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Eligibility For Benefits Under The US-Cyprus Double Tax Convention And The Reduced US Tax Rate On Dividends From Qualified Foreign Corporations

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In a memorandum¹ dated September 10, 2013, released in October 2013, the office of Associate Chief Counsel of the US Internal Revenue Service announced that a Cyprus-resident holding company qualified for benefits under the US-Cyprus double tax convention ("the US-Cyprus convention") and the reduced tax rate on dividends from qualified foreign corporations, despite not meeting the share ownership requirements stipulated in the convention.

Under section 1(h)(11) of the Internal Revenue Code ("Code"), qualified dividend income is taxed at the same reduced tax rate as net capital gains, significantly below the rate applicable to other dividends. For example, in the case of a taxpayer who would ordinarily pay tax at 39.6 percent on dividends, the rate on qualifying dividends is only 20 percent. For taxpayers with a standard rate of 15 percent or less, there is no liability to tax on qualified dividends.

Qualified dividend income includes dividends received during the taxable year from a "qualified foreign corporation." Section 1(h)(11)(C)

(i) of the Code defines a qualified foreign corporation as "any foreign corporation if (I) such corporation is incorporated in a possession of the United States, or (II) such corporation is eligible for benefits of a comprehensive income tax treaty with the United States which the Secretary determines is satisfactory for purposes of this paragraph and which includes an exchange of information program."

Notice 2011-64, 2011-37 I.R.B. 231 dated 12 September 2011 contains a list of the 57 US double taxation agreements, including the US-Cyprus convention, that meet the requirements.

One of the requirements for eligibility is that the dividends must have been received from a country whose treaty fulfils the "treaty test." In order for the Cyprus company to meet the criteria of the "treaty test," it had to be ascertained whether all the requirements of the US-Cyprus convention were met, and in particular whether the Limitation on Benefits provisions contained in article 26 of the convention were triggered.

Paragraph 1 of article 26 provides that a resident of Cyprus other than an individual is not entitled to benefits under the convention unless two conditions are satisfied. Firstly, in the case of a corporation, more than seventy-five percent of each class of shares must be beneficially owned, directly or indirectly, by one or more individual residents of Cyprus; and, secondly, the gross income of the corporation must not be used in substantial part, directly or indirectly, to meet the liabilities of persons who are resident in a country other than the United States or Cyprus.

However, paragraph 2 of article 26 (the "principal purpose test") provides an exception to this rule. It stipulates that benefits under the convention will not be denied, notwithstanding that the two conditions in paragraph 1 are not satisfied, if "the establishment, acquisition, and maintenance of the person claiming treaty benefits and the conduct of its operations did not have the obtaining of treaty benefits as a principal purpose." In brief, even if a Cyprus company does not satisfy the shareholder ownership requirement of paragraph 1, it will nevertheless be entitled to benefits under the convention provided that the principal purpose test is satisfied.

The memorandum asserts that in the case in question the Cyprus company "is being maintained for reasons unrelated to the Treaty" and that consequently "there was no 'principal purpose' of obtaining benefits under the Treaty."

While the memorandum represents a favorable outcome for the taxpayer concerned, it would have been more helpful to practitioners had it explained the circumstances and reasoning on which this conclusion was based. For example, will a business purpose be sufficient to satisfy the test? Could a Cyprus company formed for the sole purpose of obtaining qualified dividend treatment satisfy the principal purpose test, since this treatment is arguably not a benefit of the convention but of section 1(h)(11) of the Code.

The memorandum highlights the existence of this relatively unusual and potentially valuable exemption, which will no doubt be further explored by enterprising practitioners over the years to come.

ENDNOTES

- ¹ Memorandum number 201343019, available at <http://www.irs.gov/pub/irs-wd/1343019.pdf>