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subject: Qualified Dividend Income from Cypriot Holding Company -- I.R.C. section 1(h)(11)

This memorandum responds to your request for nontaxpayer-specific Chief Counsel Advice. This advice may not be used or cited as precedent.

ISSUE

Whether a Cypriot holding company with no Cypriot ownership can qualify for benefits of the U.S.-Cyprus income tax treaty (the "Treaty")¹ for purposes of I.R.C. section 1(h)(11),² which provides U.S. shareholders with a reduced rate of tax on dividends received from "qualified foreign corporations."

CONCLUSION

A Cypriot holding company with no Cypriot ownership can qualify for benefits of the Treaty for purposes of section 1(h)(11) if the establishment, acquisition, and

¹ 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 MAR. 19, 1984, *reprinted in 2 Tax Treaties (CCH)* ¶ 2303.

² Section references are to the Internal Revenue Code of 1986, as amended.

maintenance of the company and the conduct of its operations did not have as a principal purpose obtaining benefits under the Treaty. In this case, the company was established in Cyprus, and is being maintained, for reasons unrelated to the Treaty. The company qualifies for benefits under Article 26(2) of the Treaty because there was no principal purpose of obtaining treaty benefits. Thus, the company is a “qualified foreign corporation” for purposes of section 1(h)(11), and dividends received by the company’s U.S. shareholder will qualify for a reduced rate of tax.

FACTS

HoldCo is a corporation organized under the laws of Cyprus. Taxpayer, a U.S. resident, owns a portion of the outstanding shares of Holdco. The remaining shares are owned by persons who are not residents of the United States or Cyprus. HoldCo, which owns an operating company in a third country, was established in Cyprus for reasons unrelated to the Treaty. HoldCo has never earned U.S.-source income or claimed any benefit under the Treaty. On his Form 1040, Taxpayer treated dividends he received from Holdco as “qualified dividend income.”

LAW AND ANALYSIS

Under section 1(h)(11), dividends received from a ‘qualified foreign corporation’ are treated as ‘qualified dividend income’ eligible for a reduced rate of tax. Section 1(h)(1) sets forth the preferential tax rates applicable to “net capital gain.” According to section 1(h)(11)(A), net capital gain includes “qualified dividend income.”

Section 1(h)(11)(B)(i) defines qualified dividend income as “dividends received during the taxable year from (I) domestic corporations, and (II) qualified foreign corporations.” A qualified foreign corporation is “any foreign corporation if (I) such corporation is incorporated in a possession of the United States, or (II) such corporation is eligible for benefits of a comprehensive income tax treaty with the United States which the Secretary determines is satisfactory for purposes of this paragraph and which includes an exchange of information program.” Section 1(h)(11)(C)(i).

Notice 2011-64, 2011-37 I.R.B. 231 (Sept. 12, 2011), contains a list of U.S. income tax treaties that meet the requirements of section 1(h)(11)(C)(i)(II). Section 3 of Notice 2011-64 provides:

In order to be treated as a qualified foreign corporation under the treaty test, a foreign corporation must be eligible for benefits of one of the U.S. income tax treaties listed in the Appendix. Accordingly, the foreign corporation must be a resident within the meaning of such term under the relevant treaty and must satisfy any other requirements of that treaty, including the requirements under any applicable limitation on benefits provision. For purposes of determining whether it satisfies these requirements, a foreign corporation is treated as though it were claiming

treaty benefits, even if it does not derive income from sources within the United States. See H.R. Conf. Rep. No. 108-126, at 42 (2003) (stating that a company will be treated as eligible for treaty benefits if it “would qualify” for benefits under the treaty).

The Appendix to Notice 2011-64 includes Cyprus in the list of countries with which the United States has income tax treaties that meet the applicable requirements.

Paragraph 1(a)(i) of Article 3 (Fiscal Residence) of the Treaty provides that the term “resident of Cyprus” includes a Cypriot corporation. Paragraphs 1 and 2 of Article 26 (Limitation on Benefits) of the Treaty provide as follows:

(1) A person (other than an individual) which is a resident of a Contracting State shall not be entitled under this Convention to relief from taxation in the other Contracting State unless

(a) more than 75 percent of the beneficial interest in such person (or in the case of a corporation, more than 75 percent of the number of shares of each class of the corporation’s shares) is owned, directly or indirectly, by one or more individual residents of the first-mentioned Contracting State; and

(b) the gross income of such person is not used in substantial part, directly or indirectly, to meet liabilities (including liabilities for interest or royalties) to persons who are residents of a State other than a Contracting State and who are not citizens of the United States.

For the purposes of subparagraph (a), a corporation that has substantial trading in its stock on a recognized exchange in a Contracting State is presumed to be owned by individual residents of that Contracting State. A stock exchange shall be treated as a “recognized exchange” by agreement of the competent authorities of the Contracting States.

(2) Paragraph 1 shall not apply if it is determined that the establishment, acquisition and maintenance of such person and the conduct of its operations did not have as a principal purpose obtaining benefits under the Convention.

The Treasury Department Technical Explanation (the “TE”) of paragraph 2 of Article 26 provides:

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.

Taxpayer will be eligible for the reduced rate of tax on dividends he received from HoldCo if the company is a “qualified foreign corporation” under section 1(h)(11)(C)(i)(II). To be a qualified foreign corporation, HoldCo must be eligible for benefits of the Treaty. As provided by Notice 2011-64, HoldCo is treated as though it were claiming treaty benefits. HoldCo is a resident of Cyprus under Article 3(1)(a)(i) of the Treaty because it is a corporation organized under the laws of Cyprus. HoldCo cannot qualify for benefits of the Treaty under paragraph 1 of Article 26 because it is not owned by individual residents of Cyprus. The issue, then, is whether HoldCo can qualify for benefits under paragraph 2 of Article 26, which turns on whether there was a ‘principal purpose’ of obtaining benefits under the Treaty.

The TE provides examples of how a Cypriot entity might satisfy the test in paragraph 2 of Article 26. One of the examples describes a Cypriot company that conducts business operations in Cyprus. The company qualifies under paragraph 2 because it did not have a principal purpose of obtaining benefits under the Treaty. In addition to the specific examples described, the TE indicates that the test of paragraph 2 also could be satisfied in other ways.

In this case, HoldCo was established in Cyprus, and is being maintained, for reasons unrelated to the Treaty. HoldCo qualifies under paragraph 2 of Article 26 because there was no ‘principal purpose’ of obtaining benefits under the Treaty. Thus, HoldCo is a “qualified foreign corporation” for purposes of section 1(h)(11), and dividend income that Taxpayer received from HoldCo qualifies for the applicable net capital gain tax rate set forth in section 1(h)(1).