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EXPLANATION OF PROPOSED PROTOCOL TO THE INCOME TAX TREATY BETWEEN THE UNITED STATES AND BARBADOS

SCHEDULED FOR A HEARING

BEFORE THE

COMMITTEE ON FOREIGN RELATIONS
UNITED STATES SENATE

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PREPARED BY THE STAFF

OF THE

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INTRODUCTION

This pamphlet,[1] prepared by the staff of the Joint Committee on Taxation, describes the proposed supplementary protocol to the income tax treaty between the United States and Barbados. The proposed protocol was signed on December 18, 1991, and was amplified by an exchange of notes signed the same day. The proposed protocol would amend the current U.S.-Barbados income tax treaty, which was signed on December 31, 1984, and entered into force on February 28, 1986. A public hearing on the proposed protocol is scheduled on October 27, 1993, by the Senate Committee on Foreign Relations.

The primary reason for the negotiation of the proposed protocol was to reflect a basic alteration in Barbadian treaty policy and to incorporate changes in U.S. law and treaty policy. The present treaty incorporates a typical developing country approach, based on the United Nations model treaty (the "U.N. model"), which is to minimize revenue losses of the developing country partner by having very low activity thresholds for taxing permanent establishments and relatively high withholding tax rates on interest and royalties.

The proposed protocol reflects Barbadian recognition that these policies can inhibit the cross-border flow of capital and technology between the United States and Barbados. The proposed protocol would reduce the tax at source on certain interest and royalties, and place more restrictive limitations on the taxation by one treaty country of the business profits earned by a resident of the other country.

The proposed protocol also would revise rules to prevent nonresidents of the United States and Barbados from enjoying the reduced rates of tax provided in the convention, as amended by the protocol (that is, the proposed protocol contains rules designed to prevent a practice commonly referred to as treaty shopping). In addition, the proposed protocol would provide specific guidance relating to the application of the branch profits and branch-level interest taxes.

Part I of the pamphlet is a summary of the principal provisions of the proposed protocol. Part II presents a discussion of the issues raised by the proposed protocol. Part III contains a detailed explanation of the proposed protocol.[2]

[1] This pamphlet may be cited as follows: Joint Committee on Taxation, *Explanation of Proposed Protocol to the Income Tax Treaty Between the United States and Barbados* (JCS–13–93), October 26, 1993.

[2] For a copy of the proposed protocol, see Senate Treaty Doc. 102-41, September 30, 1992.

I. SUMMARY

The proposed protocol contains the following modifications to the income tax treaty between the United States and Barbados.

(1) Permanent establishment.—The proposed protocol would replace Article 5 (Permanent Establishment) of the present treaty with new rules for determining permanent establishments. The proposed article is consistent in all but one respect with the permanent establishment article in the 1981 proposed U.S. model income tax treaty (the "U.S. model" treaty). The general effect of the amendments contained in the proposed protocol would be to raise the thresholds for the taxation under Article 7 (Business Profits) by one treaty country of the business profits of an enterprise of the other country. The proposed amendments also would be relevant to the provisions of Article 14 (Independent Personal Services) of the existing treaty.

(2) Business profits.—The proposed protocol would delete the limited force of attraction feature of Article 7 (Business Profits) that is contained in the existing treaty and would conform the provision to that in the U.S. model treaty. That is, in the case of an enterprise of one treaty country that carries on or has carried on business in the other country through a permanent establishment situated therein, the business profits of the enterprise would be taxable in the other country, but only so much of them as is attributable to that permanent establishment.

(3) Dividends.—Under the proposed protocol, the prohibition of source country tax in excess of 5 percent on direct investment dividends would not apply to a dividend from a U.S. Regulated Investment Company (RIC) or Real Estate Investment Trust (REIT). In addition, the proposed protocol would amend the existing treaty to state that it exempts from the U.S. accumulated earnings tax Barbadian companies more than 50 percent of the entire voting power or value of which are owned during the last half of the taxable year by individual residents of Barbados who are not U.S. citizens. The corresponding provision in the existing treaty exempts companies based on ownership by Barbadian individuals of more than 50 percent of the entire voting power; an additional gloss on this language was added by the Senate, however, in its resolution advising and consenting to the ratification of the existing treaty. While the amendment provided in the proposed protocol is consistent with the language of the Senate resolution, it may not entirely address the concern raised by the Senate Foreign Relations Committee in its 1984 comments on the existing treaty.

(4) Interest.—The existing treaty generally allows both the United States and Barbados to tax interest derived from sources within one of the treaty countries and beneficially owned by a resident of the other country. The maximum allowable rate of tax by the source country is 12.5 percent of the gross amount of the inter-

est. The proposed protocol would reduce the maximum allowable rate of source country tax on interest to 5 percent.

*(5) **Royalties.***—The existing treaty allows both the United States and Barbados to tax royalties arising in one of the treaty countries and paid to a resident of the other country. The maximum allowable rate of tax by the source country is 12.5 percent of the gross amount of the royalties. The proposed protocol would reduce the maximum allowable rate of source country tax on royalties to 5 percent.

*(6) **Branch tax.***—The proposed protocol would add a new article to the treaty (Article 13A) which would provide guidance with respect to the application of branch profits and branch-level interest taxes imposed by either treaty country. The rate of branch tax that could be imposed by the two countries would be limited to the rate specified under the treaty (as amended by the proposed protocol) for taxes on direct investment dividends or interest, as the case may be (i.e., 5 percent). Under the existing treaty, as interpreted in Treasury regulations, the United States generally may impose a 5-percent branch profits tax, and a 12.5-percent branch-level excess interest tax, on a Barbadian corporation.

*(7) **Anti-treaty shopping provision.***—The proposed protocol would delete Article 22 (Limitation on Benefits) of the existing treaty and replace it with new provisions regarding limitations on treaty benefits. The purpose of the limitation on benefits article is to limit the benefits provided under the treaty to persons who are entitled to those benefits by reason of their residence in the United States or Barbados. The new provision would be similar to the limitation of benefits articles included in other recently ratified U.S. income tax treaties (e.g., the treaty between the United States and Germany).

II. ISSUES

The proposed protocol raises the following specific issues.

(1) Treaty shopping

The proposed protocol, like a number of U.S. income tax treaties, generally would limit treaty benefits for treaty country residents so that only those residents with a sufficient nexus to a treaty country would receive treaty benefits. Although the proposed treaty is intended to benefit residents of Barbados 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 to the same extent that it is limited in another treaty may attempt to secure a lower rate of tax by lending money, for example, 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 attempt to do this by establishing in that treaty country a subsidiary, trust, or other investing entity which then makes the loan to the U.S. person and claims the treaty reduction for the interest it receives.

The anti-treaty shopping provision of the proposed protocol is similar to an anti-treaty shopping provision in the Internal Revenue Code (as interpreted by Treasury regulations) and in several newer treaties, for example, the recently ratified income tax treaty with Germany. Some aspects of the proposed provision, however, differ either from an anti-treaty shopping provision proposed at the time that the U.S. model treaty was proposed, or from the anti-treaty shopping provisions sought by the United States in some treaty negotiations since the model was published in 1981. The issue is whether the anti-treaty shopping provision of the proposed protocol would effectively forestall potential treaty shopping abuses.

One provision of the anti-treaty shopping article of the proposed protocol is more lenient than the comparable rule in one version proposed with the U.S. model treaty. That U.S. model proposal allows benefits to be denied if 75 percent or less of a resident company's stock is held by individual residents of the country of residence, while the proposed protocol (like several newer treaties, including the current treaty with Barbados, and an anti-treaty shopping provision in the Internal Revenue Code) lowers the qualifying percentage to 50, and broadens the class of qualifying shareholders to include residents of either treaty country (and citizens of the United States). Thus, this safe harbor would be considerably easier to enter under the proposed protocol. On the other hand, counting for this purpose shareholders who are residents of either treaty country would not appear to invite the type of abuse at which the provision is aimed, since the targeted abuse is ownership by third-country residents attempting to obtain treaty benefits.

Another provision of the proposed anti-treaty shopping article differs from the comparable rule of some earlier U.S. treaties and proposed model provisions, but the effect of the change is less clear. The general test applied by those treaties to allow benefits, short of meeting the bright-line ownership and base erosion test, is a broadly subjective one, looking to whether the acquisition, maintenance, or operation of an entity did not have "as a principal purpose obtaining benefits under" the treaty. By contrast, the proposed protocol (like some other recent U.S. income tax treaties, e.g., Germany) contains a more precise test that would allow denial of benefits only with respect to income not derived in connection with the active conduct of a trade or business. (However, this active trade or business test would not apply with respect to a business of making or managing investments, so benefits could be denied with respect to such a business regardless of how actively it is conducted.) In addition, the proposed protocol would give the competent authority of the source country the ability to override this standard. The Memorandum of Understandings accompanying the proposed protocol provides some elaboration as to how these rules would be applied.

The practical difference between the proposed protocol tests and the earlier test depends upon how they would be interpreted and applied. The principal purpose test might be applied leniently (so that any colorable business purpose would suffice to preserve treaty benefits), or it might be applied strictly (so that any significant intent to obtain treaty benefits would suffice to deny them). Similarly, the standards in the proposed protocol and Memorandum of Understandings could be interpreted to require, for example, a more active or a less active trade or business (though the range of interpretation is far narrower). Thus, a narrow reading of the principal purpose test could theoretically be stricter than a broad reading of the proposed protocol tests (i.e., would operate to deny benefits in potentially abusive situations more often).

It is believed that the United States should maintain its policy of limiting treaty shopping opportunities whenever possible, and in exercising any latitude Treasury has in interpreting and applying the proposed protocol, it should satisfy itself that its rules as applied would adequately deter treaty shopping abuses. The proposed anti-treaty shopping provision may be effective in preventing third-country investors from obtaining treaty benefits by establishing investing entities in Barbados since those persons may be unwilling to share ownership of such investing entities on a 50-50 basis with U.S. or Barbadian residents or other qualified owners to meet the ownership test of the anti-treaty shopping provision. The base erosion test provides protection from certain potential abuses of a Barbadian conduit. Finally, in some cases Barbados imposes significant taxes of its own; these taxes may deter third-country investors from seeking to use Barbados entities to make U.S. investments. On the other hand, implementation of the tests for treaty shopping set forth in the proposed protocol and interpreted in the Memorandum of Understandings may raise factual, administrative, or other issues that cannot currently be foreseen. Thus, the Committee should satisfy itself that the provision as proposed is an adequate tool for preventing possible treaty-shopping abuses in the future.

(2) Accumulated earnings tax

The U.S. tax law contains special look-through rules for applying the accumulated earnings tax to a United States-owned foreign corporation. Section 535(d) of the Internal Revenue Code defines a United States-owned foreign corporation as any foreign corporation if 50 percent or more of the total combined voting power of all classes of stock of such corporation entitled to vote, *or* the total value of the stock of such corporation, is held directly or indirectly by U.S. persons. The text of the existing U.S.-Barbados treaty provides that a company which is a resident of Barbados is exempt from the U.S. accumulated earnings tax if individuals (other than U.S. citizens) who are residents of Barbados control, directly or indirectly, throughout the last half of the taxable year, more than 50 percent of the entire voting power in that company. Applying this rule on the basis of voting power alone would raise a conflict between Code section 535(d) and the treaty provision. That is, section 535(d) would be overridden by the treaty in cases where Barbadian shareholders hold a majority of the voting power of the stock in a Barbadian corporation, even if U.S. shareholders hold a majority of the value of the stock (and, thus, section 535(d) otherwise would apply).

In recognition of the possibility that U.S. taxpayers could avoid the intended effect of section 535(d) by creating Barbadian corporations in which a small class of voting stock is held primarily by Barbadians, while the majority of the value of the company is represented by non-voting stock held by U.S. persons, the Senate gave its advice and consent to the ratification of the present treaty in 1985 subject to the reservation that the treaty's reference to "voting power" shall be construed to mean "voting power or value" for purposes of the U.S. accumulated earnings tax. The treaty, as modified by the reservation, entered into force in 1986. Thus, under the treaty as it is currently in effect, the U.S. accumulated earnings tax may be applied when U.S. taxpayers own 50 percent or more of the vote and value of a Barbadian corporation.

The proposed protocol would incorporate the 1985 reservation into the portion of the treaty that provides for the exemption from the accumulated earnings tax of certain Barbadian corporations.

The amendment made by the 1985 reservation and reflected in the proposed protocol, however, did not adequately resolve the issue. Under this amendment, a Barbadian company would be exempt from the accumulated earnings tax if individuals (other than U.S. citizens) who are residents of Barbados control, directly or indirectly, throughout the last half of the taxable year, more than 50 percent of the entire voting power *or value* of the company. Thus, under the treaty and the proposed protocol, U.S. taxpayers still might avoid the intended effect of section 535(d) by creating Barbadian corporations in which a small class of voting stock is held primarily by Barbadians, while the majority of the value of the company is represented by non-voting stock held by U.S. persons. Moreover, the same result could be achieved in a case where a Barbadian company is created in which a majority of the value of the stock is held by Barbadians, but a majority of the voting stock is held by U.S. persons.

To appropriately address the concern raised by the Senate in 1985, the provision should be amended so as to provide for the exemption from the accumulated earnings tax to Barbadian companies if individuals (other than U.S. citizens) who are residents of Barbados control, directly or indirectly, throughout the last half of the taxable year, more than 50 percent of the entire voting power *and* value of the company. It may be appropriate for the Committee to clarify this issue by reserving its approval of the proposed protocol with respect to this provision.

III. EXPLANATION OF PROPOSED PROTOCOL

A detailed, article-by-article explanation of the proposed protocol to the income tax treaty between the United States and Barbados is presented below.

Article I. Permanent Establishment

The proposed protocol would replace Article 5 (Permanent Establishment) of the present treaty. The proposed Article 5 is consistent in all but one respect with the permanent establishment article in the U.S. model treaty. The general effect of the amendments contained in the proposed protocol would be to raise the thresholds for the taxation under Article 7 (Business Profits) by one treaty country of the business profits of an enterprise of the other country. The proposed amendments also would be relevant to the provisions of Article 14 (Independent Personal Services) of the existing treaty. Under Article 14, income derived by an individual who is a resident of one of the treaty countries from the performance of personal services in an independent capacity generally may not be taxed by the other country unless the person has a *regular base* available to him in the other country for the purpose of performing his activities. The Treasury Department's technical explanation of the proposed protocol ("Technical Explanation") clarifies that the term "regular base" under Article 14 of the treaty is to be understood by reference to the definition of the term "permanent establishment" in Article 5.

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, an enterprise that is a resident of one treaty 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 the 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 items of income will be taxed as business profits.

In general, under the proposed protocol, a permanent establishment would be a fixed place of business through which the business of an enterprise of one treaty country is wholly or partly carried on in the other country. A permanent establishment would include a place of management, a branch, an office, a factory, a workshop, and a mine, an oil or gas well, a quarry, or any other place of extraction of natural resources.

A permanent establishment also would include any building site or construction or installation project, or an installation or drilling rig or ship used for the exploration or exploitation of natural resources, if the site, project, or activity lasts for more than 183 days in any 12-month period.[3] The Technical Explanation explains that the 183-day period would begin when any work (including preparatory work carried on by the enterprise) physically begins in the country. The 183-day test generally would apply separately to each individual site, project, or rig; however, a series of contracts or projects that are interdependent both commercially and geographically would be treated as a single project for purposes of applying the 183-day threshold. If the 183-day threshold is exceeded, the activity would constitute a permanent establishment from its first day.

The inclusion in the proposed protocol of a 183-day threshold for constitution of a permanent establishment for the above-described activities represents the only difference between the proposed permanent establishment provision and the corresponding article in the U.S. model treaty. Under the U.S. model treaty, a building site, construction or installation project, or installation or drilling rig or ship used for the exploration or exploitation of natural resources constitutes a permanent establishment only if it lasts for more than 12 months.

The illustrative list of items included within the definition of permanent establishment under the proposed protocol differs from that under the present treaty in that the phrase "a store or premises used as a sales outlet" is deleted in the proposed protocol. The deletion of this phrase would conform the provision to the language of the U.S. model treaty, but, according to the Technical Explanation, would not change its application or scope because a store or premises used as a sales outlet would, in any event, be a fixed place or business through which the business of an enterprise is wholly or partly carried on.

In addition, the proposed protocol would delete special threshold tests dealing with dredging projects, the furnishing of services, and the maintenance of substantial equipment or material that are included in the present treaty.[4] These activities would become subject to the normal tests for determining the existence of a permanent establishment, and therefore, to a higher threshold.

As under the existing treaty, the proposed protocol would modify the general rule to provide that a fixed place of business that is

[3] Other recent U.S. income tax treaties, including the current treaty with Barbados, contain similar 183-day permanent establishment thresholds. This is also the threshold supported by the U.N. model treaty.

[4] Under the present treaty, the term permanent establishment includes a dredging project within one country, but only where the project continues there for a period or periods aggregating more than 120 days in any twelve month period (including the period of any supervisory activity connected therewith). A permanent establishment does not exist in any taxable year in which the project or activity continues there for a period or periods aggregating less than 30 days in that year. (Article 5(2)(j).)

In addition, the furnishing of services, including consultancy, management, technical, and supervisory services within one country by an enterprise of the other country through employees or other persons constitutes a permanent establishment if (1) activities of that nature continue within the first country for a period or periods aggregating more than 90 days in a 12-month period, provided that a permanent establishment shall not exist in any taxable year in which such services are rendered in that country for a period or periods aggregating less than 30 days in that year, or (2) the services are performed within that country for an associated enterprise. (Article 5(2)(k).)

The term permanent establishment under the present treaty also includes the maintenance of substantial equipment or machinery within one country, but only if such equipment or machinery is maintained there for a period of more than 120 consecutive days, provided that a permanent establishment shall not exist in any taxable year in which such equipment or machinery is maintained within that country for a period or periods aggregating less than 30 days in that year. (Article 5(2)(l).)

used for any one, or a combination, of a number of specified activities would not constitute a permanent establishment. These activities include the use of facilities solely for storing, displaying, or delivering goods or merchandise belonging to the enterprise and the maintenance of a stock of goods or merchandise belonging to the enterprise solely for storage, display, or delivery, or solely for processing by another enterprise. These activities also include the maintenance of a fixed place of business solely for the purchase of goods or merchandise or for the collection of information for the enterprise. These activities include, as well, the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character (e.g., advertising, supplying information, or conducting scientific activities). The Technical Explanation states that notwithstanding the fact that there are some differences in the descriptive language of the present treaty and the proposed protocol with respect to these activities, the proposed protocol is intended to be alike in substance to the existing treaty.

The proposed protocol provides that if a person has, and habitually exercises, the authority to conclude contracts in a treaty country on behalf of an enterprise of the other country, then the enterprise would be deemed to have a permanent establishment in the first country in respect of any activities which that person undertakes for the enterprise. Consistent with the U.S. model treaty, this rule would not apply where the contracting authority is limited to those activities (described above) such as storage, display, or delivery of merchandise which are excluded from the definition of permanent establishment. The proposed protocol contains the usual provision that the agency rule would not apply if the agent is a broker, general commission agent, or any other agent of independent status acting in the ordinary course of its business. These provisions of the proposed protocol would be more restrictive on the definition of permanent establishment than the corresponding provisions of the existing treaty. Under the existing treaty, for example, when the activities of an independent agent are devoted substantially on behalf of an enterprise, the agent is not considered an independent agent for purposes of the treaty if the transactions between the agent and the enterprise are not made under arm's length conditions.

As is the case under the present treaty, the proposed protocol provides that the determination whether a company of one treaty country has a permanent establishment in the other country would be made without regard to the fact that the company may be related to a company that is a resident of the other country or to a company that engages in business in that other country. Such relationships, thus, would not be relevant; only the activities of the company being tested would be relevant.

Article II. Business Profits

Under the existing treaty, the business profits of an enterprise of one treaty country are taxable only in that country unless the enterprise carries on or has carried on business in the other country through a permanent establishment situated therein. If the enterprise carries on or has carried on business in such a manner, the business profits of the enterprise may be taxed in the other country but only so much of them as is attributable to (1) that permanent establishment, (2) sales in the other country of goods or merchandise of the same or similar kind as those sold through that permanent establishment, or (3) other business activities carried on in the other country of the same or similar kind as those affected through that permanent establishment. This provision is similar to the corresponding provision of the U.N. model treaty. The U.S. model treaty, on the other hand, does not permit the other country to tax the types of income described in the so-called "limited force of attraction" provisions of (2) and (3) above under the business profits article.

The proposed protocol would delete the limited force of attraction feature of this provision and, thus, would conform the provision to that in the U.S. model treaty. That is, in the case of an enterprise of one treaty country that carries on or has carried on business in the other country through a permanent establishment situated therein, the business profits of the enterprise could be taxed in the other country but only so much of them as is attributable to that permanent establishment.

According to the Technical Explanation, the reference in the proposed protocol (and in the existing treaty) to a permanent establishment that "carries on or has carried on" business is intended to incorporate the rule of section 864(c)(6) of the Internal Revenue Code into the treaty. Like the Code section on which it is based, the proposed protocol provides that income attributable to a permanent establishment during its existence would be taxable in the country where the permanent establishment is situated, even if the payments are deferred until after the permanent establishment no longer exists.

Article III. Dividends

Under the existing treaty, dividends paid by a company which is a resident of one treaty country to a resident of the other country may be taxed by the other country. Such dividends may also be taxed by the first country (the "source country"). However, the tax so charged by the source country shall not exceed (a) 5 percent of the gross amount of direct investment dividends (i.e., where the recipient of the dividends is a company that owns at least 10 percent of the voting stock of the company paying the dividends), or (b) 15 percent of the gross amount of the dividends in all other cases.

Under the proposed protocol, the prohibition of source country tax in excess of 5 percent on direct investment dividends would not apply to a dividend from a U.S. Regulated Investment Company (RIC) or Real Estate Investment Trust (REIT). The proposed protocol would allow the United States to impose a 15-percent tax on a U.S. source dividend paid by a RIC to a Barbadian company owning 10 percent or more of the voting shares of the RIC. In addition, the proposed protocol would allow the United States to impose a 15-percent tax on a U.S. source dividend paid by a REIT to an individual resident of Barbados who holds a less than 10 percent interest in the REIT. There would be no limitation, under the proposed protocol, on the tax that may be imposed by the United States on a dividend paid by a REIT to a Barbadian resident if the recipient is either an individual holding a 10-percent-or-greater interest in the REIT, or a company. Such a dividend would, thus, be taxable by the United States, assuming no change in present internal law, at the full 30-percent rate.

Under the existing treaty, a corporation that is a resident of Barbados is exempt from the U.S. accumulated earnings tax if individuals (other than U.S. citizens) who are residents of Barbados control directly or indirectly, throughout the last half of the taxable year, more than 50 percent of the entire voting power of the company. However, the Senate gave its advice and consent to the ratification of the existing treaty in 1985, subject to the reservation that the treaty's reference to "voting power" shall be construed to mean "voting power or value" for purposes of the U.S. accumulated earnings tax. The proposed protocol would amend this provision to conform the treaty's language to the language in the reservation. Thus, the exemption from the U.S. accumulated earnings tax would extend to Barbadian companies more than 50 percent of the entire voting power *or value* of which are owned during the last half of the taxable year by individual residents of Barbados who are not U.S. citizens.

The proposed protocol would also amend the existing treaty by deleting a provision which preserves the right of the United States to impose a second-level withholding tax on dividends paid by a Barbadian company out of profits effectively connected with a business conducted by it in the United States. Under the proposed protocol, where a company that is a resident of one treaty country derives profits or income from the other country, the other country could not impose any tax on the dividends paid by the company, except insofar as such dividends are paid to a resident of that other country or are attributable to a permanent establishment or a regular base situated in that other country.

The Tax Reform Act of 1986 (the "1986 Act") imposed a 30-percent branch profits tax on the dividend equivalent amount for the taxable year of a U.S. branch of a foreign company. Under the Code, the U.S. second-level withholding tax on dividends generally is inapplicable to a corporation subject to the branch profits tax. The proposed protocol contains a separate provision which provides specific guidance relating to the application of the branch profits tax on Barbadian companies. (See detailed discussion of the branch tax (Article VI) below.)

Article IV. Interest

The existing treaty generally allows both the United States and Barbados to tax interest derived from sources within one of the treaty countries and beneficially owned by a resident of the other country. The maximum allowable rate of tax by the source country is 12.5 percent of the gross amount of the interest. The proposed protocol would reduce the maximum allowable rate of source country tax on interest to 5 percent.[5]

[5] An exception to source country taxation of interest provided in the existing treaty would not be altered by the proposed protocol. Under the exception, interest derived from sources in one country and beneficially owned by a resident of the other is exempt from tax at source if the interest is paid in respect of a bond, debenture, or other similar obligation issued, guaranteed, or insured by the Government of the source country or by a political subdivision, local authority, or instrumentality of that Government.

Article V. Royalties

The existing treaty allows both the United States and Barbados to tax royalties arising in one of the treaty countries and paid to a resident of the other country. The maximum allowable rate of tax by the source country is 12.5 percent of the gross amount of the royalties. The proposed protocol would reduce the maximum allowable rate of source country tax on royalties to 5 percent.

Article VI. Branch Tax

The proposed protocol would add a new article to the treaty (Article 13A). This new article would provide guidance with respect to the application of the branch profits and branch-level interest taxes. The United States currently imposes branch profits tax on a Barbadian company, subject to a general rate limitation of 5 percent.[6] The existing treaty preserves, by means of an exception to the provisions under Article 24 (Nondiscrimination), the right of one treaty country to impose branch-level taxes, but does not provide specific guidance regarding their imposition.

The Code, as amended by the 1986 Act, imposes branch-level taxes on foreign corporations earning income effectively connected with the conduct of a U.S. trade or business. The Code provides that no U.S. treaty shall exempt any foreign corporation from the branch profits tax (or reduce the amount thereof) unless the foreign corporation is a "qualified resident" of the treaty country.

The Code defines a "qualified resident" as any foreign corporation that is a resident of a treaty country, if it can meet either of the following two tests. First, any foreign corporation resident in a treaty country is a qualified resident of that country unless (1) 50 percent or more (by value) of the stock of the corporation is owned (directly or indirectly within the meaning of Code section 883(c)(4)) by individuals who are not residents of the treaty country and who are not U.S. citizens or resident aliens, or (2) 50 percent or more of its income is used (directly or indirectly) to meet liabilities to persons who are not residents of the treaty country or the United States. Second, a foreign corporation resident in a treaty country is a qualified resident if the stock of the corporation is primarily and regularly traded on an established securities market in the treaty country, or if the corporation is wholly owned (either directly or indirectly) by another foreign corporation which is organized in the treaty country and the stock of which is so traded, or is wholly owned by a U.S. corporation whose stock is primarily and regularly traded on an established securities market in the United States.

The proposed protocol provides that a company which is a resident of one treaty country may be subject in the other country to a tax in addition to the tax allowable under the other provisions of the treaty. In the case of the United States, that tax may be imposed only on two amounts. One amount is the "dividend equiva-

Also, the staff understands that although the proposed treaty would provide for a rate of source country withholding tax on interest which is lower than the rate prescribed in the present treaty, the 1986 statutory override of treaties relating to tax on excess inclusions with respect to residual interests in U.S. Real Estate Mortgage Investment Conduits (REMICs) would remain applicable. Thus, under the U.S.-Barbados treaty (as amended by the proposed protocol), a resident of Barbados that receives such an excess inclusion from a U.S. REMIC would be subject to 30-percent gross-basis U.S. tax on the excess inclusion.

[6] Treas. Reg. sec. 1.884-1T(h)(4)(i)(B).

lent amount" of the business profits of the company which are effectively connected (or treated as effectively connected) with the conduct of a trade or business in the United States and which are either attributable to a permanent establishment in the United States or subject to tax in the United States under Article 6 (Income from Real Property) or Article 13 (Gains) of the existing treaty.[7] The other amount is the excess, if any, of interest deductible in the United States in computing the profits of the company that are subject to tax in the United States and are either attributable to a permanent establishment in the United States or subject to tax in the United States under Article 6 or Article 13 of the existing treaty, over the interest paid by or from the permanent establishment or trade or business in the United States. According to the Technical Explanation, it is understood by the two treaty countries that "interest paid" for this purpose would be determined without regard to capitalized interest.

In the case of Barbados, such tax may be imposed only on two similar amounts. One amount is the amount sufficient to provide that a branch in Barbados of a United States company (or a U.S. company otherwise taxable on net income in Barbados) is taxed in a manner comparable to a similarly situated Barbadian company and its United States shareholder. The other amount is the amount of interest expenses that are deductible for computing the income of a U.S. company subject to net-basis Barbadian tax over the interest paid by or from the permanent establishment or trade or business in Barbados.

The proposed protocol would limit the rate of branch tax that may be imposed by the two countries. Under the proposed protocol, a treaty country may not impose a branch profits tax at a rate exceeding the rate specified under the treaty for taxes on direct investment dividends (i.e., 5 percent). Similarly, a treaty country may not impose a branch-level interest tax at a rate exceeding the rate specified under the treaty (as amended by the proposed protocol) for taxes on interest (i.e, generally 5 percent).

Article VII. Limitation on Benefits

The proposed protocol would delete Article 22 (Limitation on Benefits) of the existing treaty and replace it with new provisions placing limitations on treaty benefits. The purpose of the limitation on benefits article is to limit the benefits provided under the treaty to persons who are entitled to those benefits by reason of their residence in the United States or Barbados. The proposed provision would be similar to the limitation on benefits articles included in

[7] The term "dividend equivalent amount" is not defined in either the existing treaty or the proposed protocol. It is, thus, to be defined in accordance with applicable U.S. internal law (i.e., Code section 884(b) and regulations thereunder), as the term may be amended from time to time without changing the general principle thereof. Generally, the dividend equivalent amount is the earnings and profits of a U.S. branch of a foreign corporation attributable to its income effectively connected (or treated as effectively connected) with a U.S. trade or business, subject to two adjustments. These adjustments identify changes in a branch's U.S. net equity (i.e., the difference between a branch's assets and liabilities treated as connected with a U.S. trade or business) that reflect profit remittances during a taxable year. The first adjustment reduces the tax base to the extent the branch's earnings are reinvested in trade or business assets in the United States (or reduce U.S. trade or business liabilities). The second adjustment increases the tax base to the extent prior reinvested earnings are considered to be withdrawn from the U.S. trade or business—e.g., by remittances to the home office of the foreign corporation.

other recently ratified U.S. income tax treaties (e.g., the U.S.-Germany treaty).

The treaty is intended to limit double taxation caused by the interaction of the tax systems of the United States and Barbados as they apply to residents of the two countries. At times, however, residents of third countries attempt to use a treaty. Such use is known as "treaty shopping," and refers to the situation where a person who is not a resident of either treaty country seeks certain benefits under the income tax treaty between the two countries. Under certain circumstances, and without appropriate safeguards, the nonresident is able indirectly to secure these benefits by establishing a corporation (or other entity) in one of the treaty 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 reduce the income base of the treaty country resident by having the latter pay out interest, royalties, or other amounts under favorable conditions (i.e., it may be possible to reduce or eliminate the taxes of the resident company by distributing its earnings through deductible payments or by avoiding withholding taxes on the distributions) either through relaxed tax provisions in the resident country or by passing the funds through other treaty countries (essentially, continuing to treaty shop), until the funds can be repatriated under favorable terms.

Under the proposed protocol, a person that is a resident of one of the treaty countries and derives income from the other country would be entitled in that other country to all the benefits of the treaty (as amended by the proposed protocol) only if the person satisfies any one of a list of qualifications set forth in the proposed protocol. The proposed protocol provides that persons meeting the necessary qualifications would include individual residents of either the United States or Barbados and the governments of the two countries, or any political subdivision or local authority thereof. In addition, a person would not be subject to limitation on treaty benefits if it satisfies any one of (1) an active business test, (2) a public company test, or (3) an ownership and "base erosion" test, or if it is a not-for-profit entity that meets certain standards set forth in the proposed protocol.

A person would be considered to satisfy the active business test if it is engaged in the active conduct of a trade or business in its country of residence and the income derived from the other country is derived in connection with, or is incidental to, that trade or business. For this purpose, the business of making or managing investments generally would not qualify as an active trade or business unless the activities are banking or insurance activities carried on by a bank or insurance company. This active trade or business rule differs from a more general rule in some earlier U.S. income tax treaties that preserves benefits if an entity is not used "for a principal purpose of obtaining benefits" under a treaty. This particular provision of the proposed protocol is similar to provisions contained in other more recent U.S. income tax treaties (e.g., the income tax treaty between the United States and Germany).

The Technical Explanation specifies that upon satisfaction of any of the other tests set forth in this article, any income derived by the beneficial owner would be entitled to treaty benefits. By contrast, the active business test would be an item-of-income by item-of-income test, and, therefore, each item of income earned by the taxpayer would have to be tested separately.

Under the public company test, a company that is a resident of one of the treaty countries and in whose principal class of shares there is substantial and regular trading on a recognized securities exchange would be entitled to the benefits provided under the treaty regardless of where its actual owners reside. The term "recognized securities exchange" means any stock exchange registered with the Securities and Exchange Commission as a national securities exchange for purposes of the Securities Exchange Act of 1934, the NASDAQ system owned by the National Association of Securities Dealers, Inc., and any other securities exchange agreed upon by the competent authorities of the two treaty countries.

Under the ownership and base erosion test, two conditions would have to be satisfied. First, more than 50 percent of the beneficial interest in the person (in the case of a company, more than 50 percent of the number of shares of each class of shares) must be owned directly or indirectly by any combination of one or more individual residents of Barbados or the United States, citizens of the United States, the governments of the United States or Barbados, companies meeting the publicly traded test described above, or persons meeting the not-for-profit entity test described below.[8] This provision would, for example, deny the benefits of the reduced U.S. withholding tax rates on dividends, interest, and royalties paid to a Barbadian company that is controlled by individual residents of a third country. This rule is not as strict as that contained in one proposed U.S. model version of an anti-treaty shopping provision, which requires 75 percent ownership by residents of the person's country of residence to preserve benefits. It is, however, consistent with most recent U.S. income tax treaties.

Second, treaty benefits would be available only if more than 50 percent of the gross income of the person is not used directly or indirectly to meet liabilities (including liabilities for interest or royalties) to persons listed in the preceding paragraph. This rule is commonly referred to as the "base erosion" rule and is necessary to prevent a corporation, for example, from distributing most of its income through the use of deductible payments to persons not entitled to benefits under the treaty. According to the Technical Explanation, gross income for this purpose is understood to mean gross income as defined in the Internal Revenue Code of 1986, as amended. Thus, in general, the term is understood to mean gross receipts less cost of goods sold.

The proposed protocol provides that a not-for-profit organization that is a resident of one of the treaty countries would be entitled to treaty benefits if it satisfies two conditions: (1) It generally must be exempt from tax in its country of residence by virtue of its not-for-profit status, and (2) more than 50 percent of the beneficiaries,

[8] Under the existing treaty, a resident company fails the ownership test, and benefits are therefore denied, if 50 percent or less of the number of shares of *each class* of the company's shares is owned by U.S. or Barbadian residents, or U.S. citizens. Thus, assuming that the base erosion test is met, it may be that the ownership of more than half of only one of the company's classes of shares by U.S. or Barbadian residents would be sufficient to meet this ownership test. Under the proposed protocol, such ownership of only one class would not be sufficient to meet the ownership test.

members, or participants, if any, in the organization must be persons entitled to benefits under the treaty. The Technical Explanation states that organizations covered by this rule would include pension funds, pension trusts, private foundations, trade unions, trade associations, and similar organizations.

The proposed protocol provides that a person that is not entitled to treaty benefits because it does not satisfy any of the above criteria could, nevertheless, be granted benefits under the treaty if so determined by the competent authority of the country in which the income in question arises. In addition, the proposed protocol provides that the competent authorities of the two treaty countries will consult with one another with a view to developing a commonly agreed application of the provisions of the article on limitation on benefits. Moreover, the competent authorities would be mandated, in accordance with the provisions of Article 26 (Exchange of Information) of the existing treaty, to exchange such information as is necessary for carrying out the provisions of the limitation on benefits article and for safeguarding, in cases envisioned therein, the application of their respective domestic laws.

A Memorandum of Understandings (the "Memorandum") regarding the scope of the proposed limitation on benefits article was exchanged by the United States and Barbados on the same day the proposed protocol was signed, elaborating on the business connection rule and on the competent authority discretion included in the proposed protocol. The Memorandum indicates how certain provisions of the proposed protocol are to be understood both by the competent authorities and by taxpayers in the two treaty countries. It provides several examples of situations in which the good business purpose test would be considered to be met and one example where it would be considered not to be met. Under one example, the Memorandum states that U.S. source interest income on short-term investments of earnings, retained as working capital, of an active Barbadian business carried on by a Barbadian company, is incidental to the Barbadian business and, therefore, would be eligible for treaty benefits on that basis. As another example, the Memorandum states that if a third-country resident establishes a Barbadian company for the purpose of acquiring a large U.S. manufacturing company, and the Barbadian company's only other activity is the operation of a small retailing outlet which sells products manufactured by the U.S. company, dividends from the U.S. company would not be entitled to benefits under the treaty. In this case, despite an arguable business connection between the U.S. and Barbadian businesses, the active Barbadian business is not substantial in relation to the business of the U.S. subsidiary.

The Memorandum also provides guidance relating to the provision of the limitation on benefits article of the proposed protocol which would permit a person that does not satisfy any of the specific tests set forth in the proposed protocol to still obtain treaty benefits if the competent authority of the country in which the income in question arises so determines. The Memorandum states that it is anticipated that in the vast majority of cases, eligibility for treaty benefits would be determinable without resorting to competent authorities. The authorities could, of course, in reviewing a case, determine that the taxpayer has improperly interpreted the provisions of paragraph 1 of the limitation on benefits article, and that benefits should not have been claimed.

Under the Memorandum, it is assumed that, for purposes of implementing the provision which would permit the competent authorities to grant treaty benefits, taxpayers would be permitted to present their cases to the competent authority for an advance determination based on the facts, and would not be required to wait until the tax authorities of one of the countries have determined that benefits are denied. In these circumstances, the Memorandum states that it also is expected that if a competent authority determines that benefits are to be allowed, they would be allowed retroactively to the time of entry into force of the relevant treaty provision or the establishment of the structure in question, whichever is later.

In making such determinations, it is understood by the two countries that the competent authorities would take into account all relevant facts and circumstances. The factual criteria which the competent authorities would be expected to take into account include the existence of a clear business purpose for the structure and location of the income earning entity in question; the conduct of an active trade or business (as opposed to a mere investment activity) by such entity; and a valid business nexus between that entity and the activity giving rise to the income. Moreover, the Memorandum states that the competent authorities would consider, for example, whether and to what extent a substantial headquarters operation conducted in one of the countries by employees of a resident of that country contributes to such valid business nexus, and should not, therefore, be treated merely as the making and managing of investments.

The Memorandum further states that the discretionary authority granted to the competent authorities under the proposed protocol would be particularly important in view of, and should be exercised with particular cognizance of, the developments in, and objectives of, international economic integration, such as that among the member countries of the CARICOM and under the proposed North American Free Trade Agreement.

In addition, the Memorandum sets forth an example to illustrate the principles described above. Under the example, companies organized under the laws of Barbados, Jamaica, and Antigua, each of which is engaged directly or through its affiliates in active business operations in its country of residence, decide to cooperate in the development and marketing of a new computer spreadsheet program through a joint venture formed as a Barbadian corporation. The development and marketing aspects of the project are carried out by the individual joint venturers. The joint venture company, which is staffed with a significant number of managerial and financial personnel seconded by the joint venturers, acts as the general headquarters for the joint venture, responsible for the overall management of the project including coordination of the functions separately performed by the individual joint venturers on behalf of the joint venture company, development of sales strategies, and the investment of working capital contributed by the joint venturers and the financing of the project's additional capital requirements through public and private borrowings. The joint venture company derives portfolio investment income from U.S. sources generated by working capital investments.

In analyzing the facts of the example, the Memorandum provides that if the joint venture company's activities constitute an active trade or business and the U.S. source investment income is connected to that business, benefits would be allowed under the proposed protocol's good business purpose test. If, however, the activities do not constitute an active trade or business, the Memorandum states that it is expected that the U.S. competent authority would determine that treaty benefits should be allowed under the facts presented, particularly in view of (1) the clear business purpose for the formation and location of the joint venture company; (2) the significant headquarters functions performed by that company in addition to financial functions; and (3) that fact that all of the joint venturers are companies resident in CARICOM member countries in which they are engaged directly or through their affiliates in substantial active business operations.

Finally, the Memorandum of Understanding states that the competent authorities will consult further on these issues and develop additional standards for the application of the limitation on benefits article as they gain experience with the application of these rules.

Article VIII. Entry Into Force

The proposed protocol would enter into force upon the exchange of instruments of ratification. It would be effective with respect to taxes imposed in accordance with Article 10 (Dividends), Article 11 (Interest), and Article 12 (Royalties) for amounts paid or credited on or after the first day of the second month next following the date on which the proposed protocol enters into force. It would be effective with respect to other taxes for taxable years beginning on or after the first day of January next following the date on which the proposed protocol enters into force.

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