

TREASURY DEPARTMENT TECHNICAL EXPLANATION OF THE CONVENTION  
BETWEEN THE GOVERNMENT OF THE UNITED STATES OF AMERICA AND THE  
GOVERNMENT OF THE REPUBLIC OF CYPRUS FOR THE AVOIDANCE OF DOUBLE  
TAXATION AND THE PREVENTION OF FISCAL EVASION WITH RESPECT TO TAXES  
ON INCOME SIGNED AT NICOSIA ON MARCH 19, 1984

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INTRODUCTION

The technical explanation is an official guide to the Convention. It reflects policies behind particular Convention provisions, as well as understandings reached with respect to the interpretation and application of the Convention.

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## ARTICLE 1 Taxes Covered

Paragraph (1) designates the existing taxes of the Contracting States which are the subject of the Convention. In the case of the United States, these are the Federal income taxes imposed by the Internal Revenue Code ("Code"), the excise taxes imposed with respect to private foundations and the excise tax paid on insurance premiums paid to foreign insurers, but only to the extent that the risks are not reinsured, directly or indirectly, with a person not entitled to relief from such tax. The Convention does not apply to the accumulated earnings tax, the personal holding company tax or the social security taxes.

In the case of Cyprus, the covered taxes are the Income Tax, the Capital Gains Tax and the Special Contribution.

Under paragraph (2), the Convention will apply to any taxes which are substantially similar to those specified in paragraph (1) which are imposed in addition to, or in place of, the existing taxes after March 19, 1984 (the date of signature of the Convention).

Paragraph (3) provides that for purposes of Article 7 (Non-Discrimination) the Convention will apply to all taxes imposed at national, state or local levels of government by either Contracting State; and for purposes of Article 28 (Exchange of Information), the Convention will apply to taxes of every kind imposed by the national Government of either Contracting State.

## ARTICLE 2 General Definitions

Paragraph (1) defines certain basic terms used in the Convention. A number of important terms; however, are defined elsewhere in the Convention. For example, the terms "resident of Cyprus" and "resident of the United States" are defined in Article 3 (Fiscal Residence); the term "permanent establishment" is defined in Article 9 (Permanent Establishment) and the terms "interest" and "royalties" are defined in Articles 13 (Interest) and 14 (Royalties), respectively. The terms "United States" and "Cyprus" are defined to include the continental shelf areas of the Contracting States with respect to exploration and exploitation of their natural resources. For the United States, the definition of the continental shelf is interpreted in accordance with section 638 of the Code and the regulations thereunder. The term "United States" does not include Puerto Rico, Guam, the Virgin Islands or any other United States possession. The term "Contracting State" means either the United States or Cyprus, according to the context, and the term "State" means any National State, whether or not a Contracting State.

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

The terms "United States corporation" or "corporation of the United States" and "Cypriot corporation" or "corporation of Cyprus" are defined. In the case of the United States, the terms mean a corporation which is created or organized under the laws of the United States, any state thereof or the District of Columbia, as well as any unincorporated entity which is treated as a United States corporation for United States tax purposes. In the case of Cyprus, the terms mean an entity which is treated as a body corporate for tax purposes under Cyprus law, which is resident in Cyprus for purposes of Cyprus tax. The term, however, excludes a United States corporation. Thus, a United States corporation which is managed and controlled in Cyprus would be treated as a United States corporation, and not as a Cypriot corporation, for purposes of the Convention.

The competent authority in the case of the United States is the Secretary of the Treasury or his delegate, and in the case of Cyprus, the Minister of Finance or his authorized representative.

"International traffic" is defined to mean any transport by ship or aircraft, except where such transport is solely between places in the Contracting State which is not the State of residence of the person deriving the income dealt with in Article 10 (Shipping and Air Transport).

Paragraph (6) of Article 4 (General Rules of Taxation) refers to a tax burden which is substantially less than the tax generally imposed. Article 2 defines "substantially less than" to mean less than 50 percent of.

Paragraph (2) provides that in the application of the Convention, any term used but not defined in the Convention, will, unless the context requires otherwise, have the meaning which it has under the law of the Contracting State whose tax is being applied. However, if the meaning of a term under the law of a Contracting State cannot readily be determined, or if there is a conflict in meaning under the laws of the two States, the competent authorities may establish a common meaning in order to prevent double taxation or further any other purpose of the Convention. This common meaning need not conform to the meaning of the term under the laws of either Contracting State.

### ARTICLE 3 Fiscal Residence

This Article sets forth rules for determining whether an individual, a corporation or any other person is a resident of a Contracting State for purposes of the Convention. A definition of residence is important because, for the most part, only residents of the Contracting States may claim the benefits of the Convention. The Convention definition of residence is to be used exclusively for purposes of the Convention.

Paragraph (1) defines the terms "resident of Cyprus" and "resident of the United States". A resident of the United States or Cyprus, as the case may be, includes a corporation of that State, and any person, except a corporation, resident in that State for purposes of its tax. A resident of the United States also includes a U.S. citizen, wherever resident. Since a Cyprus corporation is defined in Article 2 (General Definitions) to exclude a United States corporation, a corporation which is managed and controlled in Cyprus, thus making it a resident of Cyprus under Cyprus law, would not be a resident of Cyprus under the Convention if it is a United States corporation (i.e., a corporation which is created or organized under the laws of the United States, any state thereof or the District of Columbia). The possibility of a dual-resident corporation is thereby precluded.

Furthermore, a partnership, estate or trust will be treated as a resident of a Contracting State under the Convention only to the extent that the income derived by such person is subject to tax in that State as the income of a resident, either in the hands of the person deriving the income or in the hands of its partners or beneficiaries. This rule regarding the residence of partnerships, estates or trusts is applied to determine both whether that person is entitled to treaty benefits with respect to income which it receives and, where relevant, whether a resident of the other Contracting State is entitled to treaty benefits with respect to income paid by such person.

If, under the laws of the two Contracting States, and, thus, under paragraph (1), an individual is deemed to be a resident of both the United States and Cyprus, a series of tie-breaker rules are provided in paragraph (2) to determine a single State of residence of that individual. Paragraph (3) provides that such a determination will apply for all purposes of the Convention.

The first test is where the individual has a permanent home. If that test is inconclusive because the individual has a permanent home in both States or in neither, he will be considered to be a resident of the Contracting State where his personal and economic relations are closest. If that test is also inconclusive, he will be considered to be a resident of the Contracting State where he maintains a habitual abode. If he has a habitual abode in both States or in neither, he will be treated as a resident of the Contracting State of which he is a citizen. If he is a citizen of both States or of neither, the question is left to the competent authorities, who will attempt to settle it by mutual agreement.

If, by reason of paragraph (1), a person other than an individual or a corporation is a resident of both Contracting States, paragraph (4) provides that the competent authorities will attempt to reach agreement on a single State of residence and on the application of the Convention to such person.

#### ARTICLE 4 General Rules of Taxation

Paragraph (1) contains the general rule that a resident of one Contracting State may be taxed by the other Contracting State on any income from sources within that other State, and only

on such income. The tax imposed by the source State is subject to any limitations in the Convention, such as limits on the rate of tax which may be imposed by the State of source on dividends, interest and royalties. The source of any item of income for this purpose is determined in accordance with the source rules of Article 6 (Source of Income). This rule is subject to certain exceptions, one of which is found in paragraph (3) of this Article, which relates to a resident of one State who is a citizen of the other.

Paragraph (2) states the customary rule that no provision in the Convention may restrict any exclusion, exemption, deduction, credit or other allowance accorded by the tax laws of the Contracting States. Thus, for example, if a deduction would be allowed under the Code in computing the taxable income of a Cypriot resident, such deduction will generally be available to that person in computing income under the Convention. A taxpayer may not, however, make inconsistent choices between the rules of the Code and the Convention rules. In no event may the Convention increase the overall tax burden on residents of the Contracting States. Thus, a right to tax given by the Convention cannot be exercised by the United States unless that right also exists under the Code.

Similarly, any benefit extended by any other agreement between the Contracting States cannot be denied as a result of any provision of this Convention.

Paragraph (3) contains the traditional saving clause under which both Contracting States reserve the right to tax their citizens and residents as if the Convention had not come into effect. Residence for this purpose is determined under Article 3 (Fiscal Residence) of the Convention. A citizen is defined for purposes of this rule to include a former citizen of a Contracting State whose loss of citizenship had as one of its principal purposes the avoidance of the tax of the State of former citizenship. This rule applies only for a period of ten years following the loss of citizenship. A former United States citizen will be taxable under this rule in accordance with section 877 of the Code.

Paragraph (4) sets forth certain exceptions to the saving clause in cases where its application would contravene policies reflected in the Convention which are specifically intended to afford benefits granted by a State to its citizens and residents. Thus, the benefits conferred by a Contracting State under Article 5 (Relief from Double Taxation), 7 (Non-Discrimination), 24 (Social Security Payments) and 27 (Mutual Agreement Procedure) will not be affected by the saving clause. Under a second category of exceptions, the benefits of Articles 21 (Students and Trainees) and 22 (Governmental Functions) will not be denied to a resident of a Contracting State if the individual is neither a citizen of that State nor has immigrant status there. The term "immigrant status" for United States purposes refers to a person admitted to the United States as a permanent resident under United States immigration laws (i.e., the holder of a "green card").

Paragraph (5) deals with the situation, applicable in certain circumstances under Cyprus law, where a resident of a Contracting State is subject to tax in that State on income derived from abroad only to the extent that the income is remitted to or received in that State. This paragraph provides that when such a remittance basis rule applies, exemptions or reductions in tax in the other State under the Convention will apply to an item of income only to the extent that the

income is remitted to or received in the State of residence of the recipient during the calendar year such income is paid or the next succeeding calendar year.

Paragraph (6) contains a rule designed to prevent certain types of abuse of the Convention. The paragraph provides that reductions in tax or exemptions in one Contracting State provided for in the Convention will not apply if the recipient of the income from that State who is a resident of the other State is subject in his State of residence on that income to a rate of tax or tax burden which is substantially less than the tax which would generally be imposed by that State of residence on such income if it was derived from sources within that State. Under Article 2 (General Definitions), a rate of tax or tax burden which is less than 50 percent of the rate normally applicable will be considered to be substantially less than the tax normally imposed. Thus, for example, if a corporation which is a resident of Cyprus derives dividend income from the United States, which, under Article 12 (Dividends), is subject to a maximum rate of tax in the United States of 15 percent, and if that corporation is subject to income tax in Cyprus with respect to that dividend income at a rate of 4.25 percent instead of the normal corporate income tax rate of 42.5 percent, then United States tax will be imposed on the dividend income at the statutory rate of 30 percent rather than the treaty rate of 15 percent. This rule will be applied on an item of income by item of income basis. This denial of benefits rule does not apply to pension income dealt with in paragraph (1) of Article 23 (Private Pensions and Annuities). Thus, the source country exemption for pension income provided in that paragraph will continue to apply whether or not the recipient of the pension is subject to tax at normal rates in his country of residence. (See the explanation of Article 26 (Limitation on Benefits) for an additional discussion of this paragraph and its relation to Article 26.)

## ARTICLE 5 Relief From Double Taxation

In order to avoid double taxation, each Contracting State agrees in this Article to provide to its citizens or residents a credit against its taxes for the taxes paid by such person to the other Contracting State.

In paragraph (1), the United States agrees to allow to a citizen or resident of the United States as a credit against United States tax the appropriate amount of taxes paid or accrued to Cyprus, in accordance with the provisions and subject to the limitations of United States law (as it may be amended from time to time without changing the general principle of paragraph (1)). Under Article 12 (Dividends), no Cypriot tax may be imposed on dividends paid to a resident of the United States in excess of the tax paid at the corporate level on the income out of which the dividend is paid. Therefore, no United States credit is allowed with respect to a dividend paid by a Cypriot corporation, except when the recipient is a United States corporation which owns at least ten percent of the voting power of the Cypriot corporation paying the dividend. In the latter case, the United States will allow a credit for the appropriate amount of Cypriot tax paid by the Cypriot corporation with respect to the income out of which the dividend is paid. Any credit allowed under this paragraph is based on the Cypriot tax paid, but is subject to the limitations in United States law, which limit the credit to the amount of United States taxes paid on income

from sources outside the United States (see, for example, code section 904(g)). This provision does not require the United States to maintain a per-country or overall limitation, so long as the general principle of a foreign tax credit remains in effect. For purposes of applying this paragraph, the rules in Article 6 (Source of Income) will be used to determine the source of income.

Under paragraph (2), Cyprus agrees to provide to its citizens or residents a credit against Cypriot tax for the appropriate amount of United States taxes paid, in accordance with the provisions and subject to the limitations of Cyprus law (as it may be amended from time to time without changing the general principle of paragraph (2)). In the case of a Cypriot corporation which receives dividends from a United States corporation in which the Cypriot corporation owns at least 10 percent of the voting power, the credit will include the appropriate amount of United States tax paid by the corporation paying the dividends with respect to the income out of which the dividends are paid. The credit will be based on the amount of United States tax paid, but will not exceed the portion of the Cypriot tax (computed before the allowance of the credit) applicable to the items of income from United States sources. For purposes of applying this paragraph, the rules of Article 6 (Source of Income) will be used to determine the source of income.

This Article is not subject to the saving clause of paragraph (3) of Article 4 (General Rules of Taxation). Thus, each Contracting State will allow a credit to its citizens and residents in accordance with the provisions of this Article, even if those provisions provide a benefit not available under the internal law of the Contracting State granting the credit.

## ARTICLE 6 Source of Income

This Article contains the source rules which are used in applying the rules of the Convention. For example, under Article 4 (General Rules of Taxation), one Contracting State may tax a resident of the other Contracting State only on income from sources within the first-mentioned Contracting State (provided, with certain exceptions, such resident is not a citizen of the first-mentioned State).

Paragraph (1) provides, as a general rule, that dividends will be treated as income from sources within a Contracting State only if paid by a corporation of that State. An exception to this general rule provides that a dividend will be deemed to be from United States sources if paid by a corporation other than a United States corporation (including a Cypriot corporation) which derives 50 percent or more of its total gross income from one or more permanent establishments which that corporation has in the United States. This rule is similar to that in Code section 861(a)(2)(B). It differs from the Code rule, however, in several respects. For example, it deals with income derived from a permanent establishment rather than a trade or business, and it does not specifically provide that only a pro rata portion of the dividend will be treated as income from sources within the United States. However, since Article 4 (General Rules of Taxation) provide, in effect, that the Convention cannot operate to increase a person's United States tax, the

proration specified in the Code will be applied to determine the portion of the dividend paid by such non-United States corporation which will be treated as United States source income. In the case of a dividend which would be treated under the general rule as being from Cypriot sources (i.e., paid by a Cypriot corporation), but which, under the exception, would be treated as being from United States sources, the portion of the total dividend, after proration, to which the exception applies would be treated as United States source income, and any excess would be treated as Cypriot source income.

Paragraph (2) provides, as a general rule, that interest will be treated as income from sources within a Contracting State only if the interest is paid by the Contracting State itself, a political subdivision or local authority of that State or by a resident of that State. An exception to this general rule provides that if the person paying the interest (whether or not that person is a resident of a Contracting State) has a permanent establishment in a Contracting State, and the indebtedness on which the interest is paid was incurred in connection with that permanent establishment and the interest is borne by the permanent establishment (i.e., the interest is deducted in computing the income of the permanent establishment), then the interest will be deemed to be from sources in the Contracting State in which the permanent establishment is situated. Similarly, if a resident of a Contracting State has a permanent establishment in a State other than a Contracting State, then interest paid on indebtedness incurred in connection with that permanent establishment, which is borne by the permanent establishment, will be deemed to be from sources in the State in which the permanent establishment is situated.

A further exception provides that interest will be deemed to be from sources within the United States if paid by a Cypriot corporation which derives 50 percent or more of its total gross income from one or more permanent establishments which that Cypriot corporation has in the United States. This is similar to the rule in Code section 861(a)(1)(C) and (D). It differs from the Code rule, for example, in that the rule in the Convention does not provide for proration. As in the case of dividends, however, the ability of the United States to exercise its taxing rights under this provision is limited by its right to impose tax under the Code. Thus, the Code proration rules will apply.

Under paragraph (3), royalties, as defined in paragraph (2) of Article 14 (Royalties), are treated as income from sources within a Contracting State only to the extent that they are for the use of or the right to use in that Contracting State the property or rights giving rise to the royalties.

Paragraph (4) provides that income from real property, as described in Article 15 (Income from Real Property), has its source in the Contracting State in which the real property is situated.

Under paragraph (5), income from the rental of tangible personal property has its source in a Contracting State only if the property is used in that Contracting State, or is held for use there.

Paragraph (6) provides the rule for the source of income from the performance of personal services. The general rule is that income received by an individual for the performance

of labor or personal services, either as an employee or in an independent capacity, will be treated as income from sources in a Contracting State only to the extent that the services are performed in that State. Income from labor or personal services includes pensions (as defined in paragraph (3) of Article 23 (Private Pensions and Annuities)) paid in respect of such services.

There are several exceptions to the general rule, under which income from personal services may be sourced in a Contracting State other than the State where the services are performed: Income from personal services performed aboard ships or aircraft operated by a resident of a Contracting State in international traffic will be treated as income from sources only within that Contracting State if the services are rendered by a member of the regular complement of the ship or aircraft. Remuneration described in Article 22 (Governmental Functions) and payments described in Article 24 (Social Security Payments) are treated as income from sources within a Contracting State only if paid by or from the public funds of that State or a political subdivision or local authority of that State. In addition, Article 20 (Directors' Fees) provides that a portion of directors' fees paid by a corporation of a Contracting State may be taxed in that State; this paragraph treats that portion of the fees as income from sources within that State.

Paragraph (7) provides that income from the purchase and sale of property (including tangible and intangible personal property and real property) will be treated as income from sources in a Contracting State if either

- (1) the property is sold in that Contracting State, or
- (2) the property is of the type described in Paragraph (1)(a) or (b) of Article 16 (Gains) and the property is located or deemed to be located (under paragraph (3) of Article 16) in that Contracting State.

Thus, for example, if the property is shares in a United States corporation which is a United States real property holding corporation (i.e., a "United States real property interest"), the income from the sale of those shares will be income from sources in the United States even if the sale takes place outside the United States.

The source of gains described in paragraph (2)(b) of Article 14 (Royalties) will be determined under paragraph (3) of this Article, not under this paragraph.

Paragraph (8) contains a general qualification to the preceding source rules. It provides that industrial and commercial profits attributable to a permanent establishment which the recipient, a resident of a Contracting State, has in the other Contracting State will be treated as income from sources within that other Contracting State. Industrial and commercial profits attributable to such permanent establishment may include any items of income described in the preceding paragraphs of this Article (except paragraph (6)) if the item of income is effectively connected with the permanent establishment. (See the explanation of paragraph (6)(b) of Article 8 (Business Profits) for a discussion of the "effectively connected" concept.)

Under paragraph (9), the source of any item of income not described in the preceding paragraphs of this Article will be determined by each Contracting State in accordance with its own law. If the source rules of the Contracting States with regard to a particular item of income

differ, or if the source of an item of income is not readily determinable under the laws of a Contracting State, the competent authorities may establish a common source of that item of income for purposes of the Convention in order to prevent double taxation or further any other purpose of the Convention.

Several of the source rules set out in this Article may differ in some degree from those in the Code. Since as noted previously, paragraph 2 of Article 4 (General Rules of Taxation) provides, in effect, that the Convention will not increase a person's overall United States tax, a taxpayer is not required to apply the Convention rules in calculating his United States tax liability if the Code rules provide a more favorable result. A taxpayer may not, however, make inconsistent choices between Code and Convention rules.

## ARTICLE 7 Non-Discrimination

Paragraph (1) provides that a citizen of one Contracting State shall not be subject to more burdensome taxes in the other Contracting State than a citizen of that other Contracting State who is in similar circumstances. This paragraph would not apply in the case of a citizen of Cyprus who is not resident in the United States and a citizen of the United States who is not resident in the United States, to require that the Cyprus citizen not be subject to more burdensome United States taxation than the citizen of the United States. The citizen of the United States is subject to United States taxation on worldwide income, while the citizen of Cyprus is not, thus making their circumstances different. However, a citizen of Cyprus who is resident in the United States, and who otherwise meets the requirements of Code section 911, would, under this paragraph, be entitled to the benefits of section 911, even though not a citizen of the United States.

Paragraph (2) provides that a Contracting State may not impose more burdensome taxes on a permanent establishment of a resident of the other Contracting State than it imposes on its own residents carrying on similar activities. This provision, however, does not obligate a Contracting State to grant to individual residents of the other Contracting State any personal allowances, etc., on account of civil status or family responsibility, which it grants to its own individual residents.

Paragraph (3) prohibits discrimination in the allowance of deductions. Except where the provisions of paragraph (1) of Article 11 (Related Persons), paragraph (5) of Article 13 (Interest) and paragraph (4) of Article 14 (Royalties) apply (all of which permit denial of deductions in certain circumstances in transactions between related persons), interest, royalties and other disbursements paid by a resident of one Contracting State to a resident of the other shall be deductible in the first-mentioned Contracting State under the same conditions as if they had been paid to a resident of that first-mentioned Contracting State. The term "other disbursements" is defined to include a reasonable allocation of executive and general administrative expenses (other than expenses which constitute "stewardship" expenses undertaken for the benefit of the investor), research and development expenses and other expenses incurred for the benefit of a

group of related persons which includes the person incurring the expense. This paragraph also requires that a debt of a resident of one Contracting State owed to a resident of the other be deductible for purposes of any capital taxation in the first-mentioned Contracting State under the same conditions as if the debt were owed to a resident of the first-mentioned State. Though the Convention does not generally cover capital taxes, under paragraph (3) of Article 1 (Taxes Covered), the non-discrimination provisions apply to taxes of all kinds, imposed at all levels of government in both Contracting States.

Paragraph (4) requires that a Contracting State not impose other or more burdensome taxation (including connected requirements) on a corporation of that State which is owned or controlled, directly or indirectly, by residents of the other Contracting State than it imposes on other similar corporations of that Contracting State. Thus, a Cypriot subsidiary of a United States corporation must not be subject to more burdensome taxation in Cyprus than a Cypriot corporation owned by residents of Cyprus.

This Article is not subject to the saving clause of paragraph (3) of Article 4 (General Rules of Taxation). Thus, a resident of a Contracting State who is a citizen of the other Contracting State may claim the benefits of this Article in that other Contracting State.

## ARTICLE 8 Business Profits

This Article provides rules for the taxation by a Contracting State of income from business activity carried on by a resident of the other Contracting State.

Paragraph (1) sets forth the general rule that industrial or commercial profits (as defined in paragraph (6)(a)) of a resident of one Contracting State are exempt from tax in the other Contracting State unless that resident is engaged in industrial and commercial activity (as defined in paragraph (5)) through a permanent establishment in that other Contracting State. Permanent establishment is defined in Article 9 (Permanent Establishment). Where there is a permanent establishment, only the industrial and commercial profits attributable to the permanent establishment may be taxed.

The saving clause of paragraph (3) of Article 4 (General Rules of Taxation) applies to this Article, so that if, for example, a citizen of the United States who is a resident of Cyprus derives industrial and commercial profits from the United States, the United States may tax those profits even if the individual has no permanent establishment in the United States.

Under paragraph (8) of Article 6 (Source of Income), industrial or commercial profits which are attributable to a permanent establishment which a resident of one Contracting State has in the other Contracting State will be considered to be from sources within that other State. Under this rule, items of income described in Code section 864(c)(4)(B) attributable to a permanent establishment situated in the United States will be subject to tax by the United States.

In determining the proper attribution of industrial or commercial profits to a permanent establishment under the Convention, paragraph (2) provides that both Contracting States will attribute to a permanent establishment the profits which the establishment would have earned had it been an independent entity engaged in the same or similar activities under the same or similar conditions.

Under paragraph (3), expenses which are reasonably connected with the profits of a permanent establishment, including executive and general administrative expenses, wherever incurred, will be allowed as deductions in determining the industrial or commercial profits of the permanent establishment.

Paragraph (4) provides that a Contracting State will not attribute profits to a permanent establishment of a resident of the other Contracting State merely because of the purchase of goods or merchandise by that permanent establishment, or by that resident for its own account. Paragraph (2) does not override paragraph (4), so that where a permanent establishment purchases goods for its home office, the industrial and commercial profits will not include any notional figure representing profits from purchasing activities.

Paragraph (5) defines the term "industrial and commercial activity". The term includes the conduct of manufacturing, mercantile, banking, insurance, agricultural, fishing or mining activities, the operation of ships or aircraft, the furnishing of services and the rental of tangible personal property. The term does not include the performance of personal services by an individual, which is dealt with in Articles 17 and 25. The term "industrial and commercial profits" is defined in paragraph (6)(a) to mean income derived from industrial and commercial activity. The term also includes income from real property, dividends, interest, royalties and gains, but only if the property or rights giving rise to that income is effectively connected with a permanent establishment in a Contracting State. Such income need not be derived from industrial or commercial activity, but unless the recipient is engaged in industrial and commercial activity, under paragraph (1), the Contracting State in which the permanent establishment is situated may not tax that income under this Article.

Paragraph (6)(b) provides criteria for determining when property or rights are effectively connected with a permanent establishment. The factors to be taken into account include whether rights or property are used or held for use in carrying on industrial or commercial activities through the permanent establishment and whether those activities were a material factor in the realization of the income derived from the property or rights. In making such a determination, due regard is to be given to whether or not the property, rights or income were accounted for through the permanent establishment. The concept of effective connection as used in this Convention is narrower than the concept in Code section 864(c)(3), which includes a limited "force of attraction" rule not present in the Convention.

Under paragraph (7), where industrial or commercial profits include items of income which are dealt with separately in other articles of the Convention, the provisions of those articles, except where they specifically provide to the contrary, will take precedence over the provisions of this Article. Thus, for example, the taxation of interest will be determined under

Article 13 (Interest) and not under this Article, except when, as provided in paragraph (4) of Article 13, the indebtedness giving rise to the interest is effectively connected with a permanent establishment.

## ARTICLE 9 Permanent Establishment

This Article defines the term "permanent establishment". The existence of a permanent establishment is relevant under Article S (Business Profits) to the taxation of industrial or commercial profits and in determining the applicability of other provisions of the Convention.

Under paragraph (1), the term "permanent establishment" means a fixed place of business through which a resident of a Contracting State engages in industrial or commercial activity. Paragraph (2) gives an illustrative, non-exclusive, list of fixed places of business which will constitute a permanent establishment. This list includes a branch, an office, a factory, a workshop, a warehouse, and a store or other sales outlet.

The list also includes a mine, quarry or other place of extraction of natural resources, and a building site or construction or installation project or an installation or drilling rig or ship used to explore for natural resources, but only if that site, etc., exists or lasts for more than six months. Under this rule, the six month period begins only when work physically commences in the other Contracting State; A series of contracts or projects which are interdependent both commercially and geographically is to be treated as a single project for purposes of applying the six month test. If the six month test is exceeded, the site or project constitutes a permanent establishment from its first day.

Paragraph (3) lists a number of exceptions to the general rule that a fixed place of business through which industrial or commercial activity is carried on will constitute a permanent establishment. The activities listed in the paragraph are considered to be preparatory or auxiliary to industrial or commercial activity. The exceptions are cumulative, and a fixed place of business used only for one or more of the listed activities will not constitute a permanent establishment.

Paragraphs (4) and (5) deal with the use of agents. Under paragraph (4), a dependent agent of a resident of a Contracting State in the other Contracting State will be deemed to be a permanent establishment of that resident if the agent has and habitually exercises an authority to conclude contracts in the name of that resident, unless his activities are limited to those specified in paragraph (3), which would not constitute a permanent establishment if exercised through a fixed place of business. Under paragraph (5), a resident of a Contracting State will not be deemed to have a permanent establishment in the other Contracting State merely because it engages in industrial or commercial activity in that other Contracting State through an independent agent who is acting in the ordinary course of his business.

Paragraph (6) provides that, in determining whether a resident of a Contracting State has a permanent establishment in the other Contracting State, no account shall be taken of the fact

that the first-mentioned resident may be related (within the meaning of Article II (Related Persons)) to a resident of the other Contracting State, or to any person who engages in industrial or commercial activity in that other Contracting State, whether or not through a permanent establishment.

Under paragraph (7), for purposes of the Convention, the provisions of this Article also apply in determining whether any person has a permanent establishment in any State. Thus, the principles of Article 9 would be used, in applying the Convention, to determine whether a resident of a third State has a permanent establishment in the United States or Cyprus, and whether a resident of the United States or Cyprus has a permanent establishment in a third State.

## ARTICLE 10 Shipping And Air Transport

Paragraph (1) provides that, notwithstanding Article 8 (Business Profits) and Article 16 (Gains), income derived by a resident of a Contracting State from the operation in international traffic of ships or aircraft shall be exempt from tax in the other Contracting State. The exemption also covers gains from the sale, exchange or other disposition of such ships or aircraft. The term "international traffic" is defined in paragraph (1)(h) of Article 2 (General Definitions).

Under paragraph (2), profits derived from the rental on a full or bareboat basis of ships or aircraft which are operated in international traffic by the lessee, or which rental profits are incidental to profits, described in paragraph (1), from the operation in international traffic of ships or aircraft, are included within profits from the operation of ships or aircraft in international traffic. Such profits, therefore, derived by a resident of one Contracting State are exempt from tax in the other Contracting State. Thus, if a resident of the United States leases an aircraft to a resident of Cyprus, the lease payments will be exempt from Cyprus tax if either the aircraft is used in international traffic by the resident of Cyprus, or if the United States lessor is engaged in the operation of aircraft in international traffic, and the rental profits are incidental to such operation, regardless of whether the aircraft is used internationally or domestically by the lessee.

Paragraph (3) provides that the State from the use, maintenance or profits of a resident of a Contracting rental of containers (including equipment for their transport) which are used for the transport of goods or merchandise in international traffic will be exempt from tax in the other Contracting State.

This Article is subject to the saving clause of paragraph (3) of Article 4 (General Rules of Taxation). Therefore, a Contracting State may tax the income of a resident of the other Contracting State without regard to this Article, if such resident is a citizen of the first-mentioned Contracting State.

## ARTICLE 11 Related Persons

This Article complements section 482 of the Code. It provides that where related persons engage in transactions that are not at arm's length, the Contracting States may make appropriate adjustments to the taxable income and tax liability of such related persons.

Under paragraph (1), where a person subject to the taxing jurisdiction of a Contracting State and any other person are related, and where those related persons make arrangements or impose conditions between themselves which are different from those that would be made between independent persons, then the Contracting States may, in computing the income (or loss) of such person, take into account any income, deductions, credits, etc., which would have been taken into account in the absence of such a relationship.

Paragraph (2) defines the concept of related persons. Under this paragraph, a person is related to another person if either owns or controls the other, directly or indirectly, or if any third person or persons own or control both, directly or indirectly. The term "control" includes any kind of control, whether or not legally enforceable and however exercised or exercisable.

Paragraph (3) provides that where a Contracting State has made an adjustment under paragraph (1), and the other Contracting State agrees that the adjustment was appropriate under that paragraph, that other Contracting State is obligated to make a corresponding adjustment to the income, loss or tax of the related person in that other Contracting State.

## ARTICLE 12

### Dividends

Paragraph (1) provides that dividends derived from sources within Cyprus and beneficially owned by a resident of the United States will not be subject to any tax in Cyprus in excess of the tax imposed on the profits or earnings out of which the dividends are paid. This rule reflects the imputation system under which Cyprus taxes its corporations and their shareholders. Under Cyprus law, when a Cypriot corporation pays a dividend, there is no tax imposed in Cyprus on the dividend itself. The shareholder includes the dividend in income for Cyprus income tax purposes, grossed-up by the amount of Cypriot corporate tax paid on the income out of which the dividend is paid. The shareholder is then granted a refundable credit for the amount of the gross-up. Under the Convention, a United States individual resident shareholder may compute Cyprus tax on his dividend income and, if the corporate tax paid exceeds his liability for Cyprus tax on his dividend, he may apply to the Cyprus authorities for a refund. In no case will any United States shareholder be liable to any additional tax on Cyprus on his Cypriot source dividends.

Paragraph (2) provides the rules for determining United States tax on dividends paid to residents of Cyprus. The general rate of United States tax on dividends derived from sources within the United States and beneficially owned by a resident of Cyprus is limited to 15 percent of the gross dividend. The rate is limited to 5 percent if (1) at least 10 percent of the outstanding voting stock of the United States corporation was owned by the Cyprus corporation during the

portion of the taxable year of the United States corporation prior to the payment of the dividend and all of the preceding taxable year, and (2) not more than 25 percent of the gross income of the United States corporation for the prior taxable year (if any) consists of certain passive income.

Paragraph (3) provides that the limitations on source country tax in paragraphs (1) and (2) do not apply if the beneficial owner of a dividend who is a resident of a Contracting State has a permanent establishment in the other Contracting State, and the dividend is paid with respect to shares which are effectively connected with the permanent establishment. In that case the taxation of the dividend income is determined under Article 8 (Business Profits) and not under this Article.

Paragraph (4) provides, in general, that a Contracting State may not tax the dividends paid by a corporation of the other Contracting State. However, such dividends may be taxed by that other Contracting State if the recipient has a permanent establishment in that other Contracting State, and the shares in respect of which the dividends are paid are effectively connected with such permanent establishment. In addition, if dividends are paid by a corporation of Cyprus which derives 50 percent or more of its total gross income from one or more permanent establishments which that corporation has in the United States, the United States may tax those dividends, and the limitations of paragraph (2) do not apply.

This Article is subject to the saving clause of paragraph (3) of Article 4 (General Rules of Taxation). Thus, the United States may tax a dividend received by a resident of Cyprus without regard to the limitations of this Article if that Cyprus resident is a citizen of the United States.

## ARTICLE 13

### Interest

Under paragraphs (1) and (2), as a general rule, interest derived and beneficially owned by a resident of a Contracting State from sources within the other Contracting State may be taxed by both Contracting States, but the tax in the Contracting State of source may not exceed 10 percent of the gross amount of the interest. However, under paragraph (3), interest is exempt from tax in the Contracting State of source if it is derived

- (1) by the other Contracting State, or an instrumentality of that other Contracting State which is not subject to tax on its income by that Contracting State,
- (2) by a resident of the other Contracting State with respect to a debt obligation which is guaranteed or insured by that other Contracting State or instrumentality,
- (3) by a bank or other financial institution, or
- (4) by a resident of that other Contracting State with respect to a debt obligation arising in connection with the sale of property or the performance of services.

Under paragraph (4), the provisions of paragraphs (2) and (3) do not apply if the beneficial owner recipient of the interest is a resident of a Contracting State who has a permanent establishment in the other Contracting State, and the indebtedness giving rise to the interest is effectively connected with that permanent establishment. In that case, the interest will be taxed

under the provisions of Article 8 (Business Profits).

Under paragraph (5), where a person pays interest to a related person (as defined in Article 11 (Related Persons)) and the interest exceeds the amount which would have been paid to an unrelated person, then only the portion of the interest which would have been paid to an unrelated person will be subject to the provisions of this Article, and the excess may be taxed by each Contracting State under its law, including, where applicable, the provisions of this Convention. In the case of the United States, for example, the excess portion may be treated as a dividend, in which case the provisions of Article 12 (Dividends) will apply.

Paragraph (6) defines the term "interest" for purposes of the Convention. The term means income from bonds, debentures, government securities, notes or other evidences of indebtedness, whether or not secured and whether or not carrying a right to participate in profits, and any other debt-claim. The term also includes any other income which is assimilated to income from money lent under the taxation laws of the Contracting State in which the income has its source.

Paragraph (7) provides that interest paid by a resident of a Contracting State may not be taxed by the other Contracting State unless

- (1) it is paid to a resident of that other Contracting State,
- (2) the interest is treated as income from sources within that other Contracting State under paragraph (2) of Article 6 (Source of Income),
- (3) the recipient of the interest has a permanent establishment in that other Contracting State and the indebtedness giving rise to the interest is effectively connected with that permanent establishment, or
- (4) the other Contracting State is the United States, and the person paying the interest is a Cyprus corporation which derives 50 percent or more of its income from one or more permanent establishments which that corporation has in the United States.

In the latter case, the limitation on the rate in paragraph (2) does not apply to any tax which the United States may impose on that interest.

This Article is subject to the saving clause of paragraph (3) of Article 4 (General Rules of Taxation). Thus a Contracting State may tax the interest income of a resident of the other Contracting State without regard to any limitations in the Convention, if the resident of that other Contracting State is also a citizen of the first-mentioned State.

## ARTICLE 14

### Royalties

Under paragraph (1), royalties derived from sources within one Contracting State and beneficially owned by a resident of the other Contracting State are exempt from tax by the first-mentioned Contracting State. The source of a royalty is defined in paragraph (3) of Article 6 (Source of Income).

The term "royalties" is defined in paragraph (2) as payments of any kind for the use of, or the right to use, copyrights of literary, artistic, or scientific works, motion pictures, and works on film, videotape or other means of reproduction for radio or television broadcasting, patents, designs, models, plans, secret processes or formulae, trademarks or other like property or rights, or knowledge, experience or skill (know-how). The term also includes gains derived from the sale, exchange or other disposition of property or rights described in the preceding sentence, to the extent that the amounts realized are contingent on the productivity, use or disposition of the property or right.

Paragraph (3) provides that if the beneficial owner of the royalties is a resident of a Contracting State who has a permanent establishment in the other Contracting State, the limitations of paragraph (1) will not apply if the property or rights giving rise to the royalties are effectively connected with the permanent establishment. In such a case the provisions of Article 8 (Business Profits) and not this Article will apply.

Under paragraph (4), if a person pays a royalty to a related person (defined within the meaning of Article 11 (Related Persons)) which is greater than the royalty which would have been paid to an unrelated person, the provisions of this Article apply only to the amount which would have been paid to an unrelated person. Each Contracting State may tax the excess under its own law, including any applicable provisions of the Convention. For example, the excessive portion may be treated as a dividend or as interest, depending on the circumstances and the laws of the Contracting State imposing the tax. This Article is subject to the provisions of the saving clause of paragraph (3) of Article 4 (General Rules of Taxation). Thus, royalty income derived by a resident of one Contracting State may be taxed by the other Contracting State without regard to the limitations of this Article if that resident is a citizen of that other Contracting State.

## ARTICLE 15 Income From Real Property

Paragraph (1) provides that income from real property may be taxed in the Contracting State in which the real property is situated. This rule also applies to income from the usufruct, direct use, letting or use in any other form of real property. This paragraph does not grant an exclusive taxing right to the Contracting State of the situs of the property.

"Real property" is not defined in the Convention. According to paragraph (2) of Article 2 (General Definitions), therefore, the term is defined under the laws of the Contracting States. This paragraph, however, specifies that the term includes royalties and other payments in respect of the exploitation of natural resources, as well as gains from the sale, exchange or other disposition of such property or of rights giving rise to such royalties or other payments. The term does not include interest on indebtedness secured by real property or by a right giving rise to payments in respect of the exploitation of natural resources.

Under paragraph (3), a resident of a Contracting State who is subject to tax in the other Contracting State under paragraph (1) may elect to compute the tax for any taxable year on a net

basis as if the resident were engaged in trade or business in the other Contracting State. The election is binding for the taxable year of the election and all subsequent taxable years unless the competent authorities agree to the taxpayer's request to terminate the election.

## ARTICLE 16

### Gains

Paragraph (1) states the general rule that a resident of a Contracting State is exempt from tax in the other Contracting State on gains from the sale, exchange or other disposition of assets. Subparagraphs (a) through (c) provide exceptions to this rule.

Under subparagraph (a), the United States may tax a resident of Cyprus on gain on the sale, exchange or other disposition of real property (referred to in Article 15 (income from Real Property)) situated in the United States, and a United States real property interest. Under paragraph (3), a United States real property interest is considered to be situated in the United States. Thus, the United States retains the right to exercise its full taxing rights under the Foreign Investment in Real Property Tax Act (Code section 897). This is confirmed by the statement in paragraph (2) that the provisions of Article 15 (Income from Real Property) apply in determining the United States tax on the gain described in this subparagraph, since that Article does not impose any limit on the taxing rights which may be exercised by the Contracting State in which real property is situated.

Under subparagraph (b), Cyprus may tax a resident of the United States on gain from the sale, exchange or other disposition of real property (referred to in Article 15 (Income from Real Property)), which is situated in Cyprus, and an interest in real property situated in Cyprus. Under paragraph (3), an interest in real property situated in Cyprus is considered to be situated in Cyprus. Under Cyprus law, Cyprus may tax a resident of the United States on gain from the sale, exchange or other disposition of shares in a Cypriot corporation which is a real property holding company which holds real property situated in Cyprus. This Article confirms the right of Cyprus to impose that tax on a resident of the United States under the Convention. The provisions of Article 15 (Income from Real Property) apply in determining the Cypriot tax on the gain described in this subparagraph.

Under subparagraph (c), a Contracting State may tax a resident of the other Contracting State on gain derived from the sale, exchange or other disposition of property which forms part of the business property of a permanent establishment which that resident has in the first-mentioned Contracting State, or which pertains to a fixed base available to that resident in the first-mentioned Contracting State for the purpose of performing independent personal services. The gains referred to in this subparagraph include gains from the alienation of the permanent establishment (alone or with the whole enterprise) or the fixed base. The provisions of Articles 8 (Business Profits), 15 (Income from Real Property) and 17 (Independent Personal Services), as the case may be, apply in determining the tax on the gain described in this subparagraph.

This Article is subject to the provisions of the saving clause of paragraph (3) of Article 4

(General Rules of Taxation). Thus, a Contracting State may tax a resident of the other Contracting State on gains which are otherwise exempt from tax in the first-mentioned State under paragraph (1) if that resident is a citizen of that first-mentioned State.

## ARTICLE 17 Independent Personal Services

In dealing with the taxation of income from personal services, the Convention distinguishes between independent personal services (Article 17) and dependent personal services (Article 18). The Convention also provides special rules for individuals who are artistes and athletes (Article 19), corporate directors (Article 20), students and trainees (Article 21) and Government employees (Article 22). Pensions in respect of personal service income are dealt with in Articles 22 (Governmental Functions) and 23 (Private Pensions and Annuities).

Paragraph (1) provides that an individual who is a resident of a Contracting State, and who derives income from the performance of personal services in an independent capacity, will be exempt from tax by the other Contracting State in respect of that income. However, as provided in paragraph (2), the individual may be taxed in the other Contracting State if the services are performed in that other State, and if either he is present in that other State for a period or periods aggregating 183 days or more in the taxable year, or if he has a fixed base regularly available to him in that other State for the purpose of performing his services. In the latter case, only the income attributable to that fixed base may be taxed by that other Contracting State. If the individual is a citizen of the other Contracting State, that other State may tax his income without regard to this Article under the saving clause of paragraph (3) of Article 4 (General Rules of Taxation).

The term "fixed base" is understood to be analogous to the term "permanent establishment", as defined in Article 9 (Permanent Establishment). Independent personal services include all personal services performed by an individual for his own account, where he receives the income and bears the losses arising from such services.

## ARTICLE 18 Dependent Personal Services

This Article deals with the taxation of remuneration derived by a resident of a Contracting State as an employee.

Under paragraph (1), a remuneration derived by an individual who is a resident of a Contracting State as an employee, including remuneration for services performed by an officer of a corporation, may be taxed by that Contracting State. Such remuneration derived from sources within the other Contracting State may also be taxed by the other Contracting State, with certain exceptions specified in paragraph (2). The source of such income is the Contracting State in which the services are performed (see paragraph (6) of Article 6 (Source of Income)).

Under paragraph (2), even where the remuneration described in paragraph (1) is derived from sources within the other Contracting State, that Contracting State may not tax the remuneration of an individual who is a resident of the other Contracting State if

(1) the individual is present in the first-mentioned Contracting State for a period or periods aggregating less than 183 days in the taxable year,

(2) the remuneration is paid by, or on behalf of, an employer who is not a resident of that first-mentioned Contracting State, and

(3) the remuneration is not borne as a deductible expense by a permanent establishment, a fixed base or a trade or business which the employer has in that first-mentioned Contracting State.

If any of these conditions is not met, the remuneration may be taxed by the first-mentioned Contracting State.

Paragraph (3) provides a special rule applicable to remuneration for services performed by an individual as an employee aboard ships or aircraft. Such remuneration for services performed aboard ships or aircraft operated by a resident of a Contracting State in international traffic is exempt from tax by the other Contracting State if the individual performing the services is a member of the regular complement of the ship or aircraft.

If an individual deriving income dealt with in this Article is a citizen of a Contracting State, that Contracting State may tax his employment income without regard to this Article under the saving clause in paragraph (3) of Article 4 (General Rules of Taxation).

## ARTICLE 19 Artistes And Athletes

Paragraph (1) overrides the provisions of Article 17 (Independent Personal Services) and Article 18 (Dependent Personal Services) for the taxation of the income of entertainers and athletes to permit the source State to tax such income under certain circumstances where those other Articles would not permit taxation. Income derived by a resident of a Contracting State from his personal activities as an entertainer or athlete exercised in the other Contracting State may be taxed in the other Contracting State if the amount of the gross receipts derived by the individual, not including expenses reimbursed to him or borne on his behalf, is \$500 or more per day of performance (including rehearsal time) or \$5,000 or more for the taxable year concerned (or equivalent amounts in Cypriot pounds). If the gross receipts exceed \$500 per day or \$5,000 per year, the full amount, and not just the excess, may be taxed in the Contracting State in which the services are performed. If the individual receives a fixed total amount for performing his services on more than one day, the amount received will be prorated over the number of days the individual performs his services for purposes of applying the \$500 per day test.

Income derived by producers, directors, technicians and others who are not performers or athletes is taxable in accordance with Article 17 or 18, as appropriate.

Paragraph (2) deals with the case where income for services performed by an artiste or athlete does not accrue to the performer, but to an other person. Under those circumstances, the income may be taxed in the Contracting State where the services are performed, without regard to the provisions of the Convention concerning business profits or income from independent or dependent personal services, unless it is established that neither the artiste or athlete, nor any related person, participates in that income in any manner whatsoever.

Foreign entertainers commonly perform services in the United States as employees of, or under contract with, a company or other person. That other person may act as the nominal recipient of the income in respect of the entertainer's services and the entertainer may act as its employee or contractor. In such a case, for example, in the absence of such a provision, a company providing the services of an entertainer may escape United States taxation in respect of the income for the entertainer's services under the provisions of Article 8 (Business Profits), because the company has no permanent establishment in the United States. The entertainer may also escape taxation in the United States by receiving only a small salary in the year the services are performed, and then either receiving payment in a later year when the income is subject to little or no United States tax, or liquidating the company after the services are performed. Under paragraph (2), such other person cannot claim the permanent establishment protection otherwise provided by Article 8.

For purposes of paragraph (2), income is considered to accrue to another person if that person has control over, or the right to receive, gross income derived in respect of the services of an artiste or athlete. This rule applies regardless of whether the other person is a "sham" or a conduit. Income will not, however, be deemed to accrue to the benefit of another person where it is established to the satisfaction of the competent authority of the Contracting State in which the services are performed that neither the artiste or athlete, nor related persons, participate directly or indirectly in profits of such other person in any manner, including the receipt of deferred compensation, bonuses, fees, dividends, partnership distributions or other distributions. Depending on the facts in a particular case, a person may be considered to be related to an artiste or athlete if he is an employee or agent of the artiste or athlete or if he is regularly employed by the artiste or athlete in an advisory capacity, such as his attorney, accountant or investment advisor. Paragraph (2) does not affect the rule of paragraph (1), applicable to the artiste or athlete himself.

This Article is subject to the provisions of the saving clause of paragraph (3) of Article 4 (General Rules of Taxation). Thus, if an artiste or athlete is a citizen of a Contracting State, that Contracting State may tax his income regardless of the provisions of this Article.

## ARTICLE 20 Directors' Fees

This Article provides a special rule for the taxation of directors' fees. If a resident of a Contracting State derives income in his capacity as a member of the board of directors of a

corporation of the other Contracting State which is in excess of a reasonable fixed amount payable to all directors of the corporation per day of attendance at directors' meetings in that other Contracting State, the other Contracting State may tax the excess without regard to the provisions of Articles 17 (Independent Personal Services) and 18 (Dependent Personal Services). This rule does not apply to any income which a director of a corporation may derive in his capacity as an officer or employee of the corporation. Fees paid to a director which are not in excess of a reasonable fixed amount remain subject to the provisions of Articles 17 and 18.

This Article is subject to the provisions of the saving clause in paragraph (3) of Article 4 (General Rules of Taxation), so that a director of a corporation who is a citizen of a Contracting State may be taxed on his income by that Contracting State without regard to the provisions of this Article.

## ARTICLE 21 Students And Trainees

Paragraph (1) deals with an individual who is a resident of a Contracting State and becomes temporarily present in the other Contracting State primarily for the purpose of studying at a university or other recognized educational institution in that other Contracting State, securing training necessary to qualify for the practice of a profession or professional specialty, or studying or doing research as a recipient of a grant, allowance or award from a governmental, religious, charitable, scientific, literary or educational organization. Such an individual will be exempt from tax in the other Contracting State, with respect to the amounts described below, for a period not exceeding 5 taxable years from the date of his arrival in that other Contracting State, and for such additional period, beyond the 5 years, as is necessary to complete, as a full-time student, the requirements for a postgraduate or professional degree from a recognized educational institution. The exemption applies to any gifts which the individual receives from abroad for the purpose of his maintenance, education or training; to the grant, allowance or award referred to above; and to any income which he may receive from personal services performed in that other Contracting State in an amount not in excess of \$2,000 or its equivalent in Cypriot pounds for any taxable year.

Paragraph (2) deals with an individual who is a resident of a Contracting State and becomes temporarily present in the other Contracting State as an employee, or under contract with, a resident of the first-mentioned Contracting State primarily for the purpose either of acquiring technical, professional or business experience from a person who is not a resident of the first-mentioned Contracting State or who is not related to the resident of such first-mentioned State which has sent the individual for training, or of studying at a university or other recognized educational institution in that other Contracting State. Such an individual will be exempt from tax in that other Contracting State for a period not exceeding one year with respect to any income which he receives from the performance of personal services, in an aggregate amount not exceeding \$7,500 or its equivalent in Cypriot pounds.

Paragraph (3) deals with an individual who is a resident of a Contracting State and who

becomes temporarily present in the other Contracting State for a period not exceeding one year, as a participant in a program sponsored by the government of that other Contracting State, for the primary purpose of training, research or study. Such an individual will be exempt from tax in that other Contracting State with respect to his income from personal services performed in that other Contracting State in respect of such training, research or study, in an amount not in excess of \$10,000 or its equivalent in Cypriot pounds.

The monetary limits to the earned income exemptions provided in this Article are in addition to, and not in lieu of, any exemptions, allowances or deductions provided by the Code. Thus, an unmarried resident of Cyprus who is studying in the United States and does not acquire United States residence status, and who qualifies for the \$2,000 earned income exemption, would be allowed one personal exemption in addition to the \$2,000 exemption. If an individual earns more than the monetary limit provided for in the applicable provision of this Article, or remains temporarily in the Contracting State which he is visiting as a student or trainee (under paragraphs 1 and 2) for a longer period than that specified in the applicable provision, he would not, by reason of having exceeded those limits, lose the benefit of the exemption provided by this Article.

The benefits provided by a Contracting State under this Article are not subject to the saving clause of paragraph (3) of Article 4 (General Rules of Taxation), if the individual claiming the benefits is neither a citizen of that Contracting State nor has acquired immigrant status there (i.e., in the United States, is a holder of a green card). If, however, the individual is a citizen of that Contracting State, or if he does have immigrant status there, the saving clause does apply, and that Contracting State may apply its tax without regard to this Article.

## ARTICLE 22

### Governmental Functions

This Article provides that wages, salaries and similar remuneration, including pensions, annuities and similar benefits, paid to a citizen of a Contracting State out of: the public funds of that Contracting State will be exempt from tax by the other Contracting State if the payment is for services rendered by the citizen as an employee of the first-mentioned Contracting State in the discharge of governmental functions.

Payments to employees of a Contracting State who are not citizens of that Contracting State, and payments for services which are not in the discharge of governmental functions are, as appropriate, dealt with in the other Articles of the Convention dealing with the taxation of income from personal services. For example, a resident of the United States who is not a United States citizen and who is employed in the United States Embassy in Nicosia, will be subject to the provisions of Article 18 (Dependent Personal Services) in the determination of his tax liability, if any, to Cyprus. The taxation of his pension by Cyprus in respect of his United States Government service will be determined under the provisions of Article 23 (Private Pensions and Annuities).

The provisions of this Article are not subject to the saving clause of paragraph (3) of Article 4 (General Rules of Taxation) in respect of an individual who is neither a citizen nor a resident with immigrant status in the Contracting State in which the services are performed. In other cases the saving clause does apply. Thus, if a citizen of Cyprus is employed in the Cypriot Embassy in Washington, and that individual is also a citizen of the United States or has immigrant status in the United States (i.e., he holds a green card), the United States may tax the salary of that individual without regard to this Article. If, however, he is neither a citizen of the United States, nor has immigrant status there, the provisions of this Article will be applicable.

### ARTICLE 23 Private Pensions And Annuities

Paragraph (1) provides that pensions and other similar remuneration (other than such payments dealt with in Article 22 (Governmental Functions)) paid to an individual who is a resident of a Contracting State in consideration of past employment are taxable only in that Contracting State. The term "pensions and annuities" is defined to mean periodic payments made by reason of retirement or death in consideration for services rendered, or by way of compensation for injuries received in connection with past employment.

Under paragraph (2), alimony and annuities paid to an individual who is a resident of a Contracting State are taxable only in that Contracting State. The term "annuities" is defined to mean 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 for services rendered. The term "alimony" is defined to mean periodic payments made pursuant to a decree of divorce, separate maintenance agreement, or support or separation agreement which are taxable to the recipient in his Contracting State of residence, under its internal laws.

This Article is subject to the saving clause of paragraph (3) of Article 4 (General Rules of Taxation). A Contracting State, therefore, may tax a citizen of that Contracting State who is a resident of the other Contracting State on income dealt with in this Article, without regard to its provisions.

### ARTICLE 24 Social Security Payments

Social security payments and other public pensions paid by a Contracting State to a resident of the other Contracting State or to a citizen of the United States are taxable only in the Contracting State making the payment. This Article does not apply to pension payments for government service covered in Article 22 (Governmental Functions). The term "other public pensions" is understood to include United States railroad retirement pensions.

The provisions of this Article are not overridden by the saving clause (see exceptions to

the saving clause in paragraph (4) of Article 4 (General Rules of Taxation)). A citizen or resident of the Contracting State, therefore, who receives a social security payment from the other Contracting State is exempt from tax on that payment in his State of residence or citizenship.

ARTICLE 25  
Diplomatic And Consular Officers

This Article provides that nothing in the Convention will affect the fiscal privileges of diplomatic and consular officials under either the general rules of international law or under the provisions of special agreements.

ARTICLE 26  
Limitation on Benefits

This Article, taken together with paragraph (6) of Article 4 (General Rules of Taxation), is designed to prevent abuse of the Convention by limiting the benefits of the Convention to those residents of a Contracting State who are properly entitled to those benefits. The intent of these two sets of provisions is, first, to prevent residents of third countries from establishing entities in a Contracting State for the purpose of deriving treaty benefited income from the other Contracting State. This is an issue of particular importance to the United States in a treaty with a country like Cyprus which has established in its domestic law a system of special measures providing substantially reduced tax rates in Cyprus on income derived from certain offshore activities and investments. With little difficulty, a nonresident of Cyprus can establish an entity in Cyprus to derive such income.

It is also the intent of these provisions to deny the granting of treaty benefits by one Contracting State to a resident of the other Contracting State, even if the beneficial owner of the income is a resident of that other Contracting State, where the income is subject to tax in that other Contracting State at a rate which is substantially less than the rate generally applicable to income in that other Contracting State. Since one of the principal purposes of a tax treaty is to avoid double taxation, the justification for reductions in tax by treaty in the State of the source of income ceases to exist when that income is exempt or subject to substantially reduced taxes in the State of residence of the income recipient. This limitation on benefits under the Convention (paragraph (6) of Article 4) will apply with respect to several provisions of Cyprus law. For example, section 28(A) of Cypriot law provides that certain offshore companies in Cyprus which are owned by aliens are taxed at a rate of 4.25 percent instead of the normal rate of 42.5 percent. Similarly, under section 8(w) of Cyprus law, a 90 percent exemption is provided for offshore dividends or profits of a Cypriot resident. There are other provisions of Cyprus law to which this provision would be similarly applicable. This provision of the Convention has applicability in the United States as well as in Cyprus. Residents of the United States, for example, who benefit from the exclusion of foreign earned income under Code section 911, would not be entitled to treaty benefits from Cyprus with respect to that excluded income.

Paragraph (1) of Article 26 denies any relief from taxation by a Contracting State under the treaty to a resident of the other Contracting State, other than an individual (individuals are covered by paragraph (6) of Article 4), unless two conditions are satisfied, or unless the provisions of paragraph (2) apply. The first condition is that more than 75 percent of the beneficial interest in the resident of that other Contracting State (or if that resident is a corporation, more than 75 percent of the number of shares of each class of its shares) is owned, directly or indirectly, by one or more individual residents of that State. The second condition, which must also be satisfied if treaty benefits are to be granted, is that the gross income of that resident not be used in substantial part, directly or indirectly, to meet liabilities to persons who are not residents of a Contracting State and who are not United States citizens. The term "liabilities", as used in the second condition, means deductible expenses, and includes liabilities for interest (including accrued interest on original issue discount obligations if deductible under Cypriot law) and royalties. The term "gross income" has the same meaning for purposes of this Article as its meaning under the Code, thus, for example, cost of goods sold would be deducted from the gross receipts of a manufacturing enterprise before applying the second test.

The ownership test in the first condition will be presumed to be met by a corporation that has substantial trading in its stock on a recognized stock exchange in a Contracting State. A stock exchange will be a "recognized exchange" only if so designated by agreement of the competent authorities. Since Cyprus does not presently have a stock exchange, no exchanges are specified in the Convention. It is contemplated, however, that the competent authorities will agree that the major United States stock exchanges and the NASDAQ system in the United States will qualify. If and when a stock exchange is established in Cyprus, the competent authorities will, at that time, consider whether the listing and trading frequency requirements of the exchange are sufficient for it to be a recognized exchange.

Under paragraph (2), paragraph (1) will not apply, and benefits will not be denied, even if the conditions of paragraph (1) are not met, if it is determined that 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. This test recognizes that there are bona fide business reasons for an entity in a Contracting State to be owned by residents of a third State. In many circumstances, the granting of treaty benefits to such a person is not inconsistent with the objectives of the treaty. This test would be met, for example, if a Cyprus company owned by residents of third countries conducts business operations in Cyprus and holds investments in the United States, or engages in business activities in the United States, which are related or incidental to those business activities. For example, if the Cyprus company lends money to a supplier in the United States in order to assure a source of supply, and thereby derives interest income from the United States, that income could be considered incidental to its business activities. The test of paragraph (2) would also be met if the aggregate Cypriot tax burden is equal to or greater than the tax reductions claimed under the Convention. The test could also be satisfied in other ways. It should be noted that a resident of Cyprus who, under paragraph 6 of Article 4, fails to qualify for treaty benefits cannot have the benefits restored by virtue of paragraph 2 of this Article.

Paragraph (3) provides a special rule concerning certain trust situations. The benefits of

the Convention do not apply to income derived by a trustee which, under the Convention, is treated as income of a resident of a Contracting State, if a principal purpose of the use of the trust was to obtain a benefit under the Convention. For example, if a United States resident establishes one or more Cypriot accumulation trusts with United States beneficiaries to receive dividends from United States corporations in order to reduce the United States tax on those dividends, the reductions in United States tax provided under paragraph (2) of Article 12 (Dividends) will not apply.

This Article is not intended to impose any added burden on United States withholding agents, and withholding agents will not be required to verify a person's ownership or purposes.

In applying this Article, the normal burden of proof rules apply. For example, under present United States procedures, an entity that is a resident of Cyprus and that believes it is entitled, under one of the alternative tests of this Article, to the 10 percent United States tax rate on interest provided by paragraph (2) of Article 13 (Interest) would merely file an Internal Revenue Service Form 1001 with the appropriate withholding agent to claim the benefit. The Internal Revenue Service retains the right, on audit, to examine the return. The United States, of course, is not bound in the future to continue to apply current procedures, and any change in United States withholding procedures could be applicable under this Convention as well.

## ARTICLE 27

### Mutual Agreement Procedure

This Article provides for cooperation between the competent authorities to resolve disputes which may arise under the Convention. Paragraph (1) provides that a resident of a Contracting State may, if he considers that the actions of one or both of the Contracting States may result for him in taxation which is not in accordance with the Convention, present his case to the competent authority of the Contracting State of which he is a resident. He need not have exhausted the remedies in the national laws of the Contracting States before bringing his case to the competent authority.

If the competent authority to which the case is brought judges the case to have merit, it shall endeavor to come to an agreement with the competent authority of the other Contracting State in order to avoid taxation contrary to the provisions of the Convention.

Paragraph (2) authorizes the competent authorities to seek to resolve difficulties or doubts that may arise as to the application of the Convention. The paragraph includes examples of the kinds of matters about which the competent authorities may reach agreement. They may agree to the same attribution of income, deductions, credits or allowances of a resident of a Contracting State to its permanent establishment in the other Contracting State, or to the same allocation of these items between two or more persons. They may also agree to the same determination of the source of an item of income, to uniform accounting for income and deductions, to the same characterization of an item of income and to a common meaning of a term. Such agreements need not conform to the internal law provisions of the Contracting States. The competent authorities

may discuss the application of the provisions of domestic law regarding penalties, fines and interest in a manner consistent with the purposes of the Convention. They may also consult together for the purpose of eliminating double taxation, with respect to the taxes covered by the Convention under Article 1 (Taxes Covered), by extending the principles of the Convention to cases not specifically provided for in the Convention. This list is not intended to be exhaustive Of the matters about which the competent authorities may reach agreement.

Paragraph (3) provides that the competent authorities may communicate directly with each other (including face to face meetings) for the purpose of reaching agreement under this Article. Under paragraph (4), if the competent authorities are able to reach agreement, taxes will be imposed, and refunds or credits allowed, by the Contracting States as necessary to give effect to the agreement. Such agreement will be implemented notwithstanding any time limits in the domestic law of the Contracting States. Thus, for example, if the agreement requires a refund of tax in a Contracting State, that refund will be made even if the statute of limitations in that Contracting State may have expired The statute of limitations, however, will not be overridden to impose additional tax, because of the provisions of paragraph (2) of Article 4 (General Rules of Taxation), under which a taxpayer's tax liability cannot be increased as a result of the application of any provision of the Convention.

Paragraph (5) gives to the competent authorities the authority, by mutual agreement, to increase any dollar amounts specified in the Convention. Thus, for example, if, after the Convention has been in force for some time, economic conditions have changed so as to make the dollar threshold for exempt earned income by students under paragraph (2)(b)(i) of Article 21 (Students and Trainees), or the income threshold for entertainers under paragraph (1) of Article 19 (Artistes and Athletes), unrealistically low, the competent authorities may agree to a higher threshold. Such changes can result only in a reduction of tax liabilities under the Convention, not in an increase.

The competent authorities of the Contracting States, under paragraph (6), are each authorized to prescribe any rules and regulations which may be necessary for carrying out the purposes of the Convention.

## ARTICLE 28 Exchange of Information

This Article provides for exchanges of information between the competent authorities of the Contracting States, and should be read along with the notes exchanged by the Contracting States at the time of the signing of the Convention, in order to understand fully the scope of the information exchanges contemplated by this Article.

Paragraph (1) provides that the competent authorities may exchange such information as is pertinent to carrying out both the provisions of the Convention, and of the domestic laws of the Contracting States concerning the taxes covered by the Convention (see Article 1 (Taxes Covered)). Thus, for example, information may be exchanged with respect to a covered tax, even

if the transaction to which the information relates is a purely domestic transaction in the requesting State, or is an international transaction not involving the Contracting State to which the request is made, and, therefore, is not for the purpose of carrying out the provisions of the Convention.

This paragraph grants to each competent authority the power to secure whatever information is necessary for it to obtain in order to be able to comply with a request for information under this Article. As is explained in the exchange of notes, the United States already possesses the authority to secure any information to which this Article relates. The Government of Cyprus, on the other hand, may appear not to have full authority in this regard solely in its internal law. However, this provision of the Convention empowers the competent authority of Cyprus to implement the broad scope of the information exchange, including the following types of information which may otherwise not be available to it: bank information in the custody of a taxpayer; information in the custody of a bank; information in possession of the Central Bank of Cyprus relating to beneficial stock ownership; information in the possession of the registered legal owner of a corporation relating to beneficial stock ownership; and information in the possession of a trustee relating to beneficial ownership. It is further understood that civil and criminal sanctions may be imposed in Cyprus in the event that a person from whom such information has been requested does not disclose it.

Paragraph (1) also provides assurances that any information exchanged will be treated as secret and will be disclosed only to persons concerned with the assessment, collection, enforcement or prosecution in respect of the taxes to which the information relates, or to persons concerned with the administration of these taxes. Under this latter provision, information can be disclosed, for example, to legislative bodies involved in the administration of taxes, and their agents, such as the United States General Accounting Office. Such bodies are, of course; subject to the same restrictions as to the use of any information received, both under the Convention and under internal law, as are the competent authorities.

Paragraph (2) provides that when information is requested by a Contracting State in accordance with this Article, the other Contracting State is obligated to obtain the requested information as if the tax in question were the tax of that other Contracting State, even if that State has no direct tax interest in the case to which the information relates. The paragraph further provides that the requesting State may specify the form in which information is to be provided (e.g., depositions of witnesses and authenticated copies of original documents), in order that it be usable in the judicial practice of that State. The other Contracting State will provide the information in the requested form to the same extent that it can obtain information in that form under its own laws and administrative practices with respect to its own taxes.

Paragraph (3) explains that the obligations undertaken in paragraphs (1) and (2) to provide information do not require a Contracting State to carry out administrative measures at variance with the laws or administrative practice of either Contracting State, to supply information not obtainable under the laws or normal administrative practice of either Contracting State, or to supply information which would disclose trade secrets or other information, the disclosure of which would be contrary to public policy: A Contracting State may, however, at its

discretion, provide information which it is not obligated to provide under the provisions of this paragraph. The exchange of notes makes clear that Cyprus is prepared to undertake measures and provide information which may not be, but for the provisions of this Convention, otherwise empowered to undertake or provide.

As explained in paragraph (4), the Convention contemplates that information will be exchanged either on a routine basis, or on request in relation to a specific case. The competent authorities may agree on the types of information to be exchanged on a routine basis. Information may, of course, be exchanged in other circumstances, or under other procedures.

Under paragraphs (5) and (6), the competent authorities are obligated to notify each other of amendments to the covered taxes, or the adoption of new taxes which, by virtue of paragraph (2) of Article 1 (Taxes Covered), become covered taxes; and to transmit texts of the amendments or new statutes. They are also obligated to notify each other of the official publication of any materials concerning the application of the Convention.

#### ARTICLE 29 Assistance in Collection

Paragraph (1) provides that one Contracting State will give limited assistance to the other Contracting State in collecting its taxes. Each Contracting State is required to collect on behalf of the other Contracting State only those taxes imposed by the other Contracting State as will assure that any exemption or reduced rate of tax granted under the Convention is not enjoyed by persons not entitled to such benefits.

Paragraph (2) makes clear that a Contracting State is not obligated to carry out measures at variance with the laws, administrative practice or public policy of either Contracting State with respect to the collection of its own taxes.

#### ARTICLE 30 Entry into Force

This Article provides for the ratification of the convention and for the exchange of instruments of ratification. The Convention will enter into force upon the exchange of instruments of ratification. The provisions of the Convention will first have effect with respect to the income of calendar years or taxable years, and in the case of taxes payable at the source, with respect to payments made, on or after January 1 of the year next following the year in which the Convention enters into force.

#### ARTICLE 31 Termination

This Article provides that the Convention will remain in force indefinitely, but may be terminated by either Contracting State. The Convention may be terminated at any time after five years from its entry into force, provided that at least six months prior notice has been given through diplomatic channels. In the event that such notice is given, the Convention will cease to have force and effect in respect of income of calendar years or taxable years beginning, in the case of taxes payable at the source, payments made, on or after January 1 of the year next following the expiration of the six months' period.