent authorities of the two countries may establish a common source for the item of income for purposes of the treaty.

Article 7. Non-Discrimination

The proposed treaty contains a comprehensive non-discrimination article relating to all taxes of every kind imposed at the national, state, or local level. It is similar to the non-discrimination article in the U.S. model treaty and to provisions that have been embodied in other recent U.S. income tax treaties.

In general, under the proposed treaty, neither country may discriminate by imposing more burdensome taxes on citizens of the other country than it imposes on its own citizens in similar circumstances. This provision applies whether or not the citizens in question are residents of one or both of the countries. However, for purposes of U.S. tax, U.S. citizens who are not residents of the United States and Cypriot citizens who are not residents of the United States are not in similar circumstances. Thus, for example, the United States could tax a U.S. citizen residing abroad at graduated rates on his worldwide income, while taxing a Cypriot resident abroad at flat rates on his U.S. source income.

Under the proposed treaty, one country cannot impose less favorable taxes on permanent establishments of residents of the other country than it imposes on its comparable residents carrying on similar activities. However, neither country is required to grant to residents of the other country the personal allowances, reliefs, or deductions for tax purposes on account of personal status or family responsibilities which it grants to its own residents.

Each country is required (subject to the arm's-length pricing rules of Articles 11(1) (Related Persons), 13(5) (Interest), and 14(4) (Royalties)) to allow its residents to deduct interest, royalties, and other disbursements paid by them to residents of the other country under the same conditions that it allows deductions for such amounts paid to residents of the same country as the payor. The term "other disbursements" includes charges for amounts expended by a resident of one country for purposes of a resident of the other, including a reasonable allocation of executive and general administrative expenses, research and development expenses, and other expenses incurred for the benefit of a group of related enterprises. For this purpose, executive and general administrative expenses do not include expenses for a type of activity which is not for the benefit of the resident of the other country, but instead constitutes a "stewardship" or "over-seeing" function undertaken for the first-mentioned resident's own benefit as an investor. For purposes of capital taxes, debts that are owed residents of the other country are to be deductible to the extent that they would be deductible if owed to a resident of the country of residence of the obligor.

The rule of non-discrimination also applies to corporations of one country that are owned in whole or in part by residents of the other country. Corporations resident in one country, the capital of which is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other country, will not be subjected in the first country to any taxation or any connected requirements that are other or more burdensome than the taxation and connected requirements that the first country imposes or may impose on its similar corporations.

The non-discrimination article does not override the right of the United States to tax foreign corporations on their dispositions of U.S. real property interests because the effect of the provisions imposing such tax is not discriminatory. The election to be treated as a U.S. corporation under Code section 897(i) precludes the possibility of discrimination.

The saving clause (which allows the country of residence or citizenship to tax notwithstanding certain treaty provisions) does not apply to the non-discrimination article.

Article 8. Business Profits

U.S. Code rules

U.S. law distinguishes between the business income and the investment income of a nonresident alien or foreign corporation. A nonresident alien or foreign corporation is subject to a flat 30-percent rate (or lower treaty rate) of tax on certain U.S. source income if that income is not effectively connected with the conduct of a trade or business within the United States. The regular individual or corporate rates apply to income (from any source) which is effectively connected with the conduct of a trade or business within the United States.

The taxation of income as business or investment income varies depending upon whether the income is U.S. or foreign. In general, U.S. source periodic income (such as interest, dividends, rents, and wages), and U.S. source capital gains are effectively connected with the conduct of a trade or business within the United States only if the asset generating the income is used in or held for use in the conduct of the trade or business, or if the activities of the trade or business were a material factor in the realization of the income. All other U.S. source income of a person engaged in a trade or business in the United States is treated as effectively connected income.

Foreign source income is effectively connected income only if the foreign person has an office or other fixed place of business in the United States and the income is attributable to that place of business. Only three types of foreign source income can be effectively connected income: rents and royalties derived from the active conduct of a licensing business; dividends, interest, or gain from stock or debt derived in the active conduct of a banking, financing or similar business in the United States; and certain sales income attributable to a U.S. sales office.

Except in the case of a dealer, trading in stocks, securities, or commodities in the United States for one's own account does not constitute a trade or business in the United States and accordingly income from those activities is not taxed by the United States as business income. This concept includes trading through a U.S.-based employee, a resident broker, commission agent, custodian, or other agent or trading by a foreign person physically present in the United States.

Proposed treaty rules

Under the proposed treaty, industrial and commercial profits of a resident of one country are taxable in the other country only to the extent they are attributable to a permanent establishment in the other country through which the resident is engaged in industrial or commercial activity. This is one of the basic limitations on a country's right to tax income of a resident of the other country.

The taxation of business profits under the proposed treaty differs from U.S. rules for taxing business profits primarily by requiring more than merely being engaged in a trade or business before a country can tax business profits, and by substituting an "attributable to" standard for the Code's "effectively connected" standard. Under the Code, all that is necessary for effectively connected business profits to be taxed is that a trade or business be carried on in the United States. Under the proposed treaty, on the other hand, some level of fixed place of business must be present and the business profits must be attributable to that fixed place of business.

"Industrial or commercial profits" are income derived from industrial or commercial activity. Industrial or commercial activity includes the conduct of manufacturing, mercantile, banking, insurance, agricultural, fishing, or mining activities, the operation of ships or aircraft, the furnishing of services, and the rental of tangible personal property. However, the term does not include the performance of personal services by an individual either as an employee or in an independent capacity. Income from those activities is covered separately (Articles 17 and 18). Industrial and commercial profits also include investment income (dividends, interest, royalties, and capital gains) and income derived from real property and natural resources, but only if the property or other rights giving rise to the income are effectively connected with a permanent establishment, whether or not the income is derived from industrial or commercial activities. In determining whether property or rights are effectively connected with a permanent establishment, the factors to be taken into account include whether the property or rights are used or held for use in carrying on industrial or commercial activities through the permanent establishment and whether those activities were a material factor in the realization of the income derived from the property or rights. In making a determination, due regard is to be given to whether or not the property, rights, or income were accounted for through the permanent establishment.

This definition of industrial and commercial profits generally follows that of a number of older U.S. income tax treaties. It is more detailed than the the current U.S. model treaty definition of business profits but differs little in substance from the U.S. model definition.

The industrial and commercial profits of a permanent establishment are determined on an arm's-length basis. Thus, there are to be attributed to a permanent establishment the industrial and commercial profits that would reasonably be expected to have been derived by it if it were an independent entity engaged in the same or similar activities under the same or similar conditions. For example, this arm's-length rule applies to transactions between a permanent establishment and an office of the resident enterprise located in a third country. Amounts may be attributed whether they are from sources within or without the country in which the permanent establishment is located.

In computing taxable industrial and commercial profits, deductions are allowed for all expenses reasonably connected with the profits, wherever incurred. These deductions include a reasonable allocation of executive and general administrative expenses. Thus, for example, a U.S. company that has a branch office in Cyprus but its head office in the United States will, in computing the Cypriot tax liability of the branch, be entitled to deduct a portion of the executive and general administrative expenses incurred in the United States by the head office for purposes of administering the branch. No profits will be attributed to a permanent establishment merely by reason of the purchase of merchandise by the permanent establishment for the account of the resident of which it is a permanent establishment. Thus, where a permanent establishment purchases goods for its head office, the profits attributed to the permanent establishment with respect to its other activities will not be increased by a profit element on its purchasing activities.

Where industrial and commercial profits include items of income that are dealt with separately in other articles of the treaty, those other articles, and not this article, generally will govern the treatment of those items of income.

Article 9. Permanent Establishment

The proposed treaty contains a definition of the term "permanent establishment" that generally follows the pattern of other recent U.S. income tax treaties, the U.S. model treaty, and the OECD model treaty, but contains some modifications toward the principle of source basis taxation.

The permanent establishment concept is one of the basic devices used in income tax treaties to limit the taxing jurisdiction of the host country and thus mitigate double taxation. Generally, a resident of one country is not taxable by the other country on its business profits unless those profits are attributable to a permanent establishment of the resident in that other country. In addition, the permanent establishment concept is used to determine whether the reduced rates of, or exemptions from, tax provided for dividends, interest, and royalties will apply, or whether those amounts will be taxed as business profits.

In general, under the proposed treaty, a permanent establishment is a fixed place of business through which a resident of one country engages in business in the other country. A permanent establishment includes a branch, office, factory, workshop, warehouse, store, or other sales outlet, or a mine, quarry, or other place of extraction of natural resources. It also includes a building site, construction or installation project, or installation, drilling rig, or ship used for the exploration or exploitation of natural resources but only if the site, project, drilling rig, etc. lasts for more than six months. This six-month rule differs from the 12-month rule of the U.S. model.

The general permanent establishment rule is modified to provide that a fixed place of business in one country that is only used by a resident of the other country for any or all of a number of specified activities will not constitute a permanent establishment. These activities include the use of facilities for storing, displaying, or delivering merchandise belonging to the resident; the maintenance of a stock of goods belonging to the resident for the purpose of storage, display, delivery, or processing by another person; and the maintenance of a fixed place of business to purchase goods or merchandise or to collect information, for the resident. These activities also include the maintenance of a fixed place of business for the purpose of advertising, the supplying of information, scientific research, or similar preparatory or auxiliary activities, for the resident.

If a resident of one country maintains an agent in the other country who has, and habitually exercises, the authority to conclude contracts in that other country in the name of the resident, then the resident will be deemed to have a permanent establishment in that other country. This rule does not apply where the contracting authority is limited to those activities, such as storage, display, or delivery of merchandise (described above), that are excluded from the definition of permanent establishment. The proposed treaty contains the usual provision that the agency rule will not apply if the agent is a broker, general commission agent, or other agent of independent status acting in the ordinary course of its business.

The fact that a resident of one country is related to a person that is a resident of the other country or that is engaged in industrial or commercial activity in that other country (whether through a permanent establishment or otherwise) is not to be taken into account in determining whether the first resident has a permanent establishment in that other country.

The provisions of this article are to be applied to determine, for purposes of the treaty, whether a resident of a country other than Cyprus or the United States has a permanent establishment in Cyprus or the United States, and whether a Cypriot or U.S. resident has a permanent establishment in a third country.

Article 10. Shipping and Air Transport

As a general rule, the United States taxes the U.S. source income of a foreign person from the operation of ships or aircraft to or from the United States. An exemption from U.S. tax is provided if a ship or aircraft is documented under the laws of a foreign country that grants an equivalent exemption to U.S. citizens and corporations operating ships or aircraft documented under U.S. law. The United States has entered into agreements with a number of countries providing reciprocal tax exemptions for shipping and aircraft income.

Under the proposed treaty, income that is derived by a resident of either country from the operation of ships or aircraft in international traffic (including gains from the disposition of such ships or aircraft) will be exempt from tax by the other country. International traffic is any transportation by ship or aircraft, except where the transportation is solely between places in one of the countries (Article 2(1)(h) (General Definitions)). The exemption applies whether or not the ship or aircraft is registered in the first country. Thus, for example, Cyprus may not tax the income of a U.S. resident operating a Liberian-flag vessel.

The exemption applies to profits from the rental, on a full or bareboat basis, of ships or aircraft, if operated in international traffic by the lessee or if such rental profits are incidental to the actual operation of ships or aircraft in international traffic. (Rental on a full or bareboat basis refers to whether the ships or aircraft are leased fully equipped, manned and supplied, or not.) The exemption also applies to income derived from the use, maintenance, or rental of containers, trailers for the inland transportation of containers, or other related equipment where the containers, equipment, etc. are used to transport goods or merchandise in international traffic.

Article 11. Related Persons

The proposed treaty, like most other U.S. tax treaties, contains an arm's-length pricing provision similar to section 482 of the Code that recognizes the right of each country to make an allocation of income to that country in the case of transactions between related persons, if an allocation is necessary to reflect the conditions and arrangements that would have been made between independent persons.

For purposes of the proposed treaty, a person is related to another person if either person owns or controls directly or indirectly the other, or if any third person or persons own or control directly or indirectly both. For this purpose, the term "control" includes any kind of control, whether or not legally enforceable, and however exercised or exercisable.

Where a redetermination of tax liability has been made by one country pursuant to this article, the other country, if it agrees that the adjustment was in accordance with this article, will make a corresponding adjustment to the income, loss, or tax of the related person in that other country.

The proposed treaty omits the usual provision stating that this article is not intended to limit any law in either country which permits the distribution, apportionment, or allocation of income, deductions, credits, or allowances between non-independent persons when such law is necessary to prevent evasion of taxes or to reflect clearly the income of those persons. That provision clarifies that the United States retains the right to apply its inter-company pricing rules (Code sec. 482) and its rules relating to the allocation of deductions (Code secs. 861, 862, and 863, and Treas. Reg. sec. 1.861.8). Staff is informed that the provision was omitted because the Cypriot negotiators considered it superfluous. The Cypriot negotiators reportedly agreed that the United States would retain the right under the proposed treaty to apply its inter-company pricing and deduction allocation rules, notwithstanding the omission of the provision.

Article 12. Dividends

In general

This article generally reduces to 15 percent the rate of U.S. tax on U.S. source dividends paid to Cypriot "portfolio" investors and to five percent the rate of U.S. tax on U.S. source dividends paid to

Cypriot "direct" investors. The article also limits the Cypriot tax on dividends derived by U.S. residents from Cypriot companies and provides such U.S. shareholders with a credit against the Cypriot tax. Under this provision, U.S. shareholders will not be liable for any Cypriot tax on Cypriot source dividends beyond that owed by the distributing company on the profits out of which the dividends are paid. U.S. shareholders who are individuals will be entitled to a refund of the Cypriot corporate taxes paid on those profits to the extent the corporate taxes exceed the U.S. shareholders' tax liability in Cyprus. The inclusion of these rules reflects Cyprus' credit system which integrates in part the corporate income tax with the individual income tax. The integrated tax system of Cyprus differs from the classical system of two-tiered corporate taxation presently used by the United States (under which dividends received by shareholders are generally taxed without regard to the taxes paid by the distributing company). U.S. income tax treaties currently in force with two other countries that have partially integrated systems, the United Kingdom and France, also contain dividend credit provisions.

U.S. taxation of dividends paid to foreign persons

The United States imposes a 30-percent withholding tax on the gross amount of U.S. source dividends paid to nonresident alien individuals and foreign corporations. The 30-percent tax does not apply if the foreign recipient is engaged in a trade or business in the United States and the dividends are effectively connected with that trade or business. In such a case, the foreign recipient is subject to U.S. tax like a U.S. person at the standard graduated rates, on a net basis. U.S. source dividends, for purposes of the 30-percent tax, are dividends paid by a U.S. corporation (other than an "80/20 company" described in Code sec. 861(a)(2)(A)). Also treated as U.S. source dividends for this purpose are certain dividends paid by a foreign corporation, if at least 50 percent of the gross income of the foreign corporation, in the prior three-year period, was effectively connected with a U.S. trade or business of that foreign corporation. The tax imposed on the latter dividends is often referred to as the "second tier" withholding tax.

Cypriot system for taxing dividends

Under Cypriot law, Cypriot residents generally receive a tax credit with respect to dividends received from companies registered in Cyprus. The credit equals the Cypriot corporate tax deducted (paid) by the distributing company on the profits out of which the dividends are paid. The Cypriot shareholder includes in its chargeable (taxable) income the amount of the dividends received, "grossed up" by the Cypriot corporate tax paid with respect to the dividends. The Cypriot shareholder may then set off against its Cypriot tax liability the amount of the corporate tax paid. If the credit for the corporate tax paid exceeds the shareholder's tax liability, the excess is refunded to the shareholder. The Cypriot corporate tax rate generally is 42.5 percent. It is reduced to 25 percent for the first 10 years of a Cypriot public company's existence, to 4.25 percent for foreign source income of a Cypriot company registered as an overseas company, owned by foreign persons, and managed and controlled in Cyprus, and to zero for foreign source income of branch of a similar company managed outside Cyprus. The Cypriot personal income tax is progressive with rates ranging from 10 to 60 percent.

Shareholders not resident in Cyprus that receive dividends from companies registered in Cyprus also generally receive a credit for the corporate tax paid with respect to the dividends; however, in the absence of a treaty, a nonresident generally is taxed on Cypriot source dividends at the top corporate rate of 42.5 percent rather than at the rate otherwise applicable to the nonresident under Cypriot law. Nonresidents may not receive a refund of corporate tax paid with respect to a Cypriot source dividend.

Cyprus does not impose a gross withholding tax on Cypriot source dividends paid to nonresidents.

Proposed treaty rules

United States

Under the proposed treaty, the United States agrees generally to limit its tax on dividends paid by U.S. companies to Cypriot residents to 15 percent of the gross amount of the dividend. The U.S. tax is limited to five percent of the gross amount of the dividend if the recipient of the dividend is a Cypriot corporation and two conditions are met. First, the recipient must own 10 percent or more of the outstanding shares of the voting stock of the payor corporation. Second, not more than 25 percent of the gross income of the payor corporation may consist of interest or dividends (other than interest derived from the conduct of a banking, insurance, or financing business and interest or dividends received from subsidiary corporations, 50 percent or more of the outstanding shares of the voting stock of which are owned by the payor corporation at the time the interest or dividends are received). The U.S. model similarly limits to five and 15 percent, respectively, the rates of U.S. tax on U.S. source dividends derived by "direct" investors (that is, substantial corporate investors), and "portfolio" investors (that is, investors other than direct investors). However, to qualify for the five-percent rate under the U.S. model, only the first condition noted above must be met. Additional treaty rules affecting the taxation of U.S. source dividends are discussed below under "Other rules."

Cyprus

Under the proposed treaty, Cyprus generally agrees not to impose any tax on dividends derived from sources within Cyprus by a resident of the United States in excess of the Cypriot corporate tax imposed with respect to the profits or earnings out of which the dividends are paid. A U.S. resident shareholder generally receives a credit against its Cypriot tax liability for the amount of the Cypriot corporate tax paid on those profits or earnings.

The treaty provides an individual resident of the United States with a refund of any Cypriot corporate tax imposed with respect to the profits or earnings out of which a dividend is paid to the extent that that tax exceeds the individual's personal tax liability in Cyprus. As indicated above, in the absence of a treaty, the Cypriot corporate tax is nonrefundable to nonresidents because, under Cypriot law, nonresidents are generally taxed on Cypriot source dividends at the top corporate tax rate of 42.5 percent. Under the proposed treaty, Cypriot source dividends of U.S. resident individuals generally are subject to tax at the Cypriot personal income tax rates applicable to income of Cypriot resident individuals. However, the dividends are subject to a maximum Cypriot tax of 42.5 percent (the current maximum Cypriot corporate tax), instead of 60 percent (the current maximum Cypriot personal tax). Also, U.S. resident individuals have only their Cypriot source income counted in determining the applicable marginal rate. Thus, U.S. individual shareholders are generally treated more favorably under the treaty than they would be in its absence and are sometimes treated more favorably by virtue of the treaty than their Cypriot counterparts are.

U.S. corporate shareholders are also treated more favorably under the treaty than they would be in its absence: The treaty lowers the Cypriot tax rate applicable to their Cypriot source dividends from the top corporate rate of 42.5 percent that is otherwise generally applicable to the rate applicable to the profits or earnings from which the dividends are paid. However, U.S. corporate shareholders apparently may be treated less favorably then their Cypriot counterparts are in some cases: As indicated above, Cypriot corporate shareholders are subject to tax on Cypriot source dividends at the rates otherwise applicable to them as Cypriot corporations rather than at the rates applicable to the profits or earnings out of which the dividends are paid. Since Cyprus subjects some nonresident corporations to lower tax rates than resident corporations, nonresident corporate shareholder in Cypriot resident companies might be better off (in the aggregate) with the rule applicable to Cypriot corporate shareholders. Under U.S. income tax treaties currently in force, however, no country with a partially integrated system except the United Kingdom provides substantial U.S. corporate investors *any* portion of the credit provided its own residents. The U.S. treaty with the United Kingdom provides substantial U.S. corporate investors with a credit equal to one-half of the credit that a U.K. resident would be entitled to were he the recipient of the dividend.

Other rules

The treaty limitations on U.S. dividend withholding tax and the treaty rules governing the Cypriot dividend tax credit will not apply if the recipient of the dividend has a permanent establishment in the source country and the shares with respect to which the dividend is paid are effectively connected with the permanent establishment. In that case, the dividend is taxed as industrial and commercial profits (Article 8). The U.S. model treaty contains a similar rule and a related rule that dividends attributable to a fixed base of an individual located in the source country are taxed as independent personal services income. The proposed treaty, like a number of older U.S. income tax treaties, omits the related rule.

The proposed treaty provides that dividends paid by a corporation of one country to a person other than a resident of the other country generally will be exempt from tax by the other country.

This exemption will not apply if the recipient of the dividends has a permanent establishment in that other country and the shares with respect to which the dividends are paid are effectively connected with that permanent establishment. The exemption also will not apply if the corporation paying the dividends is a Cypriot corporation which derives 50 percent or more of its total gross income from one or more permanent establishments which the corporation has in the United States. In that case, the Code's second tier withholding tax will apply without reduction. Thus, third-country residents that do extensive business in the United States generally will be unable to set up a Cypriot base company to avoid imposition of the second tier withholding tax. This treaty provision does not preserve the tax in all cases, however. Absent a treaty, the second tier withholding tax generally applies to a dividend if 50 percent or more of the foreign payor's gross income during the previous three-year period was effectively connected with the conduct of a U.S. trade or business. Under the proposed treaty, the tax will not apply unless that U.S. trade or business rises to the level of a U.S. permanent establishment. The proposed treaty rule generally follows the U.S. model.

The U.S. model treaty and most recent U.S. income tax treaties define the term "dividends;" the proposed treaty does not. This leaves to local law the definition of the term in certain cases.

Article 13. Interest

In general, the United States imposes a 30-percent tax on U.S. source interest paid to foreign persons under the same rules that apply to dividends. However, the Tax Reform Act of 1984 repealed the tax for interest paid on certain portfolio indebtedness to nonresident alien individuals and foreign corporations. (This change was effective for interest paid on portfolio indebtedness issued after July 18, 1984, the date of enactment of the 1984 Act.) U.S. source interest, for purposes of the 30-percent tax, generally is interest on debt obligations of U.S. persons, but not interest on deposits in banks. U.S. source interest for this purpose also includes interest paid by a foreign corporation if at least 50 percent of the gross income of the foreign corporation, in the prior three-year period, was effectively connected with a U.S. trade or business of that corporation. The tax imposed on the latter interest is often referred to as the "second tier" withholding tax.

The proposed treaty generally allows the imposition of a withholding tax at source on interest. However, the treaty limits the tax to 10 percent of the gross amount of the interest. This 10-percent tax limitation contrasts with the U.S. model position, not generally achieved, that interest should be exempt from tax at source.

In certain cases interest *will* be exempt from source country tax under the proposed treaty. These are where the beneficial recipient is (i) the other country or its instrumentality; (ii) a resident of the other country, if the debt is guaranteed or insured by that other country or its instrumentality; (iii) a bank or financial institution; or (iv) a resident of the other country with respect to debt obligations arising in connection with the sale of property or the performance of services.

As in the case of dividends, if the interest is paid on debt that is effectively connected with a permanent establishment, the interest is taxed as industrial and commercial profits (Article 8), that is, the 10-percent rate limitation and exemptions of this article do not apply. The 10-percent rate limitation and exemptions also are not intended to apply if the recipient of the interest is a nominee for a nonresident.

The proposed treaty addresses the issue of non-arm's-length interest charges between related parties by holding that the amount of interest for purposes of applying this article will be the amount of arm's-length interest. Where any interest paid by a person to any related person (Article 11) exceeds an amount which would have been paid to an unrelated person, the treaty's interest provisions apply only to so much of the interest as would have been paid to an unrelated person. The excess payment may be taxed by each country according to its own law, including the other provisions of the treaty where applicable. For example, excess interest paid to a parent corporation may be treated as a dividend under local law and thus be entitled to the benefits of Article 12 of the proposed treaty.

The proposed treaty limits the taxation by a country of interest paid by a resident of the other country in a manner generally parallel to its treatment of similar dividends. For example, the United States' second tier withholding tax on interest is preserved under the proposed treaty to the same extent that the second tier withholding tax on dividends is preserved. In addition, interest paid by a resident of one country may be taxed by the other country if the interest is treated as from sources within that other country under Article 6(2) (Source of Income).

The proposed treaty defines "interest" as income from bonds, debentures, government securities, notes, or other evidences of indebtedness, whether or not secured and whether or not carrying a right to participate in profits, and debt-claims of every kind, as well as all other income which, under the tax law of the country in which the income has its source, is assimilated to income from money lent.

Article 14. Royalties

Under the same system that applies to dividends and interest, the United States imposes a 30-percent tax on U.S. source royalties paid to foreign persons. Royalties are from U.S. sources if they are for the use of property located in the United States. U.S. source royalties include royalties for the use of or the right to use intangibles in the United States. Such royalties include motion picture royalties.

Under the proposed treaty, royalties derived by a resident of one country from sources within the other generally are exempt from tax by the source country. Thus, the proposed treaty generally exempts from the U.S. 30-percent tax on royalties paid to foreign persons royalties paid to Cypriot residents, and exempts from Cypriot withholding tax royalties paid to U.S. residents. These reciprocal exemptions are similar to those provided in the U.S. model treaty. No exemption is intended to apply if the recipient of a royalty is a nominee for a nonresident.

Royalties are defined for purposes of this article as payments of any kind made as consideration for the use of, or the right to use, copyrights of literary, artistic, or scientific works, motion pictures and works on film, videotape or other means of reproduction used for radio or television broadcasting, patents, designs, models, plans, secret processes or formulae, trademarks, or other like property or rights, or knowledge, experience, or skill (know-how). Also included are gains derived from the sale, exchange, or other disposition of any such property or rights to the extent that the amounts realized are contingent on the productivity, use, or disposition of the property or right.

As in the case of dividends and interest, if the property or right giving rise to the royalty is effectively connected with a permanent establishment, the royalty is taxed as industrial and commercial profits (Article 8). As in the case of interest, if the royalty is paid between related persons (Article 11) and exceeds an arm's-length amount, the excess is not treated as a royalty, but may be taxed by each country according to its own law, including the other provisions of the treaty where applicable. For example, excess royalties paid to a parent corporation may be treated as a dividend under local law and thus be entitled to the benefits of Article 12 of the proposed treaty.

Article 15. Income from Real Property

The proposed treaty provides that income from real property, including royalties and other payments in respect of the exploitation of natural resources (e.g., oil) and gains derived from the sale, exchange, or other disposition of real property or of the right giving rise to these royalties or other payments, may be taxed by the country in which the real property or natural resources are situated. Additional rules regarding the taxation of dispositions of real property are provided in the gains article (Article 16).

Interest on indebtedness secured by real property or secured by a right giving rise to royalties or other payments in respect of the exploitation of natural resources is not regarded as income from real property. However, income derived from the usufruct, direct use, letting, or use in any other form of real property is regarded as income from real property.

A resident of one country who is subject to tax in the other country on income from real property, including royalties and other payments in respect of the exploitation of natural resources and gains derived from the sale, exchange or other disposition of real property or of the right giving rise to these royalties, may elect for any taxable year to compute the tax on that income on a net basis as if the resident were engaged in trade or business in the other country. This election will be binding for the taxable year of the election and all subsequent taxable years unless the competent authorities of the two countries, pursuant to a request by the taxpayer made to the competent authority of the country in which the taxpayer is a resident, agree to terminate the election. This election closely resembles that currently provided to foreign investors under the Code. The current U.S. model treaty provides a similar net basis tax election, but the election has been omitted from several recent U.S. treaties.

This article is similar in substance to the corresponding article of the U.S. model treaty but, in form, resembles more closely the article governing income from real property found in some older U.S. income tax treaties.

Article 16. Gains

Generally, gain realized by a nonresident alien or a foreign corporation from the sale of a capital asset is not subject to U.S. tax unless the gain is effectively connected with the conduct of a U.S. trade or business or, in the case of a nonresident alien, he is physically present in the United States for at least 183 days in the taxable year. However, under the Foreign Investment in Real Property Tax Act of 1980, as amended ("FIRPTA"), a nonresident alien or foreign corporation is taxed by the United States on gain from the sale of a U.S. real property interest as if the gain were effectively connected with a trade or business conducted in the United States. "U.S. real property interests" include interests in certain corporations holding U.S. real property.

The proposed treaty generally provides that gains derived by a resident of one country will be exempt from tax by the other country. The general exemption does not apply in two situations. In those situations, gains may be taxed by both countries (with relief from double taxation provided pursuant to Article 5).

First, gains from the sale, exchange, or other disposition of real property referred to in Article 15 (Income from Real Property) that is situated in the United States, or a U.S. real property interest are not exempt from tax by the United States. Similarly, gains from the sale, exchange, or other disposition of real property referred to in Article 15 that is situated in Cyprus, or an interest in real property situated in Cyprus is not exempt from tax by Cyprus. (For purposes of the treaty, a U.S. real property interest (for example, stock in a U.S. real property holding company) is considered to be situated in the United States and an interest in real property situated in Cyprus is considered to be situated in Cyprus.) In conjunction with Article 15, this provision allows the United States to tax any transaction of a Cypriot resident taxable under FIRPTA and allows Cyprus to subject U.S. residents to its tax on the disposition of shares in a Cypriot real property holding company that holds Cypriot real property.

Second, gains on the sale, exchange, or other disposition of property that forms a part of the business property of a permanent establishment or a fixed base (including gains on the disposition of the permanent establishment or the fixed base itself) are not exempt from tax in the country where the permanent establishment or fixed base is located. These gains will be taxed in that country as industrial or commercial profits (Article 8) or income from independent personal services (Article 17), as appropriate.

Article 17. Independent Personal Services

The United States taxes the income of a nonresident alien individual at the regular graduated rates if the income is effectively connected with the conduct of a trade or business in the United States by the individual. (See discussion of U.S. taxation of business profits under Article 8 (Business Profits).) The performance of personal services within the United States can be a trade or business within the United States (Code sec. 864(b)).

The proposed treaty limits the right of a country to tax income from the performance of personal services by a resident of the other country. Under the proposed treaty, income from the performance of independent personal services is treated separately from salaries, wages, and similar remuneration received by employees.

Under the proposed treaty, income from the performance of independent personal services in one country by an individual resident of the other country is exempt from tax in the country where the services are performed unless the individual performing the services (1) is present in the country where the services are performed for 183 days or more during the taxable year or (2) has a fixed base regularly available to him in that country for the purpose of performing the services. In the latter case, the country where the services are performed can tax only that portion of the individual's independent personal services income that is attributable to his fixed base in that country.

The exemption from tax provided in this article is similar to that provided in the United Nations model treaty between developed and developing countries. The U.S. and OECD model treaties, by contrast, provide a broader tax exemption; they do not contain a 183-day rule but rather allow taxation in the nonresident country only on the basis of a fixed base regularly available there to the individual performing the independent personal services.

For purposes of this article, independent personal services include all personal services performed by an individual for his own account where the individual receives the income and bears the losses arising from the services; independent personal services are not limited to services performed by persons in professions such as physicians, lawyers, engineers, architects, dentists, and accountants.

Article 18. Dependent Personal Services

Under the Code, the income of a nonresident alien individual from the performance of personal services in the United States is not taxed if the individual is not in the United States for at least 90 days during a taxable year, the compensation does not exceed $3,000, and the services are performed as an employee of a foreign person not engaged in a trade or business in the United States or they are performed for a foreign office or place of business of a U.S. person.

Under the proposed treaty, income from labor or personal services performed as an employee (including income from services performed by an officer of a corporation) in one country (the source country) by a resident of the other country will not be taxable in the source country if three requirements are met: (1) the individual is present in the source country for less than 183 days during the taxable year; (2) his employer is not a resident of the source country; and (3) the compensation is not borne by a permanent establishment, a fixed base, or a trade or business which the employer has in the source country. This source country tax exemption is similar to that provided in the U.S. model. However, under the

U.S. model, the third requirement for the exemption is less strict. Under the model, the exemption will apply (provided requirements (1) and (2) are met) even if the income is borne by a trade or business of the employer in the source country, so long as that trade or business does not rise to the level of a permanent establishment or fixed base in the source country.

Compensation derived by an employee aboard a ship or aircraft operated by a resident of one country in international traffic may be taxed by that country under the proposed treaty. The treaty generally exempts such compensation from tax by the other country, provided that the compensation is in respect of employment as a member of the regular complement of the ship or aircraft. However, under the saving clause (Article 4), such compensation may be taxed by that other country if the employee resides there. This provision differs from the corresponding provision of the U.S. model treaty which permits taxation of the compensation only in the country where the employee resides.

Article 19. Artistes and Athletes

The proposed treaty contains a separate set of rules that apply to the taxation of income earned by entertainers (such as theater, motion picture, radio, or television "artistes" or musicians) and athletes. These rules apply notwithstanding the other provisions dealing with the taxation of income from personal services (Articles 17 and 18) and are intended, in part, to prevent entertainers and athletes from using the treaty to avoid paying any tax on their income earned in one of the countries.

Under the proposed treaty, each country may tax nonresident entertainers and athletes on the income from their personal activities as such performed in the country if their gross receipts (not including reimbursed expenses or expenses borne on their behalf) exceed $500 or its equivalent in Cypriot pounds per day, or a total of $5,000 or its equivalent in Cypriot pounds for the taxable year concerned. (The comparable annual total in the U.S. model treaty is $20,000 (including reimbursed expenses); the model does not apply a daily threshold.) Thus, if a Cypriot entertainer maintained no fixed base in the United States and performed (as an independent contractor) for one day of a taxable year in the United States for total compensation (excluding reimbursed expenses) of $400, the United States could not tax that income. If however, that entertainer's total compensation for that day were $600, the full $600 (less appropriate deductions) would be subject to U.S. tax. If the entertainer performed 20 days of the taxable year in the United States for $400 compensation per day (excluding reimbursed expenses), or $8,000 of total compensation, the full $8,000 (less appropriate deductions) would be subject to U.S. tax.

In addition, the proposed treaty provides that where income in respect of personal activities performed by an entertainer or athlete in his capacity as such accrues not to the entertainer or athlete, but to another person, that income may be taxed by the country in which the activities are performed in any situation where the entertainer or athlete or persons to whom he is related participate directly or indirectly in the profits of that other person receiving the income. For this purpose, participation in the profits of the recipient of the income includes the receipt of deferred compensation, bonuses, fees, dividends, partnership distributions, or other distributions. (This provision applies notwithstanding the business profits and personal services articles (Articles 8, 17, and 18).) This provision is intended to prevent highly paid performers and athletes from avoiding tax in the country in which they perform by routing the compensation for their services through a third person such as a personal holding company or trust located in a country that would not tax the income.

Article 20. Directors' Fees

The proposed treaty provides that fees derived by a resident of one country in his capacity as a member of the board of directors of a corporation of the other country (but not including fixed or contingent payments derived in his capacity as an officer or employee) may be taxed in that other country (notwithstanding the general limits on source country taxation of personal services income set forth in Articles 17 and 18) to the extent that the fees are in excess of a reasonable fixed amount payable to all directors of the corporation per day of attendance at the directors' meeting in that other country. The U.S. model treaty does not contain this additional grant of source country tax jurisdiction.

Article 21. Students and Trainees

The proposed treaty provides special host country tax exemptions for income of a resident of one country who visits the other as a student or trainee. These treaty exemptions are broader than those provided in the U.S model for income of visiting students and trainees. They are similar to the exemptions incorporated in a number of older U.S. income tax treaties.

Students

Under the proposed treaty, an individual who is a resident of one country when he becomes temporarily present in the other country (the "host country") for the primary purpose of studying at a university or other recognized educational institution in that country, securing training required to qualify him to practice a profession or professional specialty, or studying or doing research as a recipient of a grant, allowance, or award from a governmental, religious, charitable, scientific, literary, or educational organization is eligible for a limited exemption from tax in the host country. The exemption is limited to a period not exceeding five taxable years from the date of the individual's arrival in the host country, and any additional period of time necessary to complete, as a full-time student, educational requirements as a candidate for a postgraduate or professional degree from a recognized educational institution. The exemption applies only to the grant, allowance, or award just noted, gifts from abroad for the purpose of the individual's maintenance, education, or training, and up to $2,000 (or its equivalent in Cypriot pounds) per taxable year of income from personal services performed in the host country.

Trainees

Under the proposed treaty, an individual who is a resident of one country at the time he becomes temporarily present in the other country as an employee of, or under contract with, a resident of his home country for the primary purpose of (1) acquiring technical, professional, or business experience from a person other than a resident (or a person related to a resident) of his home country or (2) studying at a university or other recognized educational institution in the host country is eligible for a limited exemption from tax in the host country. The exemption applies for a period not exceeding one year with respect to up to $7,500 (or its equivalent in Cypriot pounds) of the individual's income from personal services.

Government sponsored trainees

Under the proposed treaty, an individual who is a resident of one country when he becomes temporarily present in the other country for a period not exceeding one year as a participant in a program sponsored by the government of that other country, for the primary purpose of training, research, or study is eligible for an exemption from tax in the host country. Up to $10,000 (or its equivalent in Cypriot pounds) of the individual's income from personal services in respect of the training, research, or study performed in the host country will be exempt from tax in that country.

Article 22. Governmental Functions

The proposed treaty generally exempts wages of employees of one of the countries from tax in the other country. Under the proposed treaty, income paid from public funds of one country to a citizen of that country for personal services performed as an employee of that country in the discharge of governmental functions will be exempt from tax by the other country. Thus, for example, Cyprus would not tax the compensation of a U.S. citizen who is in Cyprus to perform services for the U.S. Government in the discharge of governmental functions. This rule also applies to public pensions, annuities, and similar benefits paid in respect of past services. This rule is not subject to the saving clause in the case of a person who is not citizen of or an immigrant in his country of residence.

This article is similar to the corresponding article of the U.S. model treaty. However, under the U.S. model, the exemption for compensation of government employees applies to compensation paid by political subdivisions and local authorities of the countries as well as to compensation paid by the countries themselves.

Article 23. Private Pensions and Annuities

Under the proposed treaty, pensions and other similar remuneration paid to an individual resident of either country in consideration of past employment are subject to tax only in the recipient's country of residence. (This rule does not apply to a pension paid by either country to a citizen of that country (Article 22 (Governmental Functions)).) The term "pensions and other similar remuneration" means periodic payments made by reason of retirement or death, in consideration for services rendered or as compensation for injuries received in connection with past employment.

The proposed treaty also provides that alimony and annuities may be taxed only in the recipient's country of residence. "Alimony" is defined as periodic payments made pursuant to a divorce decree, separate maintenance agreement, or support or separation agreement which are taxable to the recipient under the internal laws of the recipient's country of residence. "Annuities" are defined as stated sums paid periodically at stated times during life or during a specified number of years, under an obligation to make the payments in return for adequate and full consideration (other than services).

The above rules are subject to the saving clause. Thus, a country may tax a pension or alimony, for example, received by a citizen of that country residing in the other country, notwithstanding the rules of this article.

The U.S. model treaty contains special rules for child support payments that the proposed treaty omits. Under the model treaty, child support payments are taxable only in the country of the payor. Under the proposed treaty, child support payments are covered under Article 4 (General Rules of Taxation) and, thus, are taxable by the country of residence of the recipient as well as by the country of residence of the payor.

Article 24. Social Security Payments

Social security payments and other public pensions paid by one country to a resident of the other country or to a U.S. citizen are taxable only by the paying country under the proposed treaty. This rule, which is not overridden by the saving clause, exempts U.S. citizens and U.S. residents from U.S. tax on Cypriot public pensions and Cypriot residents and U.S. citizens from Cypriot tax on U.S. social security payments. Under this provision, only the United States may tax U.S. social security payments to U.S. persons residing in Cyprus. The rule thus safeguards the United States' right under the Social Security Amendments of 1983 to tax a portion of U.S. social security benefits received by nonresident individuals, while protecting any such individuals residing in Cyprus from double taxation.

According to the Treasury Department's technical explanation of the proposed treaty, the term "other public pensions" is understood to include U.S. railroad retirement pensions. This article does not apply to pension payments for government service covered under the governmental functions article (Article 22).

Article 25. Diplomatic and Consular Officials

The proposed treaty contains the usual provision stating that the treaty is not to affect the fiscal privileges of diplomatic and consular officials under the general rules of international law or the provisions of special agreements. This provision is intended to make clear that the treaty will not defeat any exemption from tax that a host country may otherwise grant unilaterally or by agreement to the salaries of diplomatic officials of the other country.

Unlike the corresponding provision found in the U.S. model treaty and most U.S. treaties, this provision is fully subject to the saving clause. This was an oversight of the negotiators. Technically, this allows Cyprus to tax U.S. diplomats who are Cypriot residents under the treaty as if the treaty had not come into effect. However, the Vienna Convention on Diplomatic Relations and the Vienna Convention on Consular Relations prohibit Cyprus from taxing the U.S. source income of U.S. diplomatic agents and consular officers, respectively. In addition, Cyprus is subject to a consular convention between the United States and the United Kingdom which prohibits host country taxation of salaries received by a consular officer as compensation for his consular services unless the officer is a national of the host country and is not also a national of the country he serves.

Article 26. Limitation on Benefits

The proposed treaty contains provisions that are intended to limit the benefits of the treaty to persons who are entitled to them by reason of their residence in the United States or Cyprus.

The proposed treaty is intended to limit double taxation caused by the interaction of the tax systems of the United Staes and Cyprus as they apply to residents of the two countries. At times, however, residents of third countries attempt to use a treaty. This use is known as "treaty shopping." Under certain circumstances, and without appropriate safeguards, the nonresident is able to secure these benefits by establishing a corporation (or other entity) in one of the countries which, as a resident of that country, is entitled to the benefits of the treaty. Additionally, it may be possible for the third-country resident to repatriate funds to that third country from the entity under favorable conditions (that is, it may be possible to reduce or eliminate taxes on the repatriation) either through relaxed tax provisions in the distributing country or by passing the funds through other treaty countries (essentially, continuing to treaty shop), until the funds can be repatriated under favorable terms.

This article contains provisions intended to limit the use of the treaty to bona fide residents of the two countries. These anti-treaty shopping provisions follow closely those of the U.S. model treaty. It is especially important to include stringent anti-treaty shopping provisions in a treaty with a "tax haven" country such as Cyprus whose tax system contains features that encourage third-country residents to channel certain investments through the country. As discussed in greater detail under Article 4, Cyprus provides substantially reduced tax rates for certain foreign source income thus making it a particularly attractive country for third-country residents to route offshore investment income (for example, from the United States) through in order to obtain treaty benefits in the source country. In addition, under Cypriot law, profits may be repatriated by a Cypriot investing company to third-country shareholders free of Cypriot tax if the company is wholly owned by nonresidents of Cyprus and managed and controlled from outside Cyprus, and the profits were earned outside Cyprus; gross royalties earned in Cyprus by third-country residents are taxed at a rate of 10 percent; and interest on foreign funds imported into Cyprus and deposited in local banks is free of Cypriot tax for five years.

Under the proposed treaty, a person other than an individual (for example, a corporation, partnership, trust, or other business organization) is not entitled to the benefits of the treaty unless it satisfies an ownership/interest payment test or a good business purpose test.

Under the ownership/interest payment test, more than 75 percent of the beneficial interest (in the case of a company, more than 75 percent of the number of shares of each class of shares) in an entity resident in one of the two countries must be owned directly or indirectly by one or more individual residents of that same country. In addition, the gross income of the entity must not be used in substantial part, directly or indirectly, to meet liabilities (including liabilities for interest or royalties) to persons residing in third countries (who are not U.S. citizens). For purposes of the ownership/interest payment test, a corporation that has substantial trading in its stock on a recognized stock exchange in Cyprus or the United States is presumed to be owned by individual residents of the country in which that stock exchange is located. A stock exchange will be treated as a "recognized stock exchange" by agreement of the countries' competent authorities. The ownership/interest payment test would, for example, deny the treaty reduction of U.S. withholding tax on U.S. source dividends and interest to a Cypriot company receiving such U.S. source income that is privately held by individual residents of a third country or that uses most of its gross income to meet interest liabilities on debt owed to individual residents of a third country.

Treaty benefits will be available to an entity that is a resident of the United States or Cyprus, notwithstanding the entity's failure to satisfy the ownership/interest payment test, if it is determined that neither the establishment, acquisition, and maintenance of the entity, nor the conduct of its operations had as one of its principal purposes the of obtaining of such treaty benefits. Accordingly, treaty benefits generally will not be limited if there was no treaty shopping motive for forming an entity and if its operation does not have as one of its principal purposes the obtaining of treaty benefits. However, the burden of overcoming the treaty shopping rule, as under U.S. tax law generally, is on the taxpayer claiming benefits.

Article 4 of the proposed treaty (General Rules of Taxation) also contains a provision designed to deny treaty benefits to third-country residents who try to obtain them by routing investment income from one of the countries through an investing entity established in the other. Article 4(6) provides that where, under the proposed treaty, one country reduces the rate of tax on, or exempts from tax, income of a resident of the other country and, under the law in force in that other country, the income is subject to a rate of tax or tax burden which is substantially less than the tax which generally would be imposed by that country on the income if derived from sources within that country, then the treaty reduction or exemption will not apply. (This provision is discussed further under Article 4).

Finally, the proposed treaty disallows treaty benefits to any income derived by a trustee that is treated as income of a resident of the United States or Cyprus for purposes of the treaty, if the trustee derived that income in connection with a scheme one of whose principal purposes was to obtain a benefit under the treaty. This provision is not found in the U.S. model treaty. Substantially identical provisions were included in the U.S. income tax treaties with Australia and New Zealand ratified in 1983.

Article 27. Mutual Agreement Procedure

The proposed treaty contains the standard mutual agreement provision which authorizes the competent authorities of the United States and Cyprus to consult together to attempt to alleviate individual cases of double taxation not in accordance with the treaty. The saving clause of the proposed treaty does not apply to this article, so that the application of this article may result in waiver (otherwise mandated by the proposed treaty) of taxing jurisdiction by the country of citizenship or residence.

Under the proposed treaty, a resident of one country who considers that the actions of one or both of the countries will cause him to pay tax not in accordance with the treaty may present his case to the competent authority of the country of which he is a resident. (Under the U.S. model treaty, an aggrieved person may also present his case to the competent authority of the country of which he is a national (but not a resident).) The competent authority then determines whether the claim has merit. If it determines that the claim does have merit, the competent authority will endeavor to come to an agreement with the competent authority of the other country with a view to the avoidance of taxation that is contrary to the provisions of the treaty.

The competent authorities of the countries are to endeavor to resolve by mutual agreement any difficulties or doubts arising as to the application of the treaty. In particular, they are authorized to agree as to the attribution of income, deductions, credits, or allowances of a resident of one country to its permanent establishment in the other country, the allocation of income, deductions, credits, or allowances between persons, the determination of the source of particular items of income, a uniform accounting for income and deductions, the characterization of particular items of income, and the common meaning of terms. They are also specifically authorized to agree on the application of the non-discrimination provisions in the case of permanent establishments and personal allowances.

The proposed treaty also contains a provision, not found in most existing U.S. treaties (but included in similar form in the U.S. model treaty), that permits the competent authorities to agree to increase dollar amounts reflected in the treaty. Thus, if economic conditions change in the future, rendering too low the treaty's dollar threshold for permitting source country taxation of students' income (Article 21), for example, the competent authorities may agree to a higher dollar threshold.

The competent authorities may also consult together for the elimination of double taxation in cases not provided for in the proposed treaty.

The treaty authorizes the competent authorities to communicate with each other directly for purposes of reaching an agreement in the sense of this mutual agreement article. When it seems advisable for the purpose of reaching an agreement, they may meet together for an oral exchange of opinions. These provisions make clear that it is not necessary to go through normal diplomatic channels in order to discuss problems arising in the application of the treaty. They also remove any doubt as to restrictions that might otherwise arise by reason of the confidentiality rules of the United States or Cyprus.

In the event that the competent authorities reach an agreement under this mutual agreement article, taxes are to be imposed and a refund or credit of taxes allowed by the countries, in accordance with that agreement. The article provides for the waiver of the statute of limitations of either country so as to permit the issuance of a refund or credit notwithstanding the statute of limitations. However, the article does not authorize the imposition of additional taxes after the statute of limitations has run.

Finally, the article authorizes the competent authorities of the two countries to prescribe whatever rules and procedures may be necessary to carry out the purposes of the treaty.

Article 28. Exchange of Information

This article forms the basis for cooperation between the two countries in their attempts to deal with avoidance or evasion of their respective taxes and to obtain information so that they can properly administer the treaty. It is similar to the corresponding article of the U.S. model treaty but differs from the U.S. model in certain respects.

The proposed treaty provides for the exchange of information that is pertinent to carrying out the provisions of the proposed treaty or the provisions of the domestic laws of the two countries concerning taxes to which the treaty applies. The exchange of information applies to all national taxes imposed by either country, whether or not otherwise covered by the treaty (Article 1).

The U.S. model treaty contains a provision making it clear that third-country residents are covered by the exchange of information rules. The proposed treaty omits this provision but it is intended that third-country residents be covered by the proposed treaty's exchange of information rules.

The proposed treaty's exchange of information article differs from that of the U.S. model in specifically empowering the competent authorities of the two countries to secure within their respective countries whatever information may be necessary to comply with the exchange of information requirements. Notes exchanged when the proposed treaty was signed indicate that, without such modification by the treaty, Cypriot law may not empower the Cypriot competent authority to obtain all of the information required to be exchanged. The notes state that the treaty will provide Cyprus with the necessary authority to implement the treaty's exchange of information rules. The notes specify that, among the types of information that the treaty will empower Cyprus to provide, are included: bank information in the custody of a taxpayer; information in the custody of a bank; information in the possession of the Central Bank relating to beneficial stock ownership; information in the possession of the registered legal owner of a corporation relating to beneficial stock ownership; and information in the possession of a trustee relating to beneficial ownership. The notes confirm the understanding of the countries that, under the laws of Cyprus, civil and criminal sanctions can be imposed in the event that a person from whom information is requested does not disclose the information. The notes also acknowledge that the United States presently has full authority under its internal law to implement the exchange of information rules.

Any information exchanged under this article is to be treated as secret. Exchanged information may be disclosed only to persons (including courts and administrative bodies) concerned with the assessment, collection, enforcement, or prosecution in respect of, or administration of, the taxes to which the treaty applies. Persons concerned with the administration of taxes include legislative bodies involved in oversight of the administration of taxes, including their agents such as, for example, the U.S. General Accounting Office, with respect to such information as they consider to be necessary to carry out their oversight responsibilities.

The proposed treaty contains limitations on the obligations of the countries to supply information. A country is not required to carry out administrative measures at variance with the law and administrative practice of either country, to supply particulars which are not obtainable under the laws or in the normal course of the administration of either country, or to supply information which would disclose any trade, business, industrial, commercial, or professional secret or trade process, or information the disclosure of which would be contrary to public policy. However, the proposed treaty expressly provides that a country may, at its discretion, provide assistance which, under the foregoing rules, it is not obligated to provide.

Upon an appropriate request for information, the requested country is to obtain the information to which the request relates in the same manner as if its tax were at issue. A requested country is to use its subpoena or summons powers or any other powers that it has under its own laws to collect information requested by the other country. It is intended that the requested country may use those powers even if the requesting country could not under its own laws. Thus, it is not intended that this provision be strictly reciprocal. For example, once the Internal Revenue Service has referred a case to the Justice Department for possible criminal prosecution, the U.S. investigators can no longer use an administrative summons to obtain information. If, however, Cyprus could still use an administrative summons to obtain requested information, it would be expected to do so even though the United States could not. The United States could not, however, tell Cyprus which of its procedures to use.

Where specifically requested by the competent authority of one country, the competent authority of the other country is to provide the information in the form requested. Specifically, the competent authority of the second country is to provide depositions of witnesses and authenticated copies of unedited original documents (including books, papers, statements, records, accounts, and writings) to the extent that they can be obtained under the laws and practices of the second country in the enforcement of its own tax laws.

The proposed treaty specifies that the exchange of information may be either on a routine basis or on request with reference to particular cases; it also specifies that the competent authorities of the two countries may agree on the information to be furnished on a routine basis.

The proposed treaty obligates the competent authority of each country to notify the competent authority of the other country of any amendment of the taxes covered by the treaty or adoption of any substantially similar taxes by the first competent authority's country. Notification is to be made by transmitting the text of the amendment or new statute. The proposed treaty also obligates the competent authority of each country to notify the competent authority of the other country of the publication in the first competent authority's country of any material concerning the application of the treaty, whether in the form of regulations, rulings, or judicial decisions. Notification is to be made by transmitting the text of the material. Similar notification rules are contained in the article of the U.S. model treaty that sets forth the taxes covered by the treaty.

Article 29. Assistance in Collection

This article requires that each country aid in collecting the taxes of the other country to the extent necessary to insure that exemptions from tax and reduced rates of tax granted under the treaty by that other country are not enjoyed by persons not entitled to those benefits. A country is not obligated by this article to carry out measures at variance with the laws, administrative practices, or public policy of either country with respect to the collection of its own taxes.

The rules of this article are similar to rules found in the U.S. model treaty. The U.S. model rules are included in the model's exchange of information article.

Article 30. Entry into Force

The proposed treaty is to be ratified and instruments of ratification exchanged in Washington as soon as possible. The proposed treaty will enter into force upon the exchange of the instruments of ratification. It will take effect with respect to income of calendar or taxable years beginning (or in the case of taxes payable at the source, payments made) on or after the January 1st of the year after the year in which it enters into force.

Article 31. Termination

The proposed treaty will remain in force indefinitely, but either country may terminate it at any time after five years from its entry into force by giving at least six months' prior notice through diplomatic channels. If a termination occurs, the termination will be effective with respect to income of calendar or taxable years beginning (or, in the case of taxes payable at the source, payments made) on or after the January 1st next following the expiration of the six-month period.

Exchange of Notes

In notes exchanged when the proposed treaty was signed, the countries confirmed their agreement under Article 28 of the proposed treaty (Exchange of Information) to exchange such information as is pertinent to carrying out the provisions of the treaty and the provisions of the domestic laws of the two countries concerning taxes covered by the treaty. The countries acknowledged that the United States presently has full authority under its internal law to implement their agreement. The countries agreed that, with respect to Cyprus, the treaty would provide the necessary authority to implement the treaty to the extent that authority appears to be lacking under the internal law of Cyprus in the absence of the treaty. The notes specify that, among the types of information that the treaty will empower Cyprus to provide, are included: bank information in the custody of a taxpayer; information in the custody of a bank; information in the possession of the Central Bank relating to beneficial stock ownership; information in the possession of the registered legal owner of a corporation relating to beneficial stock ownership; and information in the possession of a trustee relating to beneficial ownership. The notes also confirm the understanding of the countries that civil and criminal sanctions can be imposed under Cypriot law in the event that a person from whom information is requested does not disclose the information. This portion of the notes is discussed in greater detail under Article 28 above.

In the notes, the United States also offered Cyprus assurances that, when circumstances permitted, the United States would be prepared to resume discussions with a view to incorporating provisions in the treaty, consistent with U.S. income tax policies regarding other developing countries, that would minimize the interference of the U.S. tax system with investment incentives offered by the Government of Cyprus.

These assurances reflect the desire of Cyprus and other developing countries to have the United States adopt a tax sparing credit. These assurances are similar to assurances provided in certain other U.S. income tax treaties with developing countries.

Many developed countries provide a tax sparing credit in order to avoid what, in the view of some, is a conflict with the foreign investment incentive policies of developing countries. A tax sparing credit is an income tax credit provided by a country (typically a developed country) against its own tax on income from a developing country. The credit equals the full amount of the developing country's nominal tax on the income notwithstanding the developing country's reduction or elimination of the tax as part of an investment incentive program. Many developing countries (including Cyprus), for example, provide "tax holidays" to residents of other countries who invest in the developing country. Generally, under these tax holidays, the developing countries forego tax on the profits from the foreign-owned business for a period of time. Absent a tax sparing credit, however, those profits typically would be taxed in full by the country of residence of the business' foreign owner upon repatriation in dividend form. The United States has declined to give tax sparing credits.

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