[JOINT COMMITTEE PRINT]

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

SCHEDULED FOR A HEARING

BEFORE THE

COMMITTEE ON FOREIGN RELATIONS
UNITED STATES SENATE

ON JULY 30, 1985

PREPARED BY THE STAFF

OF THE

JOINT COMMITTEE ON TAXATION

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INTRODUCTION

This pamphlet[1] provides an explanation of the proposed income tax treaty between the United States and Barbados. The proposed treaty was signed on December 31, 1984, and was amplified by an exchange of notes signed the same day. The Senate Committee on Foreign Relations has scheduled a public hearing on the proposed treaty on July 30, 1985.

The proposed treaty is the first income tax treaty to be negotiated between the United States and Barbados. An extension to Barbados of the 1945 income tax treaty between the United States and the United Kingdom, under the second protocol to that treaty (ratified in 1955), was terminated by the U.S. Treasury Department, effective January 1, 1984, along with extensions of that treaty to 14 other former colonies and territories of the United Kingdom. On November 3, 1984, the United States and Barbados signed an exchange of information agreement satisfying the criteria set forth in the Caribbean Basin Economic Recovery Act of 1983 (the Caribbean Basin Initiative).

The proposed treaty is similar to other recent U.S. income tax treaties, the 1981 proposed U.S. model income tax treaty ("U.S. model treaty"), and the model income tax treaty of the Organization for Economic Cooperation and Development ("OECD model treaty"). However, there are certain deviations from those documents. Some of the treaty's provisions are based on articles of the model treaty developed by the United Nations for use between developed and developing countries ("U.N. model treaty").

The first part of the pamphlet summarizes the principal provisions of the proposed treaty. The second part presents a discussion of issues raised by the proposed treaty. The third part provides an overview of U.S. tax laws relating to international trade and investment and U.S. tax treaties in general. This is followed in part four by a detailed explanation of the proposed treaty.

[1] This pamphlet may be cited as follows: Joint Committee on Taxation, *Explanation of Proposed Income Tax Treaty Between the United States and Barbados* (JCS-31-85), July 29, 1985.

I. SUMMARY

In General

The principal purposes of the proposed income tax treaty between the United States and Barbados 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 7 and 14). 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 14, 15, and 17). The proposed treaty provides that dividends, interest, royalties, capital gains, and certain other income derived by a resident of either country from sources within the other country generally may be taxed by both countries (Articles 10, 11, 12, and 13). Generally, however, dividends, interest, and royalties received by a resident of one country from sources within the other country are to be taxed by the source country on a restricted basis (Articles 10, 11, and 12).

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.

Like other U.S. tax treaties, the proposed treaty contains a "saving clause." Under this provision, the United States retains the right to tax its citizens and residents as if the treaty had not come into effect. 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; that is, the treaty will only be applied to the benefit of taxpayers.

Differences in proposed treaty and model treaty

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) The proposed treaty prohibits the United States from imposing its accumulated earnings tax on Barbadian companies that are controlled by individual residents of Barbados (who are not U.S. citizens), or on Barbadian companies that manufacture approved products under Barbados' investment incentive legislation. The accumulated earnings tax is not a covered tax under the U.S. model treaty, and its imposition is therefore not limited by the model.

(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) U.S. citizens who are not also U.S. residents are not generally covered by the treaty. The U.S. model does cover such U.S. citizens. However, the United States has rarely been able to negotiate coverage for nonresident citizens.

(4) The definition of a permanent establishment in the proposed treaty is broader than that in the U.S. model and in many existing U.S. treaties. The principal areas in which the proposed treaty departs from the U.S. model are the inclusion as a permanent establishment of a sales outlet; a building site, a construction, assembly, or installation project, or a drilling rig or ship, if the site, project, or activity continues for more than 183 days in a twelve-month period (rather than the U.S. model's 12 months); a dredging project lasting more than 120 days in a twelve-month period; and the maintenance of substantial equipment or machinery for more than 120 consecutive days. In addition, engaging in supervisory activities in connection with building sites, construction projects, drilling rigs, etc. for more than 183 days in a twelve-month period, or furnishing services through employees or other persons for more than 90 days in a twelve-month period or for an associated enterprise would create permanent establishment status under the proposed treaty but not under the U.S. model. An independent agent of an enterprise will constitute a permanent establishment under the proposed treaty if the agent's activities are devoted substantially on behalf of that enterprise and the transactions between the agent and the enterprise are not made under arm's-length conditions; the U.S. model does not contain this rule though a few U.S. treaties with developing countries do.

(5) The proposed treaty differs from the U.S. model in not providing investors in real property in the country not of their residence with an election to be taxed on such investments on a net basis. However, current U.S. law allows such an election and Barbadian law provides foreign persons with such treatment.

(6) The proposed treaty departs from the U.S. model treaty's definition of "business profits" by excluding income from the rental or license of films or tapes. Instead, such income is treated as royalties. Thus, such income will be taxable in the source country on a

gross basis (at a reduced rate), rather than on a net basis as business income.

(7) The proposed treaty provides that to the extent that it has customarily done so a country may determine business profits attributable to a permanent establishment on the basis of an apportionment of the worldwide profits of the enterprise, if the result is in accordance with the principles contained in the business profits article. Most recent U.S. income tax treaties and the U.S. model treaty do not contain this provision, which is drawn from the OECD and U.N. models. Staff is informed that Barbados has customarily imposed tax on the premium income of nonresident insurers or foreign insurance companies by apportioning worldwide profits based on the ratio of premiums earned in Barbados to worldwide premiums.

(8) The proposed treaty departs from the U.S. model treaty's business profits article in two other ways. First, business profits can be attributed to a permanent establishment if they are derived from sales or other activities similar to those effected through the permanent establishment (even if not carried out by the permanent establishment). Second, the proposed treaty specifies that a country may tax business profits that are properly attributable to a permanent establishment, even after the permanent establishment has ceased to exist.

(9) The proposed treaty generally limits the tax at source on gross interest to 12.5 percent; interest paid by the governments of the countries (including political subdivisions), or by others on debt-claims guaranteed or insured by the governments is exempt from source country tax. Under the U.S. model, by contrast, interest is generally exempt from source country withholding 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, Barbadian 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 Barbadian tax (limited to 12.5 percent by the treaty) on Barbadian source interest on similar indebtedness.

(10) The proposed treaty generally limits the tax at source on gross royalties, including movie royalties, to 12.5 percent. The U.S. model exempts royalties from source country tax.

(11) The proposed treaty limitation on source country withholding tax on royalties paid to residents of the other country applies, by its terms, only if the recipient of the income is also its beneficial owner. Under the U.S. model treaty, by contrast, this limitation on source country withholding tax generally applies so long as the beneficial owner of the income resides in the nonsource country; in that case, initial receipt of the income by an intermediary that is not the beneficial owner is irrelevant.

The proposed treaty language is similar to that of the OECD model treaty. Read literally, the proposed treaty language permits royalties received from sources in one country by an agent for the licensor (or other beneficial owner of the royalty) to be taxed fully by the source country even though the beneficial owner resides in the other treaty country. The commentaries on the OECD model indicate, however, that this language should not be interpreted to deny the reduced source country withholding tax rates to royalty payments received by a nominee or other agent of the licensor when the licensor is a resident of the nonsource country. Staff is informed by the Treasury Department that the countries intend the language to be interpreted in a manner consistent with the OECD commentaries.

(12) The proposed treaty allows source country taxation of independent personal services income if the worker is present in the source country for more than 90 days in a taxable year, or earns more than $5,000 in a taxable year. The U.S. model treaty does not allow taxation of such income on those bases. 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.

(13) The proposed treaty allows source country taxation of dependent personal services income if the worker earns more than $5,000 in a calendar year. The U.S. model looks solely to the worker's presence in the source country and the status of the employer (resident or permanent establishment in the source country), and thus does not permit taxation of dependent personal services income on the basis of a dollar threshold.

(14) The proposed treaty allows directors' fees derived by a resident of one country, in his capacity as a member of the board of directors of a company which is a resident of the other country, to be taxed in that other country if the fees are for services rendered in that other country. The U.S. model treaty, on the other hand, treats directors' fees as personal service income or as a distribution of profits. Under the U.S. model treaty (and the proposed treaty), the country where the recipient resides generally has primary taxing jurisdiction over personal service income, and the source country tax on distributed profits is limited.

(15) Under the proposed treaty, source country taxation of income derived by entertainers and athletes from their activities as such is permitted if the income exceeds $250 a day or $4,000 in a taxable year. Under the U.S. model treaty, entertainers and athletes may not be taxed in the source country unless they earn more than $20,000 there during a taxable year. Most U.S. income tax treaties follow the U.S. model approach, although with a lower annual income threshold for taxation than the U.S. model contains.

(16) The proposed treaty permits a student or apprentice from one country who is studying in the other country to elect to be taxed as a resident of the host country, as an alternative to the general treaty rule exempting such persons from tax in the host country on payments received from outside the host country for education and maintenance. The U.S. model treaty does not provide such an election.

(17) The proposed treaty allows the source country to tax any income not otherwise specifically dealt with under the treaty. This rule applies even if the country of residence does not tax the income. 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 treaties.

(18) The proposed treaty's anti-treaty shopping provision differs from that of the U.S. model treaty. (See discussion under "Issues," Part II, below.)

(19) Income derived by a resident of one country that may be taxed in the other country under the proposed treaty is deemed to arise in that other country for purposes of the double taxation relief article of the proposed treaty. However, the proposed treaty omits the U.S. model provision stating that this source rule does not apply in determining foreign tax credits for foreign taxes paid by U.S. residents to third countries. The effect of this omission in this case appears limited, since application of the special source rule is at the outset limited to "relief from double taxation pursuant to this Article."

(20) The proposed treaty's non-discrimination provision differs from the U.S. model treaty's in several ways. First, it protects all legal persons deriving their status as such from the United States, rather than U.S. citizens alone, thus broadening the article. Second, it prohibits discrimination only with respect to taxes covered by the treaty, rather than all taxes, thus narrowing the article. Third, it specifies that Barbados' branch profits and foreign insurance company taxes are not prohibited by the non-discrimination rule, and that the United States may (similarly) impose a branch-level tax without contravening the non-discrimination rule.

(21) The proposed treaty generally requires persons seeking competent authority relief (under the mutual agreement procedure) to apply to the country of which they are residents. Only with respect to non-discrimination claims may a person apply to the authority of the country of which he or she is a national (but not a resident). Under the U.S. model treaty, a national may apply for relief under any provision of the treaty, not just the non-discrimination article.

(22) The proposed treaty's exchange of information provision generally follows that of the U.S. model, but is somewhat narrower in scope. The U.S. model treaty provides for the exchange of information relating to taxes of every kind imposed by the two countries. The proposed treaty provides for the exchange of information, in the case of Barbadian taxes, relating only to taxes covered by the treaty. However, in the case of U.S. taxes, the article does cover the full range of taxes imposed under the Internal Revenue Code. The U.S. model treaty provides that each country will collect taxes for the other country to the extent necessary to insure that benefits of the treaty are not going to persons not entitled to those benefits. The proposed treaty does not contain this collection rule. The proposed treaty contains the additional statement, not found in the U.S. model, that the competent authorities will develop conditions, methods, and techniques concerning the matters respecting which exchange of information will be carried out.

(23) The proposed treaty's rules regarding its entry into force differ from the U.S. model, in that they provide that the treaty will be retroactively effective as of January 1, 1984. The previous treaty with Barbados was terminated by the United States as of that date, so this rule would repair a lapse in treaty coverage of U.S. companies operating in Barbados and U.S. individuals working there.

II. ISSUES

The proposed treaty raises the following specific issues.

(1) Accumulated earnings tax—vote or value

Because the proposed treaty does not take into account recent amendments to the U.S. accumulated earnings tax, it appears to override that tax in an unanticipated manner that could invite abuse.

Code section 535(d) was added by the Deficit Reduction Act of 1984 to preserve the accumulated earnings tax with respect to U.S. income received by a U.S.-owned foreign corporation. Section 535(d) applies if U.S. shareholders own a majority of the voting power or value of stock in a foreign corporation.

The proposed treaty provides that a company which is a resident of Barbados will be exempt from 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. If this treaty rule were applied on the basis of voting power alone, a conflict with section 535(d) could arise; section 535(d) would be overridden by the treaty in cases where Barbadian shareholders held a majority of the voting power of stock in a Barbadian corporation, even if U.S. shareholders held a majority of the value of the stock (and thus section 535(d) would otherwise apply). U.S. taxpayers could avoid the intended effect of section 535(d) by creating Barbadian corporations in which a small class of voting stock was primarily held by Barbadians, while the majority of the value of the company was represented by non-voting stock held by U.S. persons. Thus, U.S. taxpayers could accumulate U.S. source income in a Barbadian corporation, thereby avoiding current U.S. tax. It may be appropriate for the Committee to reserve its approval of the proposed treaty with respect to this issue, to ensure that the matter is clarified.

(2) Developing country concessions

The proposed treaty contains a number of developing country concessions. Many of these concessions are found in the United Nations model income tax treaty for use between developed and developing countries, and in other U.S. tax treaties with developing countries.

First, the proposed treaty departs significantly from the U.S. and OECD model treaties in providing for relatively broad source basis taxation. The proposed treaty's permanent establishment clause, for instance, 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 U.S. or OECD model treaty. Under the proposed treaty, the use of a drilling rig in a country for more than

183 days creates a permanent establishment there; under the U.S. model, drilling rigs must be present for at least one year. Thus, under the proposed treaty, business profits attributable to a U.S. drilling rig located in Barbadian waters, for example, will be taxable by Barbados if the rig stays there for more than six months. Certain construction activities create a permanent establishment under the proposed treaty if they continue in a country for more than 183 days, in contrast with the 12-month threshold in the U.S. model. Also, under the proposed treaty, unlike the U.S. model, the performance of certain supervisory services in connection with building sites, etc., or the performance of certain consulting and other services though personnel engaged by an enterprise for that purpose (even if the enterprise has no fixed place of business in the country of performance) can, by itself, create a permanent establishment. The practical effect of these rules could be to allow more Barbadian taxation of U.S. mineral exploration activities, construction activities, and consulting services carried out in Barbados than would be permitted under the U.S. model's provisions.

In addition, a nominally independent agent of an enterprise may constitute a permanent establishment of that enterprise under the proposed treaty if the agent's activities are devoted substantially on behalf of that enterprise and the dealings between the agent and the enterprise are not at arms length. The U.S. model does not contain this rule, although a few other U.S. treaties with developing countries do.

Other concessions to source basis taxation in the proposed treaty include maximum rates of source country tax on interest and royalties (but not dividends) that are higher than those provided in the U.S. model treaty and some existing U.S. treaties; 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 source-country taxation rules for independent personal services income, dependent personal services income, directors' fees, and entertainers' income that are all broader than those contained in 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, certain administrative assistance requirements contained in the U.S. model and many existing U.S. income treaties have been omitted from the proposed treaty. As previously discussed, the treaty prohibits the United States from imposing its accumulated earnings tax on Barbadian companies that are controlled by individual residents of Barbados (who are not U.S. citizens). It also prohibits imposition of the tax on manufacturing companies operating under Barbados' investment incentive regime.

The issue is whether these developing country concessions are appropriate U.S. treaty policy and, if so, whether Barbados is an appropriate recipient of these concessions. The concessions acknowledge Barbados' status as a capital importing country. Some or all of the concessions are arguably necessary in order to obtain treaties with developing countries such as Barbados. 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; in general, uncertainty regarding the foreign taxation of U.S. investors has been a significant problem for U.S. investors. An income tax treaty with Barbados also may be desirable for non-tax reasons, such as the promotion of development in Barbados through increased U.S. investment there rather than through direct economic assistance. On the other hand, 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 similar concessions.

As one of its developing country concessions, the proposed treaty defines a permanent establishment to include a dredging project that continues for more than 120 days in a twelve-month period. This treatment contrasts with the general 183-day permanent establishment rule of the proposed treaty. In its 1984 report on the income tax treaty with Canada, the Senate Committee on Foreign Relations expressed its view that the permanent establishment threshold for drilling contractors should be the same as that provided for enterprises engaged in construction activities.[2] The proposed treaty presents a similar issue as to whether unequal treatment for dredging activities is appropriate. On the one hand, it might be argued that a consistent rule should apply to construction, drilling, and dredging operations. On the other hand, it might be argued that sufficient differences exist between the first two activities and dredging activities to justify different thresholds for taxation, just as different thresholds are provided for such other activities as personal services and equipment rental. In addition, it might be argued that this treatment must be viewed in the context of an overall agreement containing reciprocal concessions that benefit a broad range of U.S. taxpayers and the United States. Staff is informed that the Treasury Department is not aware of any dredging activity being conducted by U.S. persons in Barbadian waters.

(3) 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 tax reductions and tax exemptions provided in 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 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 sub-

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[2] Tax Convention and Proposed Protocols with Canada, Report of the Senate Committee on Foreign Relations, Exec. Rpt. No. 98-22. May 21, 1984, p. 7-8.

sidiary, 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.

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. For example, 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 provision of the proposed treaty differs from the anti-treaty shopping provision of the current U.S model. While the U.S. model provision is only one of several approaches that the Treasury Department considers satisfactory to prevent treaty shopping abuses, the model provision is nonetheless a standard against which to compare the proposed treaty's anti-treaty shopping provision. The issue, then, is whether the proposed anti-treaty shopping provision effectively forestalls potential treaty shopping abuses.

One provision of the anti-treaty shopping article of the proposed treaty is more lenient than the comparable rule in the 1981 U.S. model and other U.S. treaties. The U.S. model 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 treaty (like several newer treaties) 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 is considerably easier to enter, under the proposed treaty. 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 anti-treaty shopping article differs from the comparable rule of the U.S. model, but the effect of the change is less clear. The general test applied by the U.S. model to deny benefits is a broad one, looking to whether the acquisition, maintenance, or operation of an entity had "as a principal purpose obtaining benefits under" the treaty. By contrast, the proposed treaty contains a more precise test that allows 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 does not apply with respect to a business of making or managing investments, so benefits can be denied with respect to such a business regardless of how actively it is conducted.) The practical difference between the two tests will depend upon how they are interpreted and applied. The principal purpose test may be applied leniently (so that any colorable business purpose suffices to preserve treaty benefits), or it may be applied strictly (so that any significant intent to obtain treaty benefits suffices to deny them). Similarly, the active trade or business test could be interpreted to require 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 be stricter than a broad reading of the active business test (i.e., would operate to deny benefits in potentially abusive situations more often).

However, the IRS may find it relatively difficult to sustain a narrow reading of the principal purpose test. (In litigation involving Code section 367, for example, which utilized a principal purpose test until 1985, courts have consistently refused to apply this test to transactions where taxpayers could claim any business purpose.) Given that possibility, it may well be that the test contained in the proposed treaty will prove stricter than that in the U.S. model treaty.

Finally, the proposed treaty's active trade or business exception does not apply to a person engaged in a banking or insurance business whose income is taxed in its country of residence at a rate substantially below the rate generally applicable to business income in that country. The comparable rule in the U.S. model treaty is not limited to banking and insurance businesses. It may be argued that this formulation of the rule is logical, since banking and insurance are the activities granted reduced rates of tax by Barbados that would best lend themselves to treaty-shopping abuses. The reduced rate of tax afforded under certain industrial development incentives, by contrast, would probably not lend itself to treaty-shopping abuse, since those incentives require substantial business operations, while treaty shopping involves the movement of passive income through a conduit entity in a treaty country. On the other hand, Barbados could amend its laws in the future to provide reduced rates of tax for other types of foreign income (not covered by this provision) that could lend themselves to treaty shopping abuses (e.g., passive royalty income).

The proposed treaty also provides an exception that preserves benefits for publicly traded companies.

The United States should maintain its policy of limiting treaty shopping opportunities whenever possible. Although drafted to limit foreseeable cases of abuse, the anti-treaty shopping provision of the proposed treaty may not prevent all potential unintended uses of the treaty by third-country investors. Treaty shopping possibilities in Barbados at present appear relatively limited. In general, Barbadian taxes on foreign investors and foreign income are relatively high, with the exception of the incentive regimes that are specifically addressed by the proposed treaty's anti-treaty shopping rule. Interest and dividend payments to foreign enterprises are subject to withholding tax (although at reduced rates under several treaties). On the other hand, there is no guarantee that the present impediments to use of the proposed treaty by third-country investors will continue in the future. Changes in Barbadian law and administrative practice with respect to foreign investors could occur. Experience has shown that if abuses develop after a treaty is ratified it is very difficult to negotiate solutions. Thus, the Committee should be satisfied that the provision as proposed is an adequate deterrent of possible treaty-shopping abuses in the future.

(4) 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 and interest they derived from 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 Barbados only "[i]n accordance with the provisions and subject to the limitations of the law of the United States (as it may be amended from time to time without changing the general principle hereof)" (Article 23, paragraph 1). The proposed treaty also provides that "[f]or the purposes of allowing relief from double taxation pursuant to this article," any income of a resident of one country (who is not a resident of the other country) that the other country can tax will be deemed to arise in the country that can tax the income (Article 23, paragraph 3).

The issue is whether the proposed treaty allows the 1984 change to the foreign tax credit limitation 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 would control it and the proposed treaty would not prevent operation of the change. 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 the 1984 change is read as a source rule for purposes of the proposed treaty, then the proposed treaty would prevent operation of the change. The argument for this latter view is that the language in paragraph 3 relates to the U.S. obligation to credit Barbadian taxes, and that it means nothing unless it obligates the United States to credit taxes on income that the *treaty* treats as foreign source income. Thus, the proposed treaty might make payments from a Barbadian corporation to a U.S. person Barbadian source, even if the Barbadian 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 ensure that report language and Treasury's technical explanation clarify the retention of the 1984 changes to the Code.

The proper operation of the resourcing provision may be particularly important in the case of Barbados. Barbados has sought to promote itself as a center for the insurance of non-Barbadian risks. One of the principal problems that the resourcing provisions of the 1984 Act addressed was the insurance of U.S. risks by foreign corporations owned by U.S. persons. Before that Act, dividends from foreign insurers (and subpart F inclusions with respect to their income) were always foreign source. The Act sources those income inclusions by looking through to the risks insured.

(5) Dividends paid deduction and imputation credit

The Administration's tax reform proposal presents another issue. The Administration proposal would allow a 10-percent dividends paid deduction to U.S. corporations. The purpose of this deduction is to reduce the burden of the two-tiered taxation of corporate profits under the "classical" system of present law, which imposes a tax at the corporate and shareholder levels. The dividends paid deduction would extend to some dividends paid to foreign shareholders. Absent treaty protection, however, the proposal would impose on such dividends a compensatory withholding tax designed to prevent elimination of all tax on 10 percent of corporate profits where shareholders are not U.S. taxpayers. The proposed treaty with Barbados would prohibit U.S. imposition of this compensatory withholding tax. Although the Administration proposal would not initially impose a compensatory tax on dividends paid to protected treaty country recipients, including Barbadian recipients, it would delegate to the Secretary of the Treasury the authority to override treaties to impose a compensatory dividend withholding tax on a country-by-country basis. The purpose of this delegation is, in part, to seek equivalent relief from treaty partner countries.

Many countries which reduce the burden of the two-tier tax do so through a mechanism other than a dividends paid deduction. These countries, including Barbados, give resident shareholders a tax credit when they receive dividends. Barbados' tax credit for resident shareholders reflects taxes that the corporation paid on the profits it is distributing in the form of dividends. For the shareholder, the credit is basically the economic equivalent of a partial dividends paid deduction. However, Barbados, like other countries, does not give this credit to foreign shareholders unilaterally. Some countries have given part of this credit to U.S. shareholders by treaty, but the proposed treaty with Barbados does not do so. Under the Administration tax reform proposal, the Secretary of the Treasury could impose the compensatory withholding tax if the home country of the recipient (such as Barbados) continued to deny economically equivalent relief to dividends paid by local companies to American shareholders.

The Committee might address this issue in one of three ways. One possibility is consenting to the treaty as proposed. Congress might not enact any dividend relief, or it might enact a credit mechanism for dividend relief like Barbados uses. In either of those events, there would be no treaty violation by the United States. (Even though the credit method and the deduction method proposed by the Administration achieve the same economic result (at least if the credit is refundable), the credit method does not violate treaties while the deduction method does.) However, if Congress does enact dividend relief, consent to the treaty as proposed could lead to disappointment by Barbados, if the United States were to later override the treaty and impose a compensatory tax on dividends paid to Barbadian shareholders, as contemplated by the Administration proposal. Alternatively, if the treaty is consented to as proposed and the United States enacts dividends relief but fails to impose the compensatory tax on dividends paid to Barbadian shareholders (out of a concern for the expectations of the Barbadian government based on the recently negotiated treaty), then the dividends paid deduction would improperly eliminate all U.S. tax on 10 percent of corporate profits paid out to Barbadian shareholders. Second, the Committee could seek a reservation allowing the United States to impose a compensatory withholding tax if it decides to do so. This course could present a condition that the Barbadian government finds unacceptable, so that it could delay or prevent the proposed treaty's taking effect. Third, the Committee could await legislative progress on the Administration proposals for tax reform to decide how to handle this issue. This course too, would delay the treaty, however.

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Regardless of whether or not the United States adopts a dividends paid deduction, an issue is presented by the treaty's failure to require that Barbdos grant its imputation credit to U.S. shareholders of Barbadian corporations. Relief is granted to U.S. shareholders under the U.S. treaties with France and the United Kingdom, which have imputation corporate tax systems similar to Barbados'. The issue raised is whether the United States should insist on greater relief for its shareholders in Barbadian companies. The reduction of the dividend withholding tax does provide some relief. However, the imputation credit may give Barbadian shareholders a greater Barbadian tax reduction than the withholding tax reduction gives comparable U.S. shareholders.

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 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"). They are also taxed 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.")

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 gross 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

U.S. tax, with two exceptions: (l) 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 property.

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 business income derived in one country by residents of the other country will be taxed by the source country only if business activities in that country 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 either by 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." Thus, both countries may still assert taxing jurisdiction over the same income. This is particularly true in the case of passive income, since most countries will not exempt passive income from tax at the source.

This double taxation is generally 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

A detailed article-by-article explanation of the proposed income tax treaty between the United States and Barbados is presented below, followed by an explanation of the notes exchanged when the proposed treaty was signed.

Article 1. General Scope

The general scope article describes the persons who may claim the benefits of the proposed treaty and contains other rules including the "saving clause."

The proposed treaty applies generally to residents of the United States and to residents of Barbados, with specific exceptions designated in other articles. This application follows other U.S. income tax treaties, the U.S. model treaty, and the OECD model treaty. The treaty also applies, in limited cases designated in other articles, to persons who are residents of neither Barbados nor the United States. Article 4 defines the term "resident."

The proposed treaty provides that it does not restrict any benefits accorded by the internal laws of, or by any other agreement between, the United States and Barbados. Thus, the treaty will apply only where it benefits taxpayers.

Like all U.S. income tax treaties, the proposed treaty also contains a "saving clause." Under this clause, with specific exceptions described below, each country reserves the right to tax its citizens and residents, notwithstanding any provision of the treaty. By reason of this saving clause, unless otherwise specifically provided in the proposed treaty, the United States will continue to tax its citizens who are resident of Barbados as if the treaty were not in force. For purposes of the treaty (and, thus, for purposes of the saving clause) the term "resident" includes corporations and other entities as well as individuals (Article 4).

Under Section 877 of the Internal Revenue Code (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 to the United States the right to tax former citizens. (However, 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 certain benefits conferred by the articles dealing with associated enterprises (Article 9), pensions and child support (Article 18), relief from double taxation (Article 23), non-discrimination (Article 24), and mutual agreement procedures (Article 25). The benefits in question will be conferred by each country on it 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 government employees (Article 19), students and apprentices (Article 20), and diplomatic agents and consular officers (Article 27), are to be provided by each country to its residents who are neither citizens of, nor have immigrant status in, that country. An individual 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 (i.e., he holds a "green card").

Article 2. Taxes Covered

In the case of the United States, the proposed treaty applies to the Federal income taxes imposed under the Code, with three exceptions. It does not apply to the personal holding company tax, social security taxes, or (except as described below), the accumulated earnings tax. The treaty provides (Article 10) that income of a Barbados company is not subject to the accumulated earnings tax if derived from the manufacture in Barbados of approved products under the fiscal incentives legislation of Barbados (as in effect on the date of signature of the treaty or as the competent authorities may agree pursuant to the treaty's mutual agreement procedure (Article 25)). The treaty also exempts (Article 10) from the accumulated earnings tax a Barbadian resident company if individual Barbadian residents (other than U.S. citizens) control directly or indirectly throughout the last half of the taxable year more than 50 percent of the entire voting power of the company.

In the case of the United States, the proposed treaty also applies to the excise taxes imposed on insurance premiums paid to foreign insurers and with respect to private foundations. The excise taxes imposed on insurance premiums paid to foreign insurers are covered by the treaty only to the extent that the risks covered by the premiums are not reinsured with a person not entitled to benefits under this or another U.S. tax treaty that applies to these excise taxes. Therefore, under the business profits article (Article 8), and other income article (Article 21), income of a Barbadian 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 Barbadian 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 Barbadian 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 Barbados or another insurer entitled to exemption under a different tax treaty (such as the U.S.-French treaty). For example, a Barbadian 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 Barbadian 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 Barbadian insurer which was used by the Barbadian 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.

Additionally, the exchange of information provisions of the treaty (Article 26) apply to the Federal income taxes, taxes on self-employment income, taxes on transfers to avoid income tax, estate and gift taxes, and excise taxes.

In the case of Barbados, the treaty applies to the Income Tax (including premium income tax), the Corporation Tax (including the tax on branch profits), and Petroleum Winning Operations Tax.

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

The proposed treaty, like the U.S. model, obligates the competent authority of each country to notify the competent authority of the other country of any significant changes in the tax laws of its country and of any official published material concerning the application of the treaty, including explanations, regulations, rulings, or judicial decisions.

Article 3. General Definitions

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

The term "Barbados" means the island of Barbados and its territorial waters, including any area outside its territorial waters which, in accordance with international and Barbadian law, is an area within which the rights of Barbados with respect to the seabed and sub-soil and their natural resources may be exercised. Therefore, income earned on the Barbadian continental shelf is covered.

The term "United States" means the United States of America. When used in a geographic sense, the term means the 50 States, the District of Columbia, the waters of the United States, and any area beyond the United States' territorial waters which, in accordance with international law and U.S. law, is or may hereinafter be an area within which the rights of the United States with respect to natural resources may be exercised. The term does not include Puerto Rico, the Virgin Islands, Guam, or any other U.S. possession or territory. The definition is intended to cover the U.S. continental shelf consistent with the definition of the continental shelf contained in section 638 of the Code.

The term "person" is defined to include an individual, an estate, a trust, a company, a partnership, and any other body of persons. A "company" is any body corporate or any other entity which is treated as a body corporate for tax purposes.

An enterprise of a country is defined as an enterprise carried on by a resident of that country. Although the treaty does not define the term "enterprise," it will have the same meaning that it has in other U.S. tax treaties—the trade or business activities undertaken by an individual, company, partnership, or other entity.

The U.S. competent authority is the Secretary of the Treasury or his delegate. 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 Barbadian competent authority is the Minister of Finance and Planning, or his authorized representative.

A "national" of the United States is any individual who is a U.S. citizen and any company, association, or other entity deriving its status as such from the laws of the United States or any of its political subdivisions. A "national" of Barbados is any individual who is a Barbadian citizen and any company, association, or other entity deriving its status as such from the laws of Barbados.

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

The proposed treaty also contains the standard provision that, unless the context otherwise requires or the competent authorities of the two countries agree to a common meaning, any term not defined in the treaty is to have the meaning which it has under the applicable tax laws of the country applying the treaty.

Article 4. 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 that 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 two 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 his 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).

A person (either an individual or any entity other than a company) is considered to be a resident of a country under the proposed treaty if the person is a resident of that country under its internal law for purposes of that country's tax. However, a partnership, estate, or trust is considered to be a resident of a country under the proposed treaty 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 only one-half of the income of Barbadian trust is subject to tax in the hands of Barbadian beneficiaries, the United States would have to reduce its withholding tax on only one-half of the U.S. source income paid to the trust.

A company is considered to be a resident of Barbados under the proposed treaty if its business is managed and controlled in Barbados. A company is considered to be a resident of the United States under the proposed treaty if it was created under the laws of the United States or a political subdivision of the United States.

These residence definitions are generally based on those on the U.S. and OECD model treaties and are similar to the definitions found in other U.S. tax treaties. However, they differ in certain respects from those found in the other treaties.

Consistent with most U.S. income tax treaties, citizenship alone does not establish residence. As a result, U.S. citizens residing overseas are not entitled to the benefits of the treaty as U.S. residents. This result is contrary to U.S. treaty policy as expressed in the U.S. model, but the U.S. model result has been achieved in very few treaties.

The proposed treaty provides "tie-breaker" rules to determine the residence of an individual or company that under the basic treaty definitions would be considered to be a resident of both countries. A dual residence individual will be deemed to be a resident of the country in which he has a permanent home available to him. If this permanent home test is inconclusive because the individual has a permanent home in both countries, the individual's residence is deemed to be in the country with which his personal and economic relations are closer, i.e., his "center of vital interests." If the country in which he has his center of vital interests cannot be determined, or if he does not have a permanent home available to him in either country, he will be deemed to be a resident of the country in which he has an habitual abode. If the individual has an habitual abode in both countries or in neither of them, he will be deemed to be a resident of the country of which he is a national. If he is a national of both countries or of neither of them, the competent authorities of the countries will settle the question of his residence by mutual agreement.

Under the basic treaty definitions, a company would be considered a resident of both the United States and Barbados if it were created under the laws of the United States (or a political subdivision of the United States) but managed or controlled in Barbados.

Under the treaty's tie-breaker rule, such a company will be deemed to be a resident of the country in which created (i.e., the United States).

In the case of a person, other than an individual or a company, that is a resident of both countries under the basic treaty definitions, the treaty requires the competent authorities of the two countries to settle the question of residence by mutual agreement and to determine how the treaty applies to that person. This rule, and the tie-breaker rules for individuals and companies, are identical to the U.S. model rules.

Article 5. 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 and the U.S. and OECD model treaties. However, in order to reflect Barbados' status as a developing country, the proposed treaty definition makes a number of concessions to the principle of taxation of income at the source. Some of these concessions reflect positions suggested by the United Nations model income tax treaty for use between developed and developing countries.

The permanent establishment concept is one of the basic devices used in income tax treaties to avoid double taxation. Generally, an enterprise that is 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 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 amounts will be taxed as business profits. U.S. taxation of business profits is discussed under Article 7.

The principal areas in which the proposed treaty departs from the U.S. model are in its inclusion in the permanent establishment definition of a sales outlet; a construction project lasting more than 183 days (rather than 12 months); a drilling rig or ship used for the exploration or development of natural resources in a country for more than 183 days (rather than 12 months); an individual performing services for more than 90 days; the maintenance of substantial equipment for more than 120 days; and a dredging project lasting more than 120 days. Also, the inclusion in the time period of supervisory activity connected with construction or natural resource-type activity is a departure from the U.S. model. These departures from the U.S. model have, however, been reflected in other recent U.S. income tax treaties with developing countries, such as the treaty with Jamaica.

In general, under the proposed treaty, a permanent establishment is a regular place of business in one country through which the business of an enterprise of the other country is wholly or partly carried on. The U.S. model treaty refers to a "fixed" rather than "regular" place of business but, according to the Treasury Department's technical explanation of the proposed treaty, no difference in meaning was intended. (Similarly, the term "regular base" is used throughout the proposed treaty where "fixed base" appears in the U.S. model.) Under the proposed treaty (as under the U.S.

model), a permanent establishment includes a place of management; a branch; an office; a factory; a workshop; a mine, an oil or gas well, a quarry, or any other place of extraction of natural resources; and (as additions not found in the U.S. model) a store or premises used as a sales outlet and a warehouse (in relation to a person providing storage facilities for others).

Under the proposed treaty, a permanent establishment also includes any building site, construction, assembly, or installation project, or drilling rig or ship used for the exploration or development of natural resources, but only if the site, project, etc., lasts for more than 183 days in any twelve-month period (including the period of any connected supervisory activity). A dredging project will constitute a permanent establishment if it continues for more than 120 days in any twelve-month period (including the period of any connected supervisory activity). However, a permanent establishment will not exist in any taxable year in which a site, project, or activity continues for a period or periods aggregating less than 30 days.

An enterprise will also have a permanent establishment if it furnishes services, including consultancy, management and technical, or supervisory services in a country through employees or other personnel, but only if these continue within that country for more than 90 days in any twelve-month period. No permanent establishment will result, however, in any taxable year in which these services are performed less than 30 days. However, the 90-day minimum requirement does not apply, and a permanent establishment will result, if the services are performed for an associated enterprise (Article 9). This services provision is similar to the six-month services rule of the United Nations model treaty. It is not found in the U.S. model treaty but has been included, in some form, in some recent U.S. income tax treaties with developing countries (e.g., Jamaica and the Philippines).

An enterprise will have a permanent establishment if it maintains substantial equipment or machinery in a country but only if the equipment or machinery is maintained in that country for a period of more than 120 consecutive days. No permanent establishment will, however, exist in any taxable year in which the equipment or machinery is maintained within that country for less than 30 days.

The general permanent establishment rule is modified to provide that a regular place of business that is used for any 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 enterprise, and the maintenance of a stock of goods belonging to the enterprise for purposes of storage, display, or delivery, except where the goods or merchandise are held for sale by the enterprise in a store or premises used as a sales outlet. Also included are the maintenance of goods for processing by another person, the purchase of goods or merchandise, the collection or provision of information, advertising, scientific research, and similar preparatory or auxiliary activities for the enterprise.

Even if an enterprise of one country does not have a permanent establishment in the other country under the foregoing rules, it may still be treated as having one to the extent that goods or merchandise are sold by or on behalf of the enterprise for use, consumption, or disposition in that other country. This special rule applies only if the goods or merchandise are either subjected to processing in that other country or purchased in that other country and not subjected to processing outside the other country.

If an enterprise of one country maintains an agent in the other country who has, and habitually exercises, the authority to enter into contracts in that other country in the name of the enterprise, then the enterprise will be deemed to have a permanent establishment in the other country with respect to the activities which the agent undertakes on its behalf. This rule does not apply where the contracting authority is limited to those activities (described above) such as storage, display, or delivery of merchandise that are excepted from the definition of permanent establishment. However, the enterprise will be treated as having a permanent establishment if the agent habitually maintains in that other country a stock of goods or merchandise from which he regularly makes deliveries on behalf of the enterprise and additional activities conducted in that other country on behalf of the enterprise have contributed to the sale of the goods or merchandise.

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. However, the proposed treaty adds the limitation (similar to one found in the United Nations model treaty and some recent U.S. treaties) that, when the activities of the agent are devoted substantially on behalf of that enterprise, he will not be considered an agent of independent status if the transactions between the agent and the enterprise were not made under arm's length conditions.

The determination whether a company of one country has a permanent establishment in the other country is to 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. Any such relationship is thus not relevant; only the activities of the company being tested are relevant.

Article 6. Income from Real Property

This article covers income from real property. The rules governing gains from the sale of real property are in Article 13.

Under the proposed treaty, income derived by a resident of one country from real property situated in the other country, including income from agriculture or forestry, may be taxed in the country where the real property is located. The situs country may tax income derived from the direct use, letting, or use in any other form of real property. This article also applies to the income from real property of an enterprise and to income from real property used for the performance of independent personal services.

The term "real property" has the meaning which it has under the law of the country in which the property in question is situated.

This article is identical to the article of the U.S. model treaty governing income from real property, except that the U.S. model permits a resident of one country to elect to be taxed on a net basis by the other country on income from real property in that other country. Though the proposed treaty does not contain this election, such treatment is provided for U.S. real property income under the Code (secs. 871(d) and 882(d)) and for Barbadian real property income under Barbadian domestic law.

Article 7. 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 (or received by a corporation in the business of trading stocks or securities for its own account); and certain sales income attributable to a U.S. sales office.

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. Thus, income from trading through a U.S.-based employee, a resident broker, commission agent, custodian, or other agent, or from trading by a foreign person physically present in the United States is not generally taxed as business income. However, this rule does not apply to dealers or to corporations the principle business of which is trading in stocks or securities for their own account.

Proposed treaty rules

Under the proposed treaty, business profits of an enterprise of one country are taxable in the other country only to the extent that they are attributable to a permanent establishment in the other country through which the enterprise carries on business. This is one of the basic limitations under the treaty on a country's right to tax income of a resident of the other country. The proposed treaty's rules on business profits generally follow the provisions of the U.S. model treaty, except as noted below.

The taxation of business profits under the proposed treaty differs from internal 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.

For purposes of the proposed treaty, the term "business profits" includes income derived from any trade or business, regardless of whether carried on by an individual, company, partnership or other person. Income from the rental of tangible moveable property is specifically included as business profits. However, income from the rental of intangible property (including works on film, tape, etc.) is not included as business profits, and will instead be dealt with under Article 12, Royalties.

The business profits of a permanent establishment are determined on an arm's-length basis. Thus, there is to be attributed to a permanent establishment the business profits that would reasonably be expected to have been derived by it if it were a distinct and 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 business profits, deductions generally are allowed for expenses, wherever incurred, that are incurred for the purposes of the permanent establishment. These deductions include a reasonable allocation of executive and general administrative expenses, research and development expenses, interest, and other expenses incurred for the enterprise as a whole. Thus, for example, a U.S. company which has a branch office in Barbados but which has its head office in the United States will, in computing the Barbadian tax liability of the branch, be entitled to deduct the executive, general administrative and other expenses incurred in the United States by the head office that are reasonably connected with the profits of the Barbadian branch.

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Business profits will not be attributed to a permanent establishment merely by reason of the purchase of merchandise by the permanent establishment for the account of the enterprise. Thus, where a permanent establishment purchases goods for its head office, the business profits attributed to the permanent establishment with respect to its other activities will not be increased by a profit element in its purchasing activities. The amount of profits attributable to a permanent establishment must be determined by the same method each year unless there is good and sufficient reason to change the method.

The proposed treaty includes two rules not in the U.S. model that expand the scope of the business profits that may be attributed to a permanent establishment. Although these two rules do not appear in the U.S. model treaty, similar rules have been included in other recent U.S. income tax treaties. First, the treaty provides that profits derived from sales or other business activities that are similar to the sales or other activities effected through a permanent establishment can be attributed to the permanent establishment. For example, if a U.S. manufacturer of farm equipment has a permanent sales office in Barbados (constituting a permanent establishment under Article 5), and the company effects a sale to Barbados through its home office, then the profits from that sale can be attributed to the permanent establishment and taxed in Barbados. Second, the proposed treaty specifically permits a country to tax business profits attributable to a permanent establishment that no longer exists. That is, a country may tax business profits in a year after a permanent establishment has ceased to exist, if the profits are otherwise attributable to the permanent establishment. For example, income from an installment sale effected through a permanent establishment may be taxed by the country in which the permanent establishment was located, even after the permanent establishment is liquidated. (The U.S. model is silent on this point, but could be interpreted to permit such a tax.)

The proposed treaty contains another rule not found in the in U.S. model treaty, permitting a country to determine profits attributable to a permanent establishment by apportioning the total (worldwide) profits of an enterprise, but only to the extent that it has been customary for that country to do so. Any such apportionment must be consistent with the general arms-length principle applicable to the determination of the profits of a permanent establishment. This rule is included in the OECD and UN model treaties, (as well as some other recent U.S. income tax treaties). Staff is informed that this rule was included, at the request of Barbados, to permit it to continue to apply its customary method of taxing the profits of insurance companies operating in Barbados on the basis of a formula comparing premiums earned in Barbados with worldwide premiums. (The commentary to the relevant provision of the OECD model suggests that such an apportionment method is appropriate in the case of insurance companies.) Apparently this is the only tax Barbados has "customarily" applied on an apportionment basis; thus, the proposed rule is not intended to permit Barbados to apply to any other type of business a newly-adopted apportionment of world-wide profits, such as the "unitary tax" systems employed by some states in the United States.

Where business profits include items of income that are dealt with separately in other articles of the treaty, those other articles, and not this business profits article, generally will govern the treatment of those items of income. Thus, for example, dividends generally are taxed under the provisions of Article 10 and not as business profits.

Article 8. 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 under the Internal Revenue Code if the 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 exemptions. The present treaty provides reciprocal exemptions.

Under the proposed treaty, profits which are derived by an enterprise of one country from the operation in international traffic of ships or aircraft ("shipping profits") will be exempt from tax by the other country. International traffic means any transportation by ship or aircraft, except where the transportation is solely between places in one of the countries (Article 3(1)(g) (General Definitions)). The exemption applies whether or not the ships or aircraft are registered in the first country. Thus, for example, Barbados would not tax the income of a U.S. resident operating a Liberian-flag vessel.

The exemption for shipping profits applies to profits from the rental 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 and aircraft in international traffic. The exemption also applies to income derived from the use, maintenance, or rental of containers (as well as trailers, barges, and related equipment used to transport containers) used in international traffic. In addition, the shipping and air transport provisions apply to profits from participation in a pool, joint business or international operating agency.

Article 9. Associated Enterprises

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 enterprises, if an allocation is necessary to reflect the conditions and arrangements that would have been made between independent enterprises.

For purposes of the proposed treaty, an enterprise of one country is related to an enterprise of the other country if one of the enterprises participates directly or indirectly in the management, control, or capital of the other enterprise. The enterprises are also related if the same persons participate directly or indirectly in the management, control, or capital of both enterprises.

When a redetermination of tax liability has been properly made by one country, the other country will make an appropriate adjustment to the amount of tax paid in that country on the redetermined income. In making that adjustment, due regard is to be paid to other provisions of the treaty and the competent authorities of the two countries will consult with each other if necessary.

The proposed treaty states 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 allocation is necessary to prevent evasion of taxes or to reflect clearly the income of those persons. Thus, the proposed treaty makes it clear 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).

Article 10. Dividends

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 this purpose, 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.

Similarly, Barbados imposes a withholding tax at the rate of 10 percent on most dividend payments to nonresident shareholders. However, a 40-percent rate applies to dividends paid (to resident and nonresident shareholders) with respect to preferred stock issued before January 1, 1975. Resident shareholders are granted a credit for taxes paid by the corporation on the profits out of which a dividend is paid, but this credit is not available to nonresident shareholders. (See discussion of dividends paid deduction in "Issues," Part II, above.)

The proposed treaty follows the provisions of the U.S. model treaty, with one exception. Under the proposed treaty, each country may tax dividends paid by its resident companies, but the tax is generally limited to 15 percent of the gross amount of the dividend if the beneficial owner of the dividend is a resident of the other country. The tax is limited to 5 percent of the gross amount of the dividend if the beneficial owner is a company that owns at least 10 percent of the voting stock of the company paying the dividend. These rates are the same as those called for in the U.S. model treaty. This rule does not restrict the right of a country to tax the profits out of which dividends are paid.

Like the U.S. model treaty, the proposed treaty defines "dividends" as income from shares or other rights which participate in profits and which are not debt claims. Dividends also include income from other corporate rights which is subjected to the same tax treatment by the country in which the distributing corporation is resident as income from shares. Under this provision, each country may apply its rules for determining whether a payment by a resident company is on a debt obligation or an equity interest.

The treaty limitation on source country dividend tax will not apply if the beneficial owner of the dividend has a permanent establishment (or regular base in the case of an individual performing independent personal services) in the source country and the dividend is attributable to that permanent establishment (or regular base). Dividends attributable to a permanent establishment are to be taxed as business profits (Article 7). Dividends attributable to an individual's regular base are to be taxed as income from independent personal services (Article 14).

Under the proposed treaty, one country may tax dividends paid by a company resident in the other country in only three cases. First, a country may always tax dividends that are paid to a resident of that country. Second, a country may tax dividends that are attributable to a permanent establishment or regular base located in that country. For example, if a permanent establishment located in Barbados held the stock of a U.S. company, then Barbados could tax a dividend paid by the U.S. company with respect to that stock, even if the dividend were actually paid to the owner of the permanent establishment in a country other than Barbados. Third, a country may tax dividends that are paid out of profits attributable to a permanent establishment located in that country, if those profits constitute at least 50 percent of the company's worldwide income. The effect of this third exception is to preserve the United States' right to collect its second tier withholding tax on dividends paid by foreign companies earning 50 percent or more of their income from U.S. business. The rate limitations provided for withholding taxes apply to the tax collected pursuant to this third exception, if the recipient of the dividend is a resident of Barbados.

The proposed treaty also provides that the income of a Barbadian company derived from the manufacture in Barbados of approved products under the tax incentive legislation of Barbados (as in effect on the date of signature of the treaty or as the competent authorities may agree pursuant to Article 25 (Mutual Agreement Procedure)) will not be subject to the United States accumulated earnings tax. This incentive legislation is intended to promote the development of manufacturing in Barbados by imposing a reduced corporate tax on qualifying enterprises. The provision of the proposed treaty is intended to advance this development objective by allowing corporations to accumulate capital for future expansion without being subject to U.S. tax at the U.S. shareholder level. Since these corporations are engaged in active business operations and can justify substantial capital accumulations for the needs of the business, they are relatively unlikely to attract an accumulated earnings tax in any event. In addition, a company which is a resident of Barbados will be exempt from U.S. accumulated earnings tax if individuals (other than United States 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. It may be necessary to clarify this point, since if this rule were applied on the basis of voting power alone, a conflict with Code section 535(d) could arise. (See discussion in "Issues," Part II, above.) Similar provisions with respect to the accumulated earnings tax are found in the recent U.S. treaty with Jamaica.

The proposed treaty does not contain a provision exempting a company resident in one country that derives profits or income in the other country from a tax on undistributed profits in that other country. Thus, Barbados is free to continue to apply its branch profits tax (subject to the limitations of Article 7), while the United States may impose such a tax at any time that it chooses to do so. The Administration has proposed imposition of such a tax as part of its 1985 tax reform proposal, in place of the second tier withholding tax.

It should be noted that under the saving clause of Article 1(3) (General Scope), the United States may always tax its citizens on their dividend income, even if the dividend article of the proposed treaty would otherwise apply. For example, a U.S. citizen resident in Barbados who received a dividend from a Barbadian corporation could be taxed by the United States, even though Article 10 would otherwise prohibit a U.S. tax in that case.

Article 11. 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 this purpose, 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.

Under the proposed treaty, each country may tax interest arising within that country, but the tax is generally limited to 12.5 percent of the gross amount of the interest if its beneficial owner is a resident of the other country. This limitation on source country tax does not apply if the recipient of the interest is a nominee for a nonresident. The 12.5-percent limitation contrasts with the U.S. model position, not generally achieved, that interest generally should be exempt from tax at source. The proposed treaty contains minor differences in language from the comparable provisions of the U.S. model treaty, but the Treasury technical explanation says that these minor changes are meant to have no substantive effect.

In certain cases, interest *will* be exempt from tax at source under the proposed treaty. These are where the interest is paid with respect to a debt obligation that is issued, guaranteed, or insured by the government of the source country, or by a political subdivision, local authority, or instrumentality of that country. In other words, neither country will impose a tax on interest paid with respect to its own obligations (or those of a political subdivision).

Neither the 12.5-percent limitation nor the exemptions will apply if the beneficial owner of the interest has a permanent establishment or regular base in the source country and the loan is effectively connected with the permanent establishment or regular base. In that event, the interest will be taxed as business profits (Article 7) or income from the performance of independent personal services (Article 14).

The proposed treaty does not provide a source rule for interest. Each country will therefore apply its internal law to determine the source of an interest payment. Thus, the treaty does not prohibit the United States from applying its second tier withholding tax on interest paid by foreign companies earning 50 percent or more of their income from U.S. business.

The proposed treaty addresses the issue of non-arm's-length interest charges between related parties (or parties having an otherwise special relationship) by providing that the amount of interest for purposes of applying this article will be the amount of arm's-length interest. Any amount of interest paid in excess of the arm's-length interest, for whatever reason, will be taxable according to the laws of each country, taking into account the other provisions of the proposed treaty. 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 10 of the proposed treaty.

The proposed treaty defines "interest" as income from loans of every kind, whether or not secured and whether or not carrying a right to participate in profits. In particular, it includes income from government securities and from bonds or debentures, including premiums or prizes attaching to bonds or debentures.

As in the case of dividends, under the saving clause of Article 1(3) (General Scope) the United States may always tax its citizens on their interest income, even if they are resident in Barbados.

Article 12. 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. Barbados does not at present impose a withholding tax on royalties paid to nonresidents.

Under the proposed treaty, each country may tax royalties arising within that country, but the tax is generally limited to 12.5 percent of the gross amount of the royalties if the beneficial owner of the royalties is a resident of the other country. The U.S. model treaty exempts royalties from tax at source.

The 12.5-percent tax limitation will not apply if the recipient of the royalty is a nominee for a nonresident. It also will not apply if the recipient is an enterprise with a permanent establishment in the source country or an individual performing personal services in an independent capacity through a regular base in the source country, and the property giving rise to the royalty is effectively connected with the permanent establishment or regular base. In that event, the royalties will be taxed as business profits (Article 7) or as income from the performance of independent personal services (Article 14).

The proposed treaty defines "royalties" as payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic, or scientific work including cinematographic films, films or tapes used for radio or television broadcasting, any patent, technical know-how, trade mark, design or model, plan, secret formula, or process. Royalties are also payments of any kind received as consideration for the use of or the right to use industrial, commercial, or scientific equipment, or for information concerning such equipment. The treaty's royalty definition follows that of the OECD and United Nations models. Similar definitions have been included in other recent U.S. income tax treaties, such as those with Australia and Jamaica.

The proposed treaty provides a special source rule for royalties that is meant to accomodate the U.S. source rule for royalties. Generally, as indicated above, under U.S. tax rules (Code secs. 861-62), royalty income is sourced where the property or right is being used. Under the proposed treaty, if a royalty is paid by the government of one of the countries, including political subdivisions and local authorities, or by a resident of one of the countries, then the royalty generally will be sourced in the country of residence of the payor. However, if the payor has a permanent establishment or regular base in one of the countries in connection with which the obligation to pay the royalty was incurred, and if the royalty is borne by the permanent establishment or regular base, then the royalty arises in the country in which the permanent establishment or regular base is situated. Nevertheless, the rule of the previous sentences does not apply if the property is used within one of the two countries. Thus, the United States' statutory "place of use" source rule will override the treaty's payor source rule, in the case of any conflict. For example, if a U.S. resident licenses a patent to a resident of Barbados (or in connection with a permanent establishment located in Barbados which bears the royalty payment) the treaty's general rules provide that the royalty will be sourced in (and taxable by) Barbados. However, if the patent is used within the United States, then notwithstanding the general rules the royalty will be sourced in the United States.

The proposed treaty addresses the issue of non-arm's-length royalties between related parties (or parties having an otherwise special relationship) by providing that the amount of royalties for purposes of applying this article will be the amount of arm's-length royalties. Any amount of royalties paid in excess of the arm's-length royalty will be taxable according to the laws of each country, taking into account the other provisions of the proposed treaty. 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 10 of the proposed treaty.

As in the case of dividends and interest, under the saving clause of Article 1(3) (General Scope) the United States may always tax its citizens on their royalty income, even if they are resident in Barbados.

Article 13. 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 or she 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.

Under the proposed treaty, gains from the disposition of real property may be taxed in the country where the real property is situated. Real property for this purpose is generally defined as it is under the article governing taxation of income from real property (Article 6), which in turn refers to the laws of the country in which the property is located. The proposed treaty specifies that in the case of the United States the term real property includes "U.S. real property interests," thus specifically incorporating the broad definition of real property under FIRPTA. In the absence of a parallel Barbadian statutory term, the treaty specifies that in the case of Barbados the term real property includes interests in a company, partnership, trust, or estate whose property consists wholly or principally of real property situated in Barbados.

Under the proposed treaty, gains from the disposition of personal property which are attributable to a permanent establishment that an enterprise of one country has in the other country, or gains from the alienation of personal property attributable to a regular base available to a resident of one country in the other country for the purpose of performing independent personal services, including gains from the disposition of such a permanent establishment (alone or together with the whole enterprise) or of such a regular base, may be taxed in that other country. This rule is substantially identical to that in the U.S. model treaty.

The proposed treaty sets forth the following rules that are drawn directly from the U.S. model treaty. First, gains derived by an enterprise of one country from the disposition of ships, aircraft, or containers operated in international traffic are taxable only in that country (i.e., the country of residence).

Second, gains included within the definition of royalties (in Article 12) are taxable only in accordance with the rules applicable to royalties.

Third, gains derived from the disposition of any property not specifically referred to in the article will be taxable only in the seller's country of residence.

Article 14. Independent Personal Services

The United States taxes the income of a nonresident alien 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 7.) 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 (i.e., as an independent contractor) is treated separately from salaries, wages, and similar remuneration received by employees.

Under the proposed treaty, income derived by an individual resident in one country from personal services performed in an independent capacity in the other country may be taxed in the other country only if one of three threshold tests is met. First, the nonresident country may tax the income if the individual has a regular base regularly available to him or her in the nonresident country for the purpose of performing his or her activities. Only that portion of the individual's income attributable to the regular base may be taxed in the nonresident country. Second, the nonresident country may tax the individual's independent personal services income if the individual is present in the nonresident country for more than 90 days during the taxable year concerned. Third, the nonresident country may tax the individual's independent personal services income if it exceeds $5,000 (or the equivalent in Barbados currency) in the taxable year. By contrast, the U.S. model contains only the first threshold test, and thus does not allow a country to tax independent personal services income on the basis of length of stay or amount of earnings alone. However, other recent U.S. income tax treaties with developing countries, such as those with Jamaica and the Philippines, have contained such provisions expanding the source country's right to tax independent personal services income. The provisions of the Jamaica treaty are identical to those proposed here.

The term "personal services" is not defined in the treaty, but is generally interpreted to include independent scientific, literary, artistic, educational, and teaching activities, as well as the independent activities of physicians, lawyers, engineers, architects, dentists, and accountants.

Article 15. Dependent Personal Services

Under the Code, the income of a nonresident alien 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 services performed as an employee in one country (the source country) by a resident of the other country (the residence country) will be taxable only in the residence country if four requirements are met: (1) the recipient is present in the source country for fewer than 184 days during the calendar year concerned; (2) the employer is not a resident of the source country; (3) the compensation is not borne by a permanent establishment or regular base of the employer in the source country; and (4) the amount earned in the source country is not more than $5,000 (or its equivalent in Barbados currency). Under the U.S. model, the fewer-than-184-day-test is computed on the basis of the tax year, not on the basis of the calendar year. However, because most individual U.S. taxpayers use the calendar year as their tax year, this departure from the U.S. model is of little significance. In addition, however, the U.S. model does not contain the fourth condition, the effect of which is to permit the source country to tax compensation for dependent personal services performed there if it exceeds $5,000, regardless of how limited the employee's contacts with the source country are. This expansion of source-basis taxing jurisdiction also appears in the U.S. treaty with Jamaica. The treaty with the Philippines does not contain a dollar threshold, but shortens the day threshold to 90 days.

Compensation derived by a resident of one country as a member of the crew of a ship or aircraft operated in international traffic may be taxed only in the crew member's country of residence. This provision of the proposed treaty is identical to that in the U.S. model treaty.

This article is modified in some respects for directors' fees (Article 16), pensions (Article 18), and compensation of government employees (Article 19). In addition, income derived as an entertainer or athlete is taxed in accordance with special rules (Article 17).

Article 16. Directors' Fees

Under the proposed treaty, directors' fees and similar payments, derived by a resident of one country for services rendered in the other country as a member of the board of directors of a company that is a resident of the other country, may be taxed in that other country.

This rule for directors' fees generally follows the OECD model, with the additional limitation to fees for services rendered in the other country. It differs from the rule of the U.S. model treaty, which treats directors' fees as personal services income or distributed profits, primary taxing jurisdiction over which generally belongs to the country where the recipient resides. However, rules similar to that of the proposed treaty appear in several recent U.S. tax treaties, including the treaty with Jamaica and the proposed treaties with China, Denmark, and Cyprus.

Article 17. Artistes and Athletes

The proposed treaty contains a separate set of rules that apply to the taxation of income earned by "artistes" (such actors and musicians) and athletes. These rules apply notwithstanding the other provisions dealing with the taxation of income from personal services (Articles 14 and 15), 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. This is necessary because entertainers may be able to earn substantial income without crossing over any of the other thresholds that permit source-country taxation under the treaty, since these thresholds generally look to permanent or extended contacts, while entertainers can earn their fees in a matter of hours.

Under the proposed treaty, income derived by entertainers and athletes resident in one country from their personal activities as such exercised in the other country (source country) generally may be taxed in the source country. However, such income may not be taxed by the source country if the entertainer's gross receipts (excluding expenses) do not exceed $250 a day or $4,000 in the taxable year (or the equivalent in Barbados currency). Although the dollar amounts are considerably lower than that in the U.S. model treaty ($20,000 including expenses), they are in line with other recent U.S. treaties with developing countries, such as the Philippines ($100 a day/$3,000 a year) and Jamaica ($400 a day/$5,000 a year).

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 exercised. (This provision applies notwithstanding the business profits and personal services articles (Articles 7, 14, and 15)). 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 a trust located in a country that would not tax the income. This provision does not apply if it is established that the entertainer does not participate directly or indirectly in the profits of the entity receiving the income. For example, this provision would not apply to a typical symphony orchestra, since the musicians are salaried employees with no right to a share of profits. The corresponding provision of the U.S. model treaty is substantially identical.

The proposed treaty provides that the lower thresholds for source-country taxation established by this article will not apply to (1) entertainers supported by public funds of the country of residence (including its political subdivisions); (2) non-profit organizations; or (3) entertainers and athletes who perform for non-profit organizations. Thus, the source country's right to impose tax in those cases will be determined under the general rules of Articles 7 (Business Profits), 14 (Independent Personal Services), and 15 (Dependent Personal Services). The U.S. model treaty does not contain such a rule, which relieves state-supported and non-profit entertainers from source country taxation in some cases.

Article 18. Pensions, Annuities, Alimony, and Child Support

Under the proposed treaty, a pension and other similar remuneration paid to a resident of either country in consideration of past employment generally is subject to tax only in the recipient's country of residence.

However, pensions paid to a resident of one country attributable to services performed for governmental entities of the other may be taxed only by the paying country if the recipient is a citizen of that country (see Article 19). In addition, social security benefits and other public pensions paid by one country to an individual who is a resident of the other country or to a U.S. citizen will be taxable only in the paying country. This rule, which is not subject to the saving clause, exempts U.S. citizens and residents from U.S. tax on Barbadian social security payments. The United States may continue to tax U.S. social security payments to Barbadian residents, whether or not they are U.S. citizens. The article 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 higher income individuals, while protecting any such individuals residing in Barbados from double taxation.

The proposed treaty also provides that annuities may be taxed only in the country of residence of the person who beneficially derives them. Annuities are defined as a stated sum 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 proposed treaty provides that alimony paid to a resident of a country may only be taxed in that country of residence. The term "alimony" is defined to mean periodic payments, under a separation agreement or decree of divorce, separate maintenance, or compulsory support, which are taxable to the recipient in the country of residence.

Conversely, the proposed treaty provides that payments for the support of a minor child under a separation agreement or decree of divorce, separate maintenance, or compulsory support may be taxed only by the source country.

The provisions of this article are identical to the comparable provisions of the U.S. model treaty.

Article 19. Government Service

The proposed treaty generally exempts the compensation of employees of one of the countries from tax in the other country.

Under the proposed treaty, remuneration, including a pension, paid by the government of a country (or one of the country's political subdivisions or local authorities) to a citizen of that country for services rendered to the government (or subdivision or authority) will be taxable in that country only.

If the government of a country or one of the country's political subdivisions or local authorities is carrying on a business (as opposed to functions of a governmental nature), the provisions of Articles 14, 15, and 18 will apply to remuneration and pensions for services rendered in connection with that business. Similarly, payments to employees of a country who are not citizens of that country will be subject to the provisions of Articles 14, 15, and 18, rather than this article.

The saving clause of Article 1(3) overrides this article only in the case of citizens or persons with immigrant status. For example, if a citizen of Barbados is employed in the United States by Barbados, and that individual has immigrant status in the United States (i.e., he holds a green card), then the United States may tax that individual's salary without regard to this article. If, however, the employee is neither a citizen of the United States nor has immigrant status, the provisions of the article will apply and prevent the U.S. from taxing on the basis of residence.

Article 20. Students and Apprentices

Under the proposed treaty, a resident of one country who becomes a full-time student in the other country will generally be exempt from tax in the host country on payments from abroad used for maintenance, education, or training. This rule is substantially identical to that in the U.S. model treaty.

The proposed treaty contains an additional rule, not found in the U.S. model, that has appeared in some other recent U.S. tax treaties (e.g., Jamaica). Under this rule, a student or apprentice covered by the general rule may instead elect under the treaty to be treated for tax purposes as a resident of the host country. The election applies for the entire period that the individual is covered by the general rule, and it may not be revoked except with the consent of the competent authority of the host country. The purpose of the election is to permit foreign students and trainees present in the United States to qualify for benefits such as the standard deduction (the zero bracket amount), and for the dependency deductions (if applicable). For example, for U.S. tax purposes nonresident aliens are limited to one personal deduction and they are not permitted to claim the standard deduction or the dependency deduction. By electing to be taxed as U.S. residents, they may claim these deductions but, as a consequence, they are subject to U.S. tax on their worldwide income. This election would generally be advantageous for those foreign students and apprentices who do not have any substantial income from sources outside the United States.

Article 21. Other Income

This article is a catch-all provision intended to cover items of income not specifically covered in other articles, and to assign the right to tax income from third countries to either the United States or Barbados. Thus, it applies to income from third countries as well as to income from the United States and Barbados.

As a general rule, items of income not otherwise dealt with in the proposed treaty that are derived by residents of either country will be taxable only in the country of residence. This rule, for example, gives the United States the sole right under the treaty to tax income sourced in a third country and paid to a resident of the United States. This article is subject to the saving clause of Article 1(3) in the case of U.S. citizens, so U.S. citizens who are Barbadian residents will continue to be taxable by the United States on their third-country income, with a foreign tax credit provided for income taxes paid to Barbados.

The general rule just stated does not apply if the recipient of the income (other than income from real property (Article 6)) is a resident of one country and carries on business in the other country through a permanent establishment or a regular base, and the right or property in respect of which the income is paid is effectively connected with the permanent establishment or regular base. In such a case, the provisions of Article 7 (business profits) or Article 14 (independent personal services), as the case may be, will apply.

Moreover, notwithstanding either of the above two rules, if a resident of one country receives income not dealt with elsewhere in the treaty that arises in the other country, the income may be taxed in that other (source) country. A number of existing U.S. income tax treaties apply this rule, but it is not included in the U.S. and OECD model treaties, which generally give the sole right to tax "other income" to the country of residence. This article is substantially identical to the corresponding article of the United Nations model treaty.

Article 22. Limitation on Benefits

The proposed 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. 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 (i.e., 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.

The proposed treaty contains a provision intended to prevent third-country companies that are not bona fide residents of the United States or Barbados from using the treaty to secure certain treaty benefits.

Under this rule, and subject to certain exceptions, a resident of one country that derives income from the other country is not entitled to relief from taxation in the source country otherwise provided by Articles 6 through 23, if either of two conditions is met. First, treaty benefits will be denied if 50 percent or less of the beneficial interest in the resident is owned, directly or indirectly, by any combination of individual residents of Barbados and citizens or residents of the United States. This rule is not as strict as that in the U.S. model treaty, which requires 75 percent ownership, by residents of the entity's country of residence, to preserve benefits.

Second, treaty benefits will be denied if the income of the resident is primarily used to make deductible payments to third-country residents (who are not U.S. citizens). The Treasury Department technical explanation of the proposed treaty says that this rule will generally be interpreted to apply if the entity pays out 50 percent or more of its income in deductible payments, such as interest and royalties. This provision is substantially identical to that in the U.S. model treaty.

Two general exceptions apply to the rules denying benefits. First, treaty benefits are preserved if the resident entity's income is derived in connection with, or is incidental to, the active conduct of a trade or business in the source country. However, this exception does not apply (and benefits are therefore denied) to an entity in the business of making or managing investments. Nor does the exception apply if the entity's income is from banking or insurance and is subject to tax in the residence country at a rate substantially below the rate generally applicable to business income in that country. This rule is designed to prevent treaty shopping with respect to Barbados' special investment incentive rules, by preventing incentive companies which are investment companies, banks, or insurance companies, from claiming treaty benefits. (Incentive companies actively engaged in other commercial activities may still claim treaty benefits.) This active trade or business rule replaces a more general rule in the U.S. model treaty and most recent U.S. income tax treaties that preserves benefits if an entity is not used "for a principal purpose of obtaining benefits" under a treaty.

The second major exception to the general rules denying treaty benefits applies to publicly traded companies; a company will not be denied benefits under the general rules if there is substantial and regular trading in its principal class of shares on a recognized stock exchange (which is restrictively defined).

The proposed treaty contains a rule not found in the U.S. model or in most recent U.S. income tax treaties that requires consultation between the competent authorities (upon request by one of the competent authorities) after invocation of this anti-treaty shopping article. The Treasury Department technical explanation states that this provision does not require prior agreement of the competent authorities before benefits may be denied. (A similar provision in the proposed treaty with Denmark was clarified by an exchange of notes specifying that consultation was not a prior condition to denial of benefits.)

Article 23. Relief from Double Taxation

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 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 Barbados and the United States will still tax the same item of income. Barbados waives its overriding taxing jurisdiction to the extent that this article applies; the United States does the same with respect to U.S. residents who are not U.S. citizens.

The proposed treaty, in an article substantially identical to that in the U.S. model treaty, provides parallel rules for relief from double taxation for the United States and Barbados.

United States

Under the proposed treaty, the United States will allow a foreign tax credit to a U.S. resident or U.S. citizen for income tax paid to Barbados by or on behalf of the U.S. resident or citizen. The proposed treaty further provides that the United States will allow a deemed paid credit to a U.S. corporate shareholder of a Barbadian company receiving a dividend from the Barbadian company if the U.S. corporate shareholder owns 10 percent or more of the voting stock in the Barbadian company. This credit will be allowed for the income tax paid to Barbados, by or on behalf of the distributing Barbadian company, on the profits out of which the dividends are paid. Both the regular and deemed paid foreign tax credits are to be determined in accordance with the provisions of U.S. law (as it may change from time to time, but without changing the general principles of this rule).

The proposed treaty provides that all Barbadian taxes covered by the treaty (Article 2) are considered income taxes for purposes of the U.S. foreign tax credit. Accordingly, all such Barbadian taxes will be eligible for the U.S. foreign tax credit under the proposed treaty.

Barbados

The proposed treaty provides that Barbados is to credit against the Barbadian tax imposed on a Barbadian resident any U.S. income tax payable under the treaty on the Barbadian resident's U.S. source income. The proposed treaty further provides that Barbados is to allow a credit to a Barbadian company receiving a dividend from a U.S. resident company whose shares are owned 10 percent or more by the Barbadian company. The credit is to take into account the U.S. income tax payable by the distributing U.S. company on the profits out of which the dividends are paid. All U.S. taxes covered by the treaty (Article 2) are considered income taxes for purposes of the Barbadian foreign tax credit. Both the regular and deemed paid foreign tax credits are to be determined in accordance with the provisions of Barbadian law.

Source rule

The double taxation article contains a special source rule. Income derived by a resident of one country that may be taxed in the other country under the proposed treaty is deemed to arise in that other country, while income derived by a resident of one country that may not be taxed in the other country under the proposed treaty is deemed to arise in the country of residence. The source of income will determine whether or not a credit is allowable for foreign taxes paid with respect to that income, since both countries allow foreign tax credits only with respect to foreign source income. This source rule is expressly limited to the double tax relief article, as the corresponding source rule of the U.S. model is. However, the proposed treaty omits the U.S. model provision stating that this source rule does not apply in determining foreign tax credits for foreign taxes paid by U.S. residents to third countries.

Article 24. Non-discrimination

The proposed treaty contains a non-discrimination article relating to the taxes covered by the treaty. It is similar to the non-discrimination article in the U.S. model treaty and to non-discrimination articles that have been embodied in other recent U.S. income tax treaties.

In general, under the proposed treaty, one country cannot discriminate by imposing other or more burdensome taxes (or requirements connected with taxes) on nationals of the other country than it would impose on its nationals in the same circumstances. Under both the proposed treaty and the U.S. model, this provision applies whether or not the nationals in question are residents of one or both of the countries. This rule of application is qualified, as in the U.S. model, by the rule that a U.S. national residing outside the United States and a national of Barbados residing outside the United States are not in the same circumstances for U.S. tax purposes.

As indicated above (under Article 3), "nationals" are defined as individuals having the nationality of the United States or Barbados and any company, association, or other entity deriving its status as such from the laws of the United States or Barbados. This definition corresponds closely to that contained in the OECD and United Nations model treaties. Under the U.S. model treaty, by comparison, only U.S. citizens qualify as U.S. nationals for purposes of obtaining nondiscrimination benefits. Thus, in this regard the protection against discrimination afforded by the proposed treaty is broader than that contemplated by the U.S. model treaty.

Under the proposed treaty, neither country may tax a permanent establishment of an enterprise of the other country less favorably than it taxes its own enterprises carrying on the same activities. Consistent with the U.S., OECD, and United Nations model treaties, however, a country is not obligated to grant residents of the other country any personal allowances, reliefs, or reductions for tax purposes on account of civil status or family responsibilities which it grants to its own residents. In addition, the proposed treaty specifies that Barbados is not prevented by this article from imposing its tax on the premium income of nonresident insurers and foreign insurance companies (see discussion under Article 7). It is also specified that Barbados may apply its tax on branch profits without violating this article, and that the United States could also impose such a tax on a permanent establishment maintained by a resident of Barbados.

Each country is required (subject to the arm's-length pricing rules of Articles 9 (associated enterprises), 11(4) (interest), and 12(5) (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 Treasury Department's technical explanation states that the term "other disbursements" is understood to include a reasonable allocation of executive and administrative expenses, research and development expenses, and other expenses incurred for the benefit of a group of related enterprises.

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. Enterprises resident in one country, the capital of which is wholly or partly owned or controlled, directly or indirectly, by one of more residents of the other country, will not be subjected in the first country to any taxation or any connected requirement that is other or more burdensome than the taxation and connected requirements that the first country imposes or may impose on its similar enterprises.

The nondiscrimination 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 scope of the nondiscrimination article in the proposed treaty is limited to the taxes that are covered by the agreement (i.e., national-level income taxes). Thus, in this respect the proposed treaty's protection is narrower than the U.S. model treaty, which applies to all national, state, and local taxes.

Article 25. Mutual Agreement Procedure

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

Under the proposed treaty, a person who considers that the actions of one or both of the countries will cause him or her to pay a tax not in accordance with the treaty may present his or her case to the competent authority of the country of which he or she is a resident. If the case comes under the nondiscrimination article, the person also may present his or her case to the competent authority of the country of which he or she is a national (but not a resident). The latter rule follows the United Nations model treaty; under the U.S. model treaty, a person may present his or her case to the country of which he or she is a national (but not a resident) without any restriction as to the treaty article under which the case arises. As in the U.S. model treaty, no time limit is imposed on the presentation of a person's case.

Upon the presentation of a person's case, the competent authority will make a determination as to whether the objection appears justified. If the objection appears to the competent authority to be justified and if it is not itself able to arrive at a satisfactory solution, then the competent authority will endeavor to resolve the case by mutual agreement with the competent authority of the other country, with a view to the avoidance of taxation that is not in accordance with the treaty. This provision requires the waiver of the internal statute of limitations of either country so as to permit the issuance of a refund or credit notwithstanding that statute of limitations. However, the provision does not authorize the imposition of additional taxes after the statute of limitations has run.

The competent authorities of the countries are to endeavor to resolve by mutual agreement any difficulties or doubts arising as to the interpretation or application of the treaty. They may also consult together for the elimination of double taxation in cases not provided for in the treaty. Like the U.S. model treaty, the proposed treaty enumerates particular matters as to which the competent authorities might agree, including the allocation of income, deductions, credits, or allowances, the determination of the character and source of income, the common meaning of terms, increases in specific dollar amounts referred to in the treaty (to reflect economic developments), and the application of laws regarding penalties, fines, and interest.

The proposed 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. This provision makes clear that it is not necessary to go through diplomatic channels in order to discuss problems arising in the application of the treaty. It also removes any doubt as to restrictions that might otherwise arise by reason of the confidentiality rules of the United States or Barbados.

Article 26. 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 follows the exchange of information article of the U.S. model treaty, with some modifications. It is also similar to the exchange of information articles found in the United Nations and OECD model treaties. It should be noted that Barbados and the United States have already entered into an exchange of information agreement that satisfies the conditions set forth in the Caribbean Basin Initiative legislation. The more detailed provisions of that agreement are now in force, and would not be superseded or otherwise changed by this article. The article would, however, make exchange of information between the two countries a requirement under treaty, rather than simply under an executive agreement.

The proposed treaty provides for the exchange of information that is necessary to carry 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 insofar as the taxation under those domestic laws is not contrary to the treaty. Following the United Nations model treaty, the proposed treaty adds that such exchange of information will be, in particular, for the prevention of fraud or evasion of the covered taxes.

The exchange of information under the proposed treaty is not restricted by Article 1; thus, information concerning third-country residents is covered. The U.S. model treaty provides for the exchange of information regarding all taxes imposed by either country (whether or not otherwise covered by the treaty). The exchange of information provided for in the proposed treaty is somewhat more limited since, in the case of Barbados, the proposed treaty authorizes the exchange only of information regarding taxes covered by the treaty (Article 2). However, the United States can request the exchange of information concerning a broader range of taxes, consisting generally of all taxes under the Internal Revenue Code.

Any information exchanged is to be treated as secret. Exchanged information may be disclosed only to persons or authorities (including courts and administrative bodies) involved in the assessment, collection, or administration of, the enforcement or prosecution in respect of, or the determination of appeals in relation to, the taxes to which the treaty applies. Such persons or authorities can use the information for such purposes only. They may disclose the information in public court proceedings or in judicial decisions. Persons involved in 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 necessary to carry out their oversight responsibilities. The proposed treaty specifies that the competent authorities must develop conditions, methods, and techniques concerning the matters respecting which information will be exchanged. It also specifies that information will not be disclosed to a third jurisdiction without the consent of the country that furnished the information. The Treasury Department technical explanation states that this latter rule confirms existing U.S. policy.

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, or to supply information which is not obtainable under the laws or in the normal course of the administration of either country, or to supply information that 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. Staff is informed that the Treasury Department is satisfied that the internal laws of Barbados do not contain provisions protecting bank secrecy or other provisions that by reason of this limitation would interfere with the intended operation of the exchange of information article.

The proposed treaty, like the U.S. model, requires that, upon an appropriate request for information, the requested country obtain the information to which the request relates in the same manner and to the same extent as if its tax were at issue. It also requires that, where specifically requested by the competent authority of one country, the competent authority of the other country provide the information in the form requested.

The U.S. model treaty also provides that each country will collect taxes for the other country to the extent necessary to insure that benefits of the treaty are not going to persons not entitled to those benefits. The proposed treaty does not contain such a collection provision.

Article 27. Diplomatic Agents and Consular Officers

The proposed treaty contains the rule found in other U.S. tax treaties that its provisions are not to affect the privileges of diplomatic agents or consular officers under the general rules of international law or the provisions of special agreements. Accordingly, the treaty will not defeat the exemption from tax which a host country may grant to the salary of diplomatic officials of the other country. Because the saving clause applies only with respect to individuals who are citizens (or have immigrant status), U.S. diplomats who are Barbadian residents will not be subject to Barbadian tax (unless they are citizens or immigrants of Barbados). Similarly, Barbadian diplomats who are U.S. residents will not be subject to U.S. tax (unless they are citizens or immigrants of the United States).

Article 28. Entry into Force

The proposed treaty states that it is to be ratified, and instruments of ratification exchanged, as soon as possible. The proposed treaty will enter into force when the instruments of ratification are exchanged, but its provisions will generally become effective for taxable years beginning on or after January 1, 1984. This unusual retroactive effect repairs a lapse in treaty coverage, since the previous U.S. treaty with Barbados was terminated by the United States effective after December 31, 1983. However, with respect to taxes withheld at source in the United States, the treaty will be effective for amounts paid or credited on or after the first day of the second month following the treaty's entry into force.

Article 29. Termination

This proposed treaty will remain in force indefinitely, but either country may terminate it by giving notice on or before June 30th in any calendar year after the year 1988 (i.e., five years from the date on which the treaty becomes effective). If a termination occurs, it will generally be effective with respect to taxes arising in taxable years beginning on or after January 1st of the year following that in which the notice of termination is given.

Exchange of Notes

At the signing of the proposed treaty, notes were exchanged dealing with two issues. First, the notes state that Barbados has emphasized the importance of including in the convention provisions which would promote the flow of U.S. investment to Barbados. The U.S. delegation stated that it is not able to accept such a provision at this time, but if circumstances change the United States would be prepared to reopen discussions with a view to including such a provision in the treaty. This discussion reflects the desire of Barbados and other developing countries to have the United States adopt a tax sparing credit. 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, 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, 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.

Similarly, the notes state that Barbados sought the inclusion of a provision that would treat as charitable contributions for tax purposes gifts by a resident of one country to a charitable organization in the other. The United States is not able to agree to such a provision at this time, but if its policies should change, the United States would be prepared to reopen discussions with a view to incorporating in the treaty such a provision. This discussion reflects Barbados' desire to encourage contributions by U.S. persons to Barbadian charities, by making such contributions deductible for U.S. tax purposes.

These discussions are similar to provisions included within other U.S. income tax treaties with developing countries.

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